



**FROM EURO-MED PARTNERSHIP TO EUROPEAN  
NEIGHBORHOOD: DEEPER INTEGRATION À LA CARTE  
AND ECONOMIC DEVELOPMENT**

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## Abstract

The expansion of the European Union (EU) has prompted the development of a new approach towards deeper integration with its neighbors: the European Neighborhood Policy (ENP). Following a brief discussion of the integration strategies pursued since the mid-1990s—the Barcelona Process and the associated Euro-Mediterranean Partnership (EMP) agreements—this study describes the main elements of the ENP and discusses its potential role in enhancing implementation of the EMP. To conclude, the paper offers a summary of the key strategic options for implementing the ENP and stresses the need to integrate the ENP “menu” into partner countries' priorities and national development strategies.

## ملخص

أدى توسع الاتحاد الأوروبي إلى تطور نهج جديد يُعرف بسياسة الجوار الأوروبي يهدف إلى تعميق الاندماج مع دول الجوار. وفي هذا الإطار، تبدأ الورقة بمناقشة موجزة لإستراتيجيات الاندماج المتبعة منذ منتصف التسعينيات— عملية برشلونة واتفاقيات المشاركة الأورومتوسطية المنبثقة عنها— ثم تنتقل إلى تحليل العناصر الأساسية التي تشكل سياسة الجوار الأوروبي، والدور الذي يمكن أن تسهم به في التنفيذ الفعال لاتفاقيات المشاركة الأورومتوسطية. وفي النهاية، تطرح الورقة الخيارات الإستراتيجية الرئيسية التي تواجه الدول عند تطبيق السياسة الجديدة، مع التأكيد على أهمية دمج عناصر هذه السياسة ضمن الأولويات والإستراتيجيات القومية للتنمية في الدول التي أقامت علاقات مشاركة مع الاتحاد الأوروبي.

## INTRODUCTION

The expansion of the European Union (EU) to include an additional 10 member states in 2004 created a new European “neighborhood,” both for the EU itself and for the countries in Europe, Central Asia and the Mediterranean that are geographically proximate to the EU-25. Most of these neighboring countries have a variety of cooperation arrangements with the EU, including free trade agreements that will lead to bilateral free trade in non-agricultural merchandise products in the coming decade or so. Some have the prospect of accession to the EU, with a number of countries already engaged in the negotiating process. Many have no such prospect. All of the southern Mediterranean countries in Africa and those in the Middle East belong to this group, as do those in Central Asia.

One consequence of the expansion of the EU has been the development of a new approach by the EU towards its neighbors: the European Neighborhood Policy (ENP). The ENP spans a number of dimensions of the relationship between the EU and partner countries, including political (foreign policy, security, human rights, democracy), economic (policy, integration, financial assistance), and cultural cooperation. It aims to deepen relations with partners through more extensive political dialogue, further economic integration and improved access to EU community programs. A basic principle underpinning cooperation under the ENP is commitment to common values, including democracy, the rule of law, good governance and respect for human rights. “The degree of commitment to these values will determine the level of ambition and the pace of progress of the relationship” (EU-Jordan Action Plan).

The ENP envisages that previously negotiated bilateral free trade agreements will continue to be implemented and that efforts will be made to expand them. However, provision of technical and financial assistance (development cooperation) will focus more explicitly on the areas that are identified as priorities under country-specific ENP action plans. This is a change in that to date technical and financial assistance programs have been only loosely related to negotiated agreements.<sup>1</sup> The major innovation of the ENP relative to the status quo is that it offers partners the option of “a stake” in the EU internal market. That is, the prospect

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<sup>1</sup> The adoption of the ENP implies that distinction will disappear between different regional approaches—i.e., the Euro-Med Partnership or “Barcelona Process” with MEDA grant funding as opposed to cooperation with countries in Eastern Europe and Central Asia supported by the TACIS program. Instead, there will be one common umbrella.

