

## Arab Economic Integration Between Hope and Reality

*Policy Viewpoint is intended to contribute to the discussion of ideas and policy options for enhancing economic development in Egypt. The series is based on research conducted by ECES. The content and recommendations are endorsed by the Center's Board of Directors.*

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The Arab economic integration (AEI) project has been on the agenda of Arab politicians, intellectuals, and the public at large for some 50 years. During this period, several integration attempts have been made. The Arab League was created in 1945, providing a potential focal point for carrying out such a project. The driving force for AEI has been a belief, held by many, that the formation of a united Arab economic block would strengthen the bargaining power of the region in an increasingly polarized world and offer the population an opportunity for better standards of living.

Fifty years later, the AEI project remains elusive. This contrasts with the European integration experiment, which began around the same time as the Arab project. The divergence in outcomes between the two experiments raises a host of questions. Were the expected economic gains from AEI so little as to preclude concrete and systematic actions toward integration, or was it an absence of political incentives? Did the region lack the institutional mechanisms to carry out the project, or was it opposition

from interest groups within countries that prevented real progress to date? Looking ahead, are there any lessons to be drawn from the European Union (EU) experience for the Arab region, or are the two experiments so different that progress on the AEI front requires its own unique path? These are the broad questions addressed in this edition of *Policy Viewpoint*, which draws on the papers presented at the ECES conference held in October 2001.

The rest of this edition provides an explanation of the results of past efforts at integration, an estimation of the expected benefits if integration is carried out, and the possible lessons from the EU experience for the Arab region. The concluding section outlines a recommended course of action.

### Why did Past Attempts at Arab Economic Integration Fail?

Countries in the Arab region have a long history of negotiating regional economic agreements. These agreements have been of many types, ranging from bilateral treaties to reduce tariffs for a

**Table 1. Development of Intra-Regional Trade in Selected Years, (%)**

Regional Block	Intra-Regional Exports as a Share of Total Exports						
	1970	1975	1980	1985	1990	1995	1998
Arab Countries (AFTA)	5.2	4.9	4.5	7.8	9.4	6.7	8.2
ASEAN	19.2	21.3	22.4	20.7	20.7	26.4	22.2
MERCOSUR	9	NA	12	6	9	20	25
APEC	58	NA	58	68	68	72	70
NAFTA	36	34.6	33.6	43.9	41.4	46.2	51
European Union (EU)	59.5	57.7	60.8	59.2	65.9	62.4	56.8

Sources: IMF, Direction of Trade Statistical Year Book, several issues; and World Bank, World Development Indicators, CD-ROM, 2001.

limited number of goods on a preferential basis, to ambitious integration agreements aiming at the creation of an Arab common market. Most of these agreements have not been effective; many were never fully implemented, resulting in limited intra-regional trade compared to other regions (Table 1).

To economists, regional integration agreements are less favorable than nondiscriminatory trade liberalization and could be costly in economic terms because of trade diversion. But regional agreements are not merely about economics. They are typically motivated by political objectives; the gains from which may offset or even outweigh the costs from trade diversion. While it is difficult to attach appropriate weights to both sides of the equation, the challenge is to ensure the attainment of overall net gains from regional integration.

Could the limited progress on AEI be attributed to the absence of overall net gains? Fawzy (2002) suggests that political and economic incentives have been lacking. On the political front, concerns over the distribution of gains from integration across and within countries, issues of national sovereignty, and the cost of adjustment resulting from increased competition all must have constrained AEI. Shortage of “commitment” institutions, especially of mechanisms to compensate losers, and lack of consensus on one state or more to act as regional leader(s) were other limiting factors. On the economic front, Arab countries have not had sufficient incentives to integrate because they have had similar production structures sheltered by high levels of protection. Further, because they have had less hospitable investment environments, higher transaction costs and more restrictive entry rules than in comparator countries, intra-regional investment has also been limited.

Have the significant reforms of the last two decades sufficiently changed the economic incentives to be pro AEI? Only partially. Both the incentive structure facing firms and non-tariff barriers continue to be a deterrent to Arab intra-regional trade and investment. Regarding the incentive structure, Galal and Fawzy (2002) show that the prevailing incentive structure in Egypt continues to favor production for the domestic market. This conclusion is based on a comparison of the profitability of two identical Egyptian firms in all respects, except that one of them faces the incentive structure of an exporting firm and the other the incentive structure and demand of a producer for the domestic market. It is also based on another comparison of the profitability of an Egyptian exporter versus a similar exporting firm in developing countries. The anti-export bias in Egypt persists, even when partial compensation to exporters through duty

and tax exemptions is taken into account. This bias originates from an overvalued exchange rate, high tariff levels, and high interest and corporate tax rates. This means that trade liberalization has not gone far enough to reverse decades of inward-looking import substituting industrialization strategies. Considering that a similar bias might also exist in other Arab countries, it is not surprising that intra-regional integration has been limited.

With respect to non-tariff barriers, Zarrouk (2002) estimated the magnitude and incidence of these barriers for eight Arab countries on the basis of a survey of the private sector. The results indicate that the cost of compliance with all non-tariff-related measures average 10 percent of the value of goods shipped. Next to bureaucratic red tape, customs clearance procedures are the most important source of non-tariff trading costs. The average company spends 95 man-days per year resolving problems with customs and other government authorities. Unofficial payments associated with customs clearance account for only one percent of the value of shipments, but one-fifth of the respondents reported paying between 2 and 17 percent. Excessive delays result from lengthy processes of clearance and inspection, the number of documents and signatures needed to process a trade transaction, and the frequency of problems with customs and other government authorities.

Will the 1997 Greater Arab Free Trade Area (GAFTA) reduce/eliminate these non-tariff barriers? Not quite. It is true that unlike previous attempts, GAFTA embodies specific commitments requiring across-the-board elimination of tariffs, tariff-like charges and non-tariff measures. Import duties and other barriers to trade in goods of Arab origin are to be eliminated by 2008. However, GAFTA is a preferential trade agreement limited to merchandise trade. Services and investment are excluded, greatly reducing the scope for the agreement to have a significant positive economic impact. As a result, non-tariff barriers are likely to remain important barriers to regional integration unless further reforms are undertaken.

Whatever the obstacles to AEI in the past, key to the political incentives to integrate is whether this project is likely to be beneficial or not. This is the question taken up next.

### **What is the Likely Impact of Arab Economic Integration?**

Although an assessment of the likely impact of AEI on all Arab countries is not available, Konan (2002) provides such an estimate for Egypt and Tunisia, using an economy-wide model for each country. The simulations are carried out

for both shallow (trade liberalization) and deep (trade and services liberalization) forms of integration, focusing in particular on the impact of improving the efficiency of service industries (e.g., finance, transport, marketing) in light of their importance for the competitiveness of Arab firms. Although the exact numbers differ for Egypt and Tunisia, the qualitative results are remarkably similar. The most significant result is that comprehensive service sector reforms would generate gains that are far superior to what could be attained through tariff removal alone. In the case of Tunisia, these gains are more than three times what would be generated by trade liberalization alone. For Egypt, the gains are double those resulting from liberalization of trade in goods only. The reasons why deeper reforms that improve the efficiency of the service sector would improve welfare significantly are not difficult to grasp. Reforming the service sector affects the economy as a whole, not just the external sector; it entails removing high barriers to both domestic and foreign entry, and it eliminates policies that create social waste (needless transaction costs). This differs from trade liberalization, which gives rise to efficiency gains only.

This does not mean that merchandise trade liberalization should be left out or postponed. Gains are highest if both reform agendas are pursued. Trade liberalization aligns domestic and world prices, which is a critical factor in ensuring that investments are allocated efficiently, inputs are sourced from the least costly suppliers, and firms have access to the latest technologies. Trade liberalization is also key to reducing the cost of adjustment. Not only would eliminating domestic distortions first and then turning to border distortions (trade barriers) reduce real income gains, but it would also exacerbate adjustment costs. Labor has to undergo “churning” from one sector to another. During the initial stage, domestic resources would flow to the most protected industrial and service sectors. Subsequent service sector reforms would generate shifts of productive factors in the opposite direction.

In sum, the likely economic impact of AEI is positive, at least for Egypt and Tunisia. The gains are expected to be much greater if AEI involves actions to increase the efficiency of service sectors as well as the removal of tariff and non-tariff barriers to trade. Whether similar gains can be expected for other Arab countries, especially oil-producing economies remains an open question. Assuming the net gains are positive for the majority of member countries, the question arises as to the nature and optimal path for making progress on AEI. The next section looks for clues from the EU experience.

### What Can be Learned from the EU?

In many respects, the experience of the EU is highly relevant to understand past Arab regional integration efforts and to inform future attempts at integration in the region. Both the EU and earlier AEI experiments were motivated politically. Both sought to use economic cooperation as a mechanism for integration. Proximity was another common factor. Finally, a common market was a goal both sought to achieve, although - unlike the EU - a common market was not always the objective of the Arab countries. For these reasons, it is instructive to look at the EU experience for insights, keeping in mind the historical context of the two regions, the initial conditions of their economies, and the structure of economic incentives.

Notwithstanding the above similarities, Hoekman and Messerlin (2002) show that the initial conditions - in terms of size, level of development, market structure and level of protection - that prevailed in the 1950s and 1960s in Europe are quite different from those prevailing in the Arab region today. Therefore, future AEI cannot follow the EU path, where trade liberalization was the motor for subsequent integration of factor and service markets. Instead, they argue that a more beneficial route for AEI would be to rely on simultaneous liberalization of trade and service markets.

Beyond the appropriate path to integration, what about the institutional design for carrying out the project? Winters (2002) identifies key institutional features that made the EU integration a success. From the outset, the project was seen as a whole and as a process, rather than as a series of separate steps. There was a strong political backing for integration and a central executive body to manage and push the process forward. The “grand vision” of integration provided the basis for what followed, while the European Commission acted as the guardian of the integration ideal during times of recession. Mechanisms for redistribution were devised to sustain cooperation, as did agreements to pursue integration gradually. In view of all this, the next section outlines a recommended course of action for future Arab economic integration.

### The Way Forward

Perhaps the most important first step on the road to AEI is to acknowledge the glaring fact that the project, 50 years later, remains more of a hope than a reality. No matter how well-intended past efforts have been, they have not worked effectively. Accordingly, a choice has to be made between three broad options: abandoning the AEI project altogether, continuing business as usual on the basis of regional trade liberalization, or taking a leap forward by capitalizing on the



experience to date. The choice between these options must be informed by political, not just economic, factors. Our view is that abandoning the AEI project altogether means forgoing potentially significant gains to the region. The second option is highly imperfect, since trade liberalization was met with strong resistance in the past, and regional trade liberalization is unlikely to be very beneficial. The most viable option is to capitalize on the lessons of experience to devise an alternative, more ambitious path to integration in the future, one that has clear economic payoffs.

Provided a choice is made in favor of a more ambitious AEI project, the next step is to develop a common vision about the ultimate form of that integration, at least among a small core group of countries initially. For the founders of the EU, it was clear that the objective of the union was to create a common market among member states with a common external commercial policy, and eventually the freedom of movement of goods, services, investment and people (labor). For the Arab region, it is important to clearly articulate an ultimate objective, be it the creation of an Arab common market, a shallow free trade agreement, or a deep free trade agreement. Our view is that a shallow free trade agreement, with no harmonization of domestic policies and institutions, is not as rewarding as the other two options. The choice between a deep free trade agreement and a common market is fundamentally a political decision.

Once a vision is agreed upon, the next step is to select an appropriate path to achieve it. In the EU case, regional trade liberalization provided the initial glue to further integration. The mobility of labor, liberalization of foreign direct investment flows and efforts to reduce regulatory barriers that segmented national service markets were to follow. The path followed by the Arab countries has also started with the liberalization of intra-Arab trade in goods, although subsequent steps have not been articulated. Given that labor is somewhat mobile in the Arab region and that services are relatively inefficient, an alternative path is worth considering. This path could emphasize parallel agreements on trade liberalization (as in GAFTA), labor mobility, and liberalization of services with a noticeable impact on firm competitiveness. That is not to say that all actions on the three fronts have to be undertaken upfront, but simultaneous progress on all is desirable to enhance their impact. The merits of the recommended approach are twofold: it will generate significant economic gains, and will mobilize support for further trade reform among workers, industrialists and agriculturists.

Given the vision and the path, the next step is to rethink the institutions necessary to carry out the integration project. In

the EU case, the structure included supra-national institutions - an executive agency (the European Commission); a political oversight body (the European Council); a judiciary - the European Court of Justice (ECJ); and a directly elected European Parliament. The design of the institutional arrangements for the AEI project has to take into account the nature of the agreed project and existing institutions. Broadly, if the AEI project remains a shallow form of integration focusing on regional liberalization of trade in goods, there is a minimal need for adjustment of current institutional arrangements. If the project, on the other hand, were to be redesigned in favor of an Arab common market, implementation would require major institutional changes. The model in this case is simply that of the EU. In between, if consensus develops on the creation of a deep form of regional economic integration, a careful revision of existing institutions is necessary. While the results of this revision cannot be judged upfront, the likelihood is high that it would require strengthening a focal point in the Arab League to oversee the design and enforcement of the broad issues of the agreement. This revision would also require the creation of new entities to address each of the new areas of agreement (e.g., labor mobility, liberalization of network services such as telecommunications, electricity, railways, and anti-trust policy).

Critical to the success of the entire project is both its timeframe and credibility. In particular, sufficient time should be allowed to enable countries to adjust at a socially acceptable pace of integration. The more difficult task is to build credibility, especially in light of a history of 50 years of making agreements that do not stick. But here is where politicians can make a real difference.

- All cited references are included in: Galal, Ahmed, and Bernard Hoekman. Forthcoming. *Arab Economic Integration Between Hope and Reality*. Cairo: The Egyptian Center for Economic Studies; Washington D.C.: Brookings Institution.
- This edition of *Policy Viewpoint* was written by Ahmed Galal (ECES) and Bernard Hoekman (World Bank).

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