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Institutional Prerequisites of Economic Partnership Agreements

The EU-ECOWAS Case

At the end of 2007 the WTO waiver granted for the non-reciprocal EU/ACP trade preferences will phase out. New economic partnership agreements are currently under negotiation, but whether the ACP countries will be able to benefit from them depends to a large extent on the institutional setting in those countries. The following article takes the example of the Economic Community of West African States to examine the situation more closely.

Negotiations between African, Caribbean and Pacific countries (ACP) and the European Union (EU) are in progress with the aim of concluding new Economic Partnership Agreements (EPAs) to replace the previous trade and cooperation arrangement of the Cotonou Agreement. Time is running out, however, and the initial schedule for finalising a new treaty by the end of 2007 at the latest is probably already at risk. EPAs are still the subject of fierce international discussion. While certain non-governmental organisations (NGOs) insist on seriously and urgently assessing alternative(s) (to) Economic Partnership Agreements,[1] ACP countries and the EU are still continuing their negotiations after having postponed the agreed review of alternative options for ACP countries not willing to enter into and sign an EPA with the EU from 2004 to the end of 2006.

Numerous studies assessing the EPA impacts on trade, growth and budgets have contributed to the ongoing discussions and negotiations, but could not capture all the relevant effects or failed to estimate their size with sufficient accuracy and probability. This is due in part to the weak statistical basis of the (mostly least developed) ACP countries; this often prohibits more advanced modelling. Moreover, previous analyses are based on standard assumptions which may not be fulfilled in reality. This leaves discussants, negotiators and decision-makers in an extremely uncomfortable situation of considerable uncertainty.

Institutions, Trade and Growth

In order to reduce this ambiguity and to assess the probability of anticipated or desired EPA effects, we reconsider one of the most crucial assumptions made in previous analytical work on EPA impacts, i.e. the functioning of the adjustment mechanism due to trade liberalisation in less developed environments.

It is commonly assumed in EPA-related impact studies that production factors such as labour and capital can move at no cost between industries within a country. Obviously, this is a naive view of the interaction of the participants in an economy. The reallocation of factors, i.e. a shift of capital and labour from the (declining) import-competing sector to the (expanding) export sector due to trade liberalisation, is associated with adjustment costs. For this shift of resources, the regulatory quality, as one important area of institutional quality, matters for the interaction of trade and economic growth in particular. For welfare gains from trade to materialise, the necessary institutions[2] must be in place to assure effective competition and a smooth structural adjustment process.

This hypothesis has been tested in an extensive empirical analysis of the linkages between trade, institutions and growth with special focus on the Economic Community of West African States (ECOWAS) as one of the six EPA groupings.[3] The results support our hypothesis. First of all, countries with excessive regulations cannot take advantage of trade. For example, in these countries trade-induced adjustment costs may exceed the welfare gains from increased trade

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[1] Sanoussi Bilal and Francesco Rampa: Alternative (to) EPAs. Possible scenarios for the future ACP trade relations with the EU, ECPDM Policy Management Report 11, Maastricht 2006.

[2] For a definition and basic reading cf. Douglass C. North: Institutions, Institutional Change and Economic Performance, Cambridge, MA 1990, Cambridge University Press.

[3] Matthias Busse, Axel Borrmann, Silke Neuhaus: Trade, Institutions and Growth: An Empirical Analysis of the Proposed ACP/EU Economic Partnership Agreements for ECOWAS Countries, Preliminary Study on behalf of the Friedrich-Ebert-Foundation, Hamburg 2006; available on request via busse@hwwa.de.

through specialisation and the exchange of goods and services. Excessive regulations are either part of the institutional setting or they can be the outcome of a particular setting.

Second, among a set of 17 different indicators for institutional and regulatory quality,[4] there are three indicators that matter most for the successful dismantling of trade barriers. Above all, the most significant results can be obtained for market entry regulations (starting a business), labour market regulations, and paying taxes. Starting a business describes the costs and time required to set up a new company, whereas labour market regulations measure the flexibility of hiring and firing and employment conditions. Paying taxes measures the amount of taxes a company has to pay and the quality of the tax authorities.

In particular the first two regulation indicators are very important for the reallocation of factor resources within a country, which is a prerequisite for harnessing the gains from trade. For example, high market entry barriers lead to less entry, which impede local entrepreneurs from taking full advantage of export opportunities abroad. Excessive labour market regulations impede the efficient reallocation of labour, i.e. a shift of workers between industries and/or the allocation of workers to the most productive firms.

However, the results do not imply that the other 14 institutional and regulatory indicators, such as government effectiveness, control of corruption, democratic accountability, political stability and other forms of regulation, do not matter for economic growth rates. Rather, it simply means that the indicators emphasised are more important for the relationship between trade and income/growth. Moreover, the results obtained reinforce the general belief that countries have to reform their regulatory framework to be able to benefit from increasing regional, inter-regional and/or global integration.

Institutional Quality and Performance in ECOWAS

A benchmarking for the ECOWAS,[5] as the third major result, reveals that the large majority of the 16 West African countries are most unlikely to benefit from an increasing integration into the world economy with their *present* institutional setting. Countries from this regional EPA grouping show scores for the most important indicators that fall precisely into the category of countries that are not able to benefit from trade.

As can be seen from Table 1, the overall regulation intensity in developed countries is far lower (average regulation index of 4.65) than in developing countries (-1.30). What is striking, however, is the very low scores for sub-Saharan African countries, with an average of -3.32 for the aggregated index and consistently negative figures for all ten disaggregated indicators. What is more worrying is the fact that the scores for the average regulation indicator and the majority of disaggregated indicators are even lower for ECOWAS countries than for the other sub-Saharan African countries. Among the ten disaggregated indicators, ECOWAS countries have, on average, particularly low scores for registering property, dealing with licences, labour market regulation, getting credit, and starting a business.

A few examples demonstrate that the institutional quality is even worse if we go beyond averages and look at individual ECOWAS countries and specific business regulations:

- entrepreneurs in Sierra Leone have to pay 835 per cent of (national) income per capita to start a business;
- the cost of firing an employee in Mali is equivalent to some 81 weeks' wages;
- firms in Sierra Leone which intend to pay their taxes in full would have to part with 164 per cent of their gross profits, that is, everything they earn and more;
- to import a product into Niger, it takes 19 documents, requires 52 signatures and takes 89 days to deal with the required paperwork and customs inspections;
- the judicial procedures for the enforcement of a contract in Burkina Faso take 446 days and cost some 95 per cent of the debt, i.e. almost the entire disputed amount;
- to register a property in Nigeria, the owner has to part with 27 per cent of the property value.

Though these are admittedly extreme examples, business regulations in West Africa often fail even on their own terms: higher tax rates do not always bring in more revenue, and the most tightly regulated labour markets do not always offer the best protection to workers. Rather, extremely inflexible business regulations drive firms and workers into the informal economy, beyond the reach of inspectors, trade unions and tax authorities. Needless to say, working conditions

[4] Institutional quality was measured by: (1) a set of six perception-based indicators for good governance; cf. Daniel Kaufmann, Aart Kraay, Massimo Mastruzzi: Governance Matters IV: Governance Indicators for 1996-2004, World Bank Policy Research Working Paper 3630, 2005; (2) a set of 11 disaggregated, more objective indicators for doing business, including a combined index; World Bank: Doing Business in 2006: Creating Jobs, Washington DC 2005, World Bank and Oxford University Press.

[5] We intend to apply our approach to the other EPA groupings, too.

Table 1
Doing Business Regulation Indicators, 2005

Regulation indicator	Developed countries	Developing countries			
		All	Sub-Saharan Africa (SSA)		
			All	ECOWAS	Rest of SSA
Starting a business	0.82	-0.26	-0.76	-0.72	-0.79
Labour market regulation	0.26	-0.16	-0.40	-0.95	-0.13
Paying taxes	0.73	-0.26	-0.39	-0.64	-0.27
Protecting investors	0.72	-0.17	-0.04	-0.18	0.04
Trading across borders	1.01	-0.29	-0.84	-0.67	-0.93
Getting credit	1.15	-0.27	-0.61	-0.80	-0.52
Enforcing contracts	0.86	-0.20	-0.47	-0.34	-0.54
Closing a business	1.17	-0.27	-0.42	-0.30	-0.48
Dealing with licences	0.67	-0.24	-0.65	-1.02	-0.46
Registering property	0.55	-0.20	-0.84	-1.15	-0.68
Overall regulation index	4.65	-1.30	-3.32	-3.97	-2.98

Note: All indicators are standardised; a higher value for any of the indicators indicates a better performance, i.e. less strict regulations; figures are based on a sample of 142 countries.

in the shadow economy are often much worse than in formal sectors. What is more worrying is that firms in the informal sector are less productive.[6] They cannot take advantage of economies of scale, since they must be small to stay hidden. In addition, they are less likely to engage in trade and take advantage of export opportunities abroad, i.e. the potential gains from trade cannot be realised. However, these results do not imply that the majority of ECOWAS countries will *never* be able to benefit from increasing market integration with the rest of the world, either through the EPAs, multilateral or unilateral tariff liberalisation. Rather, the results demonstrate that they are *currently* less likely to harness the gains from trade and that a reform of the institutional framework is clearly a highly important topic on the EPA negotiating agenda. For West African countries, a major reform of institutions would not only allow them to increase the welfare-improving gains from trade through specialisation and exchange, but in addition, high-quality institutions would enable them to achieve much higher gains through their direct impact on economic and social development.

Scope of Institutional Reforms

However, institutional reforms imply an enormous policy challenge for ACP countries in general and all the more so for ECOWAS and its members. The majority of them are least-developed countries and have to start from a very low level of formal institutional development. As a consequence, they face an enormous range of basic institutional reform requirements, which adds to a long agenda of other reform needs. This dampens prospects for institutional improvements achievable in the short and medium terms. Even if the focus is on those institutions that are most relevant with respect to trade liberalisation, ECOWAS (and other ACP countries) still have to cope with a vast array of problems and related efforts, which the following examples demonstrate. To improve conditions for starting a trading business, a large number of issues have to be addressed, such as property rights (access and transfer), competition law (rules for mergers, acquisitions, pricing), taxation (level and structure, incentives), financial market regulations (collateral requirements, protection of creditors), openness (rules for trade, financial services), administrative procedures and costs involved in starting a business. Setting and improving the rules for current business is similarly demanding. Again, competition law has to be addressed as well as labour market regulations, ecological and technical standards and provisions, the law and enforcement of contracts, trade supervision, and customs clearance, to mention just a few issues. And finally, conditions for closing a business are also relevant, such as insolvency law, the right of cancellation, social safety etc.

Taking into account the often limited political and administrative capacities of poor countries, a less comprehensive strategy of institutional change comprising partial reforms which address the most severe strategic bottlenecks could be considered. Aron[7] and Rodrik,[8] for example, argue that large-scale institutional transformation is hardly ever a prerequisite for getting growth going, not even in poorer countries. The initial impetus for growth could also be achieved with minimal changes in institutional arrangements. There is a need to distinguish between stimulating economic growth and sustaining it. Solid institutions appear much more important for the latter than for the former.[9] Hay, Shleifer, and Vishny[10] point in the same direction by noting that less costly and more rapid reforms could be better than comprehensive, expensive, time-consuming reforms. The World Bank supports this view by stressing that even moderate progress in parts can contribute effectively.[11] However, much more country-specific in-depth analysis is needed to verify that

[6] World Bank, op. cit.

[7] Janine Aron: Growth and Institutions: A Review of the Evidence, in: World Bank Research Observer, Vol. 15, No. 1, 2000, pp. 99-135.

[8] Dani Rodrik: Getting Institutions Right: Institutions and Economic Performance DICE Report, in: Journal for Institutional Comparisons, Vol. 2, No. 2, 2004, pp. 10-15

[9] Dani Rodrik, op. cit.; Ricardo Hausmann, Lant Pritchett, Dani Rodrik: Growth Accelerations, NBER Working Paper 10566, 2004.

[10] Jonathan Hay, Andrei Shleifer, Robert Vishny: Privatization in Transition Economies: Towards a Theory of Legal Reform, in: European Economic Review, Vol. 40, No. 3/5, 1996, pp. 559-67.

[11] World Bank: World Development Report 2002: Building Institutions for Markets, Washington, DC and New York 2001, World Bank and Oxford University Press.

this is a promising approach for a specific region like ECOWAS and its member countries. Moreover, certain institutions, being of strategic importance, have still to be selected and given priority.

Framework for Reforms

It is not the low level of institutional development alone that is a challenge for ECOWAS and other ACP countries. The origin and nature of the existing institutions and the general conditions for reform also matter. A country's institutional setting is a result of history, political and economic power and structures, and culture.[12] It tends to be persistent over time, although not immutable. Institutions typically change incrementally rather than discontinuously. While formal rules may be changed abruptly by political and judicial decision-making, informal institutions are much more difficult to penetrate by deliberate policies. However, informal constraints like customs, traditions and codes of conduct have to be included into the reform agenda with a view to increasing economic performance and efficiency by the formalisation of a growing part of informal economic activities. At the same time, informal rules have to be respected. They form a large part of a country's social capital and compensate much for the deficiencies of formal institutions. Therefore, it is a promising strategy to enhance the success of formal institutional reforms by building bridges between existing formal and informal institutions.[13]

The prospects of overcoming the persistence of existing formal and informal institutions depend on the political economy of reforms. More efficient institutions can only be introduced and be effective if there is a positive interest on the part of those with the power to devise new institutions and those who should accept, adapt to and use the new rules.[14] Therefore, the general commitment of political leaders to good governance is essential. Their willingness to use their political influence to support reforms is decisive for an effective impetus for institutional reforms.[15] Negotiations on regional and/or inter-regional trade liberalisation such as the EPAs could provide an external impetus and may help politicians to find domestic support for their reform programmes (lock-in effect).

On the other hand, institutional reforms are unlikely to take effect if they are established only in response to external pressure and designed and implemented without involving all stakeholders whose interests would directly be affected. It would pay off if all possible stakeholders of the public and the private sectors as well as other civil society representatives get involved in the reform process. Fukuda-Parr et al.[16] were able to show in the area of trade reform that developing countries which have broadened their policy-making processes by engaging in open and inclusive consultations with the private sector have generally performed better than countries where such consultations have been absent.

It was beyond the scope of our empirical analysis to try to appraise the framework conditions for EPA-induced institutional reforms in ECOWAS countries. For that, country-specific in-depth research is required. However, some of the good governance data we used in our analysis cover a part of this framework. Voice and accountability, political stability and government effectiveness are prominent examples of conditions most relevant to design, decide, implement and enforce regulatory reforms successfully. These data suggest that many ECOWAS countries are probably not well prepared for such reforms at the moment.[17]

Time Pressure

Given the tight EPA time schedule, the situation is even more critical for ECOWAS and many other ACP countries. Substantive negotiations started only in 2004 and have to be completed by the end of 2007, when the World Trade Organisation (WTO) waiver granted for the non-reciprocal EU/ACP trade preferences will phase out. The EPAs have to enter into force at the beginning of 2008 and need to be fully implemented after a transitory period of 12 years. Concerns are justified that the time-frames for trade liberalisation and the required institutional reforms do not really match.

As for the negotiation phase of the EPAs, the challenge is to get a clear picture of the size and structure of institutional reforms, to involve all stakeholders in the process as a prerequisite for success and to implement a first package of required institutional re-

[12] IMF: World Economic Outlook, September 2005, Chapter III: Building Institutions, Washington DC 2005, IMF.

[13] World Bank: World Development Report 2002, op. cit.

[14] James Anderson: Trade and Informal Institutions, in: Kwan Choi (ed.): Handbook of International Trade, Vol. 2: Economic and Legal Analyses of Trade Policy and Institutions, Malden, MA 2005, Blackwell, pp. 279-293; WTO: World Trade Report 2004: Exploring the Linkage Between the Domestic Policy Environment and International Trade, Geneva 2004, World Trade Organisation.

[15] Stefan Szepesi: Coercion or Engagement? Economics and Institutions in ACP/EU Trade Negotiations, European Centre for Development Policy Management, ECDPM Discussion Paper 56, Maastricht 2004.

[16] Sakiko Fukuda-Parr, Carlos Lopes, Khalid Malik: Capacity for Development: New Solutions to Old Problems, New York 2002, UNDP.

[17] The quality of, and progress in, governance in individual African countries have recently been assessed in: Economic Commission for Africa: African Governance Report 2005, Addis Ababa 2005.

forms. With the implementation of the EPAs, a gradual dismantling of trade barriers would start which has to be accompanied by preparatory and simultaneous institutional reforms.

There is currently an intensive debate on the appropriate length of this transitory phase. Here, the WTO conformity of submitted proposals, limiting this phase either to 10, 12, 15 or more than 18 years,[18] plays a prominent role.[19] However, a mere legalistic discussion of the issue is misleading. The timing of the EPA process should be designed according to

- the objectives of the EPAs, i.e. development via regional, inter-regional and global integration;
- the capacity of the ACP countries to cope with the required structural adjustments;
- the resources they have available to prepare for the hard and soft infrastructure needed to make the best use of the new trading environment for growth;
- their ability to master the political and administrative problems of related institutional reforms.

There is an obviously high risk of overstraining in particularly the least developed among ECOWAS and other ACP countries by an overly tight time schedule. Therefore, much more analysis of the countries' capacity to manage all this in due time has to be conducted to design a proper time schedule for the whole EPA process.

Strategies for Reform

Since the time required for institutional change also depends on the selection of an appropriate strategy for reform, ECOWAS and other ACP countries might be tempted to use strategies of institutional reform which have been sucessfully applied elsewhere, in either developed or other developing countries, thus saving time and resources and repeating the leapfrogging practised effectively by the newly industrialising countries in the field of technology.[20] However, there are serious reservations in the literature towards simplistic institutional imitation. Institutions that are effective in industrial countries can have quite different outcomes in developing countries, which, for example, have fewer complementary institutions, weaker administrative capacity, higher per capita costs, lower human capital levels, different technology, and different levels and perceptions of corruption.[21] According to Rodrik et al.,[22] desirable institutional arrangements have a large element of context specificity due to differences in historical trajectories, geography and political economy or other initial conditions. A vivid indication that there is no blueprint for an institutional design is the fact that countries with a similar level of income can have very different institutional settings.[23] But there is wide consensus in the literature that in the same way in which imported technology needs to be adapted to the local conditions, some degree of adaptation is needed in order to make imported institutions work.[24]

Regardless of whether they are imported or innovated, new institutions should be designed to complement what exists. Both the historical European example and the more recent example of China illustrate that institutions tend to function well if they complement the existing environment in terms of other supporting institutions, human capabilities and available technologies.[25] This has again much to do with the political economy of reforms: unless newly designed institutions enjoy a certain degree of political legitimacy among the members of the society in question, they are not going to work.[26]

External Support

Since simplistic institutional imitation would not work well, external support for institutional change should also be handled with care. The current discussion about EU support for the EPA process focuses very much on the volume of aid to be delivered. ECOWAS and other ACP countries have frequently re-

[18] In a submission to the WTO, the ACP countries proposed a transitory phase of more than 18 years. Cf. WTO document WT/GC/W/155 of 28.04.2004. In its second submission on the same issue, the EU has indicated greater flexibility, although refraining from suggesting a precise length of that period. Cf. WTO document TN/RL/W/179 of 12.5.2005.

[19] A. Borrmann, H. Großmann, G. Koopmann: The WTO Compatibility of the Economic Partnership Agreement between the EU and the ACP States, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, Eschborn 2005, http://www.gtz.de/de/dokumente/en-wto-epa-acp-2005.pdf. (For a summary cf. INTERECONOMICS, Vol. 41, No. 3, May/June 2006, pp. 115-120.) Other main papers on this issue are James H. Mathis: Regional Trade Agreements in the GATT/WTO. Article XXIV and the Internal Trade Requirement, The Hague 2002, T M C Asser Press; Bonapas Onguglo, Taisuke Ito: How to Make EPAs WTO Compatible? Reforming the Rules on Regional Trade Agreements, ECDPM Discussion Paper No. 40, European Center for Development Policy Management, Maastricht 2003; South Centre: Revisiting EPAs and WTO Compatibility, South Centre Analytical Note, SC/TADP/AN/DS/2, Geneva 2005.

[20] Ha-Joon Chang: Kicking Away the Ladder – Development Strategy in Historical Perspective, London 2002, Anthem Press.

[21] World Bank: World Development Report 2002, op. cit.

[22] Dani Rodrik, Arvind Subramanian, Francesco Trebbi: Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development, in: Journal of Economic Growth, Vol. 9 (2004), No. 2, pp. 131-165.

[23] Johannes Jütting: Institutions and Development: A Critical Review, OECD Development Centre, Working Paper No. 210, 2004.

[24] Ha-Joon Chang, op. cit.

[25] Douglass C. North, op. cit.; Douglass C. North: Economic Performance Through Time, in: American Economic Review, Vol. 84, No. 3, 1994, pp. 359-368.

[26] Wade Jacoby: Imitation and Politics: Redesigning Modern Germany, Ithaca, NY, and London 2000, Cornell University Press.

minded the EU that its external support for institutional reforms is part of the EU comittments made in the Cotonou Agreement.[27] They insist that their general need for financial support to implement EPAs exceeds the current financial commitments of the EU. Therefore, they expect the EU to provide additional resources to cover EPA-induced costs.[28] However, experience with development assistance shows that its impact is not only limited by its volume but, importantly, by the way the money is allocated and used. Empirical evidence on the effectiveness of institutional aid is mixed.[29] Therefore, donors and recipients should also take care of the quality of aid and be particularly aware of the risks involved in any "blueprint aid". And finally, recipient countries should understand development assistance merely as a limited supplement to their own efforts, which are indispensable to reform their institutional set-up.

[27] See inter alia Articles 1 and 9, and specifically Article 33.

[28] The Secretariat of the African, Caribbean and Pacific Group of States: ACP-EC EPA Negotiations, Joint Report on the all-ACP – EC Phase of EPA Negotiations, Areas of Convergence and Divergence, Brussels 2 October 2003, ACP/00/118/03 Rev.1 Brussels, 2 October 2003 , ACP-EC/NG/NP/43. In December 2005, the EU member states agreed upon the 10th European Development Fund (EDF), which will be about one billion euro less than the 9th EDF and not just to cover the costs of EPAs. For the present state of discussion on the funding for EPAs cf. Jonas Frederiksen, San Bilal: Financing EPAs, in: ECDPM/ICTSD: Trade Negotiation Insights, From Doha to Cotonou, Vol. 5, No. 2, March-April 2006, pp. 4-5.

[29] IMF, op. cit.