is offered of integrating partner countries into specific elements of existing and evolving EU structures, law and systems on an à la carte basis.<sup>2</sup> The implication is that partner countries must determine whether they want to pursue such integration and if so, in what areas and how. As discussed below, this requires a clear understanding of national development priorities, the preconditions for integration into a specific EU area to support economic development, and the appropriate sequencing of policy reforms and complementary measures. It also presupposes an understanding of the benefits and costs of alternative instruments of cooperation, in particular “hard law” (binding treaties) versus “soft law” (economic cooperation). To date, the EU has pursued both tracks. The ENP shifts the relative weight away from soft law, although how much will depend on the objectives, preferences and political constraints prevailing in both the EU and in each partner country.

This paper starts in Section 1 with a brief discussion of the rationales that have been offered for a bilateral (regional) integration strategy with the EU and the instruments used since the mid-1990s by the EU and its Mediterranean partners—the Barcelona Process and the associated Euro-Mediterranean Partnership (EMP) agreements. This process remains in place, and one of the objectives of the ENP is to foster the implementation of the EMP. That is, the EMP is one of the instruments of pursuing the ENP. Section 2 describes the main elements of the ENP and the mechanisms that are to be used to apply it. Section 3 assesses these in terms of the incentives to use (effectiveness of using) regional integration as a means (the instrument) to pursue liberalization and “behind the border” regulatory reforms. Section 4 summarizes the main choices and options that European partner countries and the EU face in implementing the ENP. Section 5 concludes.

Throughout this paper the focus is on economic cooperation—the political and cultural dimensions of the ENP are not discussed. While these are certainly important—the primary motivation underpinning the ENP is arguably political—the feasibility of attaining the political objectives identified in the ENP arguably will depend to a large extent on the effectiveness and impacts of the economic aspects of the partnership.

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<sup>2</sup> As noted by Emerson and Noutcheva (2005), foreign ministers decided in April 2002 at Valencia to launch the EuroMed Internal Market Program with a view to go beyond free trade towards deeper market integration, thus moving towards greater harmonization with EU norms and standards as opposed to a looser type of cooperation.

## 1. THE EURO-MEDITERRANEAN PARTNERSHIP (“BARCELONA”) PROCESS

The EU is an ongoing experiment in deep economic integration of sovereign states. The focus is on the abolition of policies that impede the free movement of goods, services, labor and capital. In addition to actions to achieve an integrated European market, the EU has been active in negotiating free trade agreements with neighboring countries, former colonies and emerging market economies.

There are three basic options for governments seeking to liberalize trade and investment regimes: unilateral action, multilateral liberalization based on the principle of most favored nation (MFN), and preferential (discriminatory) liberalization. For a small country that cannot influence its terms of trade, unilateral free trade is the best policy, although obtaining preferential access to protected foreign markets will of course generate even greater gains. However, given the small country assumption—which arguably applies to the countries in the Mediterranean region—there are few if any gains to be expected from making own liberalization conditional upon reciprocity by trading partners. Preferential liberalization through the negotiation of a free trade agreement (FTA) will also be an inferior strategy. The reason is simple: the world market is always larger than a regional one. By not discriminating across potential trading partners, domestic firms and consumers will be allowed to buy goods and services from the most efficient suppliers, wherever they are located. By granting preferential treatment to specific countries, trade *diversion* may occur—the elimination of tariffs may induce consumers and firms to source from suppliers located in a partner country that are less efficient than those located in non-member countries. It may be the case that trade *creation*—the elimination of domestic sourcing by firms and consumers in favor of imports of goods produced by more efficient suppliers in the partner country after the elimination of trade barriers—is sufficient to offset the welfare loss caused by trade diversion. The point, however, is that through unilateral MFN liberalization such losses do not occur: net gains are greater.

In practice, of course, governments do pursue preferential trade agreements. Reasons for this include political economy forces. It may not be feasible to undertake unilateral reforms because vested interests are too powerful. The credibility of autonomous reform may be enhanced by making binding commitments in an international treaty. A regional integration agreement (RIA) may offer a stronger mechanism for locking in (anchoring) economic

reforms than the WTO because it involves complete removal of most tariffs and may extend to policy areas that are not covered by the WTO—e.g., investment or factor market policies. A RIA may involve harmonizing regulatory regimes and administrative requirements relating to product standards, testing and certification procedures, mutual recognition agreements, common documents for customs clearance (e.g., the EU Single Administrative Document), coordination and cooperation on linking computer systems of customs. Such “behind the border” integration can enhance the payoffs of regional cooperation. A RIA may also allow the removal of the threat of contingent protection, such as antidumping, against partner country exports. Harmonization or recognition of administrative requirements and procedures may further improve the security of market access. Benefits will be enhanced relative to unilateral free trade if the RIA involves transfers from richer members to poorer ones. Such transfers may be financial, or take the form of technical assistance. If such transfers are conditional upon membership of the RIA and are *additional* to status quo ante flows, they can help offset the possible losses associated with tariff revenue losses and trade diversion.

### ***The Basic Euro-Mediterranean Framework***

Created in November 1995, the basic objectives of the EMP are to achieve reciprocal free trade between the EU and Mediterranean countries in most manufactured goods; grant preferential and reciprocal access for agricultural products; establish conditions for gradual liberalization of trade in services and capital; and encourage the economic integration of Mediterranean partner countries. The Barcelona Process aimed for the creation of a Euro-Mediterranean Free Trade Area by 2010. The goals and constraints imposed by Mediterranean countries are perhaps best stated in the EU Commission's request for negotiating authority: "in order to be able to enter progressively into free trade with the Union and to take on board a wide range of trade-related Community regulations (i.e., customs, standards, competition, intellectual property protection, liberalization of services, free capital movements) ... Mediterranean countries ... insist on four fundamental aspects ...: the need for long transitional mechanisms and secure safeguards; the need to obtain improved access for their agricultural exports; the need for increased financial flows ... [and] the possibility to count on the Community's help to accelerate the modernization of their social and economic systems."<sup>3</sup>

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<sup>3</sup> "Strengthening the Mediterranean Policy of the European Union: Establishing a Euro-Mediterranean Partnership," Communication from the Commission to the Council and the Parliament, October 1994.

The first Euro-Mediterranean Partnership (EMP) Agreement, negotiated with Tunisia, was signed in July 1995. It entered into force in 1998 after ratification by all EU member states. An agreement with Morocco followed in October 1995 (entry into force in 2000). Subsequent bilateral agreements were negotiated with the Palestinian Authority (an interim agreement was signed in 1997), Israel (2000), Algeria (2001, ratified in 2005), Egypt (June 2001, ratified in 2004), Jordan (November 1997, ratified 2002), and Lebanon (June 2002, ratified 2004). Negotiations with Syria were concluded at the end of 2003, but final approval has been delayed.

Each EMP is unlimited in duration and is to be implemented over a 12 to 15 year period (15 in the case of Egypt). Its operation is overseen by an Association Council that meets at the Ministerial level at least once a year, and an Association Committee meeting more frequently at the level of senior officials. The EMP has five major economic elements: (1) free movement of goods; (2) right of establishment and supply of services; (3) payments, capital, competition and other economic provisions (e.g., safeguards); (4) economic, social and cultural cooperation; and (5) financial cooperation.

*Market access.* The FTAs are for non-agricultural merchandise only. Antidumping and safeguards remain applicable to trade flows between partners. Although the EMP aims to gradually liberalize trade in agriculture, little was achieved in this area—generally extending existing preferential arrangements on a limited basis through expansion of tariff quotas. The limited liberalization of agricultural trade greatly reduced the potential benefits for partner countries.

*Establishment.* The right of establishment (i.e., freedom to engage in FDI) is an objective in the EMP. Modalities to achieve this objective are to be determined by the Association Council. No time path or target date is mentioned for its realization.

*Supply of services.* No specific commitments are made in most of the EMP agreements on liberalization of cross-border supply of services (i.e., trade). As with the right of establishment, liberalization is an objective that is to be pursued by the Association Council. The EMP simply refers to the obligations of each party under the WTO's General Agreement on Trade in Services (GATS) for those countries that are WTO members. In general, they do

not go beyond GATS commitments, although in the case of Jordan, national treatment obligations are included (although with exceptions) that go beyond the GATS.<sup>4</sup>

*Competition policy, state aids and procurement.* The EMP calls for the adoption of the basic competition rules of the EU, in particular with respect to collusive behavior, abuse of dominant position, and competition-distorting state aid insofar as they affect trade between the EU and each partner country. Implementing rules are to be adopted by the Association Council within five years. Until then, GATT rules with respect to countervailing of subsidies will apply. Antidumping also remains applicable as do safeguard clauses. Liberalization of government procurement is also an objective, but no binding disciplines on this front are included in the EMP agreements.

*Regional integration.* An objective of the EMP is to promote greater integration of the Mediterranean countries. A set of bilateral agreements between the EU and each Mediterranean country can lead to a so-called hub-and-spoke system that creates incentives for firms to locate in the “hub” (the EU) and export to all the “spokes”. This creates incentives for Mediterranean partners to liberalize intra-regional trade flows and to adopt common rules of origin. Both were in fact pursued. In the second half of the 1990s Arab League members agreed to remove all barriers to trade in goods (under the Pan-Arab Free Trade Area (PAFTA) agreement). In March 2004 the Agadir Agreement was concluded creating a free trade zone between Jordan, Egypt, Morocco and Tunisia. It includes an effort to adopt common (EU) rules of origin.

*Economic cooperation.* One-third of the Articles in each EMP agreement deal with cooperation in economic, social and cultural matters. The primary objective underlying economic cooperation is to improve competitiveness and assist in addressing adjustment costs. Instruments of economic cooperation under the EMP include information exchange, provision of expert services (consultants), support for joint ventures (e.g., the Euro-Partenariat program), and technical assistance. Much of the focus is on upgrading infrastructure broadly defined (both hard and soft) and providing support for restructuring of the economy.

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<sup>4</sup> In the case of Jordan, right of establishment (commercial presence) and national treatment is granted for international maritime transport but there are equity limitations on ownership of firms in a variety of service industries. The Lebanon and Algeria agreements also have provisions that go beyond the GATS, but there does not appear to be any additional liberalization implied.



*Financial cooperation.* Financial assistance—grants and loans—is an important dimension of the EMP. Under MEDA, during 1995-1999 some €3.4 billion in grant aid was committed, of which €800 million went to Morocco; €700 million to Egypt and €500 million to Tunisia. During 2000-2006 the total allocated rose to €5.3 billion, of which 10 percent was allocated for regional (multi-country) projects. MEDA grants are supplemented by the European Investment Bank (EIB) loans. In 2002, the Facility for Euro-Mediterranean Investment and Partnership (FEMIP) was created. As of end 2004, a total of around €12 billion had been lent to Mediterranean partner country governments by the EIB.

### ***A Brief Assessment***

What has been achieved under the EMP?<sup>5</sup> Trade policy has become less restrictive—the simple average tariff has fallen by some 10 points since the early 1990s in EU partner countries. Across MENA as a whole the simple average tariff is 12 percent. The decline in the external tariff reflects unilateral reforms and WTO commitments, as well as EMP-based and intra-Arab liberalization. It is difficult to attribute how much of this is due to the EMP, but clearly it played a role by generating the incentive for MFN reform to reduce trade diversion. Less progress appears to have been made with respect to nontariff barriers (NTBs). The region still has a high coverage ratio of NTBs (51 percent), a result of which is that the trade policies of MENA countries as a group continue to imply a high uniform tariff equivalent: 31 percent (World Bank and IMF 2005). Nontariff policies have been the focus of much concern and analysis by the private sector in MENA countries and international organizations, including the EU—in particular the operation of customs (clearance procedures) and the application of product standards and related certification procedures. This is an area that has been a focal point of bilateral assistance under the EMP and region-wide initiatives. Examples are the Euro-Mediterranean Trade and Investment Facilitation Action Plan and the Pan Euro-Mediterranean Protocol on Cumulation of Rules of Origin. In key areas much remains to be achieved. Transparency is one example—little is known about the incidence of NTBs, and there do not appear to be regular analytical surveys that allow changes over time to be monitored. Limited progress has been achieved on recognition of standards—to date, no labs in MENA have been certified by the EU.

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<sup>5</sup> What follows draws on a number of assessments in the literature—including Philippart (2004), ADE, IBM, and EPU-Natua (2003), FEMISE (2005), and Emerson and Noutcheva (2005). As discussed below, there are very few rigorous quantitative evaluation studies of the EMP—most studies focus on the general economic performance of MENA countries, not on the impact of the EMP. See e.g., FEMISE (2004) and CEC (2005a).

As noted, coverage of agricultural trade was deliberately limited under the EMP, with liberalization being limited to expanded tariff rate quotas. The emphasis of the EMP has been on technical assistance and attainment of EU standards, with particular stress on sanitary and phytosanitary (SPS)/quality norms and rural development. Only in 2004 was agreement reached to develop a road map to liberalize trade in agriculture on a reciprocal basis.

Virtually all progress on services reform in Mediterranean countries has been unilateral. MENA countries have been hesitant to commit to services policy reforms in trade agreements, whether the EMP or the WTO. Conversely, the EU has been reluctant to move in the area that matters most for Mediterranean countries: mode 4 access (temporary movement of service suppliers). The negotiations foreseen in the EMP agreements on services trade and investment—which were supposed to be launched 3 to 5 years after the entry into force of the respective agreements—have been slow to start. Obtaining agreement on the terms of reference of such talks has taken years. Negotiations have yet to be launched.

Southern Mediterranean/Arab integration has been proceeding. The Pan Arab Free Trade Area agreement (PAFTA) will remove barriers to trade in goods in 2005. There is now also agreement in principle to deepen PAFTA by turning it into a customs union and to extend its coverage to intra-Arab liberalization of services. MENA countries have signed numerous bilateral agreements with each other and neighboring countries, including Turkey. While tariffs are being removed, NTBs such as red tape, standards, and rules of origin, continue to prevail.<sup>6</sup> The Agadir Agreement between Jordan, Egypt, Morocco and Tunisia will complement the PAFTA by addressing rules of origin issues.

The EMP process has put much emphasis on economic and financial cooperation. The association agreements limit the set of “hard” disciplines to trade policies—mostly tariffs. Many of the articles and provisions of the EMP agreements comprise “best endeavor” commitments, aiming to encourage and assist partner countries to strengthen trade-related institutions and reduce the trade-restricting impacts of regulatory and other policies applied at and “behind” the border. Cooperation in these areas is pursued through a multidimensional spider web of interactions. At the regional (EMP-wide) level these span dozens of ministerial meetings and bi-monthly meetings of the Euro-Mediterranean Committee plus a number of

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<sup>6</sup> A number of PAFTA members, foremost Egypt, have indicated that they will not adhere to the 2005 timetable because of concerns that the rules of origin that were negotiated are too liberal and are not being implemented by partner countries.

Pan Euro-Mediterranean working groups on technical and sectoral issues, e.g. the Euro-Mediterranean Transport Forum. At the bilateral level, loci for interactions include Association Council and Committee meetings, technical sub-committees (although limited so far) and numerous aid projects (MEDA and EIB).

The focus of interactions in these bodies is either on “grand politics”—foreign policy— or on EU norms and partner country policies. Little information exists in the public domain on what solutions are developed for the specific issues that are on the agenda and whether issues are in fact resolved. Thus, transparency is low. Information on decisions taken, their implementation and the operation and effectiveness of EMP bodies is neither comprehensive nor readily available. One reflection of this is that there is little discussion on the Internet of issues/outcomes. The result is limited awareness and “ownership” of the EMP process, and thus presumably limited relevance in terms of the national economic reform process/debate in Mediterranean countries.

The same observation can be made of enforcement of treaty obligations. Contrary to the WTO, where disputes are prominent and well covered by the press and the professional and academic trade communities, little is known about dispute settlement under the EMP. In principle, the Association Councils are supposed to deal with disputes. If a dispute cannot be addressed through consultations with the Council, each of the two Parties may appoint an arbitrator, with the Association Council appointing a third. Arbitration decisions are to be taken by majority vote and are binding. Whether this mechanism has worked (indeed, is ever invoked) is unclear—information about the enforcement of those parts of the EMP that are binding (such as tariff removal) is not readily available.<sup>7</sup>

Economic assistance under the EMP has been multidimensional: technical and financial assistance has been directed towards supporting national policy reforms, strengthening implementing institutions—customs administration, product standards, moving towards adoption of EU norms in regulatory areas such as competition policy and environmental protection—and private sector development. Tables 1 and 2 provide a summary of the major types of activities funded. Disbursements were initially slow—during the first five years of the EMP only 26 percent of commitments were spent (ADE, IBM, and EPU-Natua 2003).

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<sup>7</sup> An Internet search did not generate references to specific disputes that were addressed in the frameworks created by the Barcelona Process.

Since then, the disbursement/commitment ratio rose to over 100 percent in 2004, reflecting in part greater reliance on decentralized (intra-country) decision-making.

**Table 1. EC Assistance for Economic Reforms (Commitments, 1995-2001) (Euro)**

Algeria	Structural adjustment facility	125.0 million o/w 30 from MEDA I
	Support for industrial restructuring and privatization	38.0 million
Egypt	Public enterprise reform and privatization program	43.0 million
	Industrial modernization program (budget support component)	110.0 million
Jordan	Structural adjustment facility I	50.0 million
	Structural adjustment facility II	80.0 million
Lebanon	Structural adjustment facility	50.0 million
	Rehabilitation of the public administration	38.0 million
	Investment planning project	25.0 million
Morocco	Structural adjustment facility I	120.0 million
	Impact study of the free trade zone	1.3 million
	Support for privatizations	5.0 million
	Support for Telecom regulation and rehabilitation	5.0 million
	Mediterranean Rocate	80.3 million
Syria	Modernization of the municipal administration I	6.0 million
	Modernization of the municipal administration II	12.0 million
	Power sector action plan	11.0 million
	Telecom sector support program	10.0 million
	Modernization of the ministry of finance	10.5 million
	Institutional and sector modernization facility	21.0 million
Tunisia	Structural adjustment facility I	100.0 million
	Structural adjustment facility II	80.0 million
	Support to privatization	10.0 million
	Strengthening the competitiveness of the Tunisian economy (part of a larger project)	0.5 million
Regional projects		
	Euro-Mediterranean regional program for the environment	6.0 million
	Euro-Mediterranean information system on know-how in the water sector	2.4 million (MEDA and EU Member States)
	Euro-Mediterranean cooperation in the energy sector	13.8 million
	Euro-Mediterranean cooperation in the transport sector	
	New approaches regarding telecommunication policy among Mediterranean partners	2.15 million
	Private participation in Mediterranean infrastructure	2.6 million
<b>Total</b>		<b>1,058.55 million</b>

Source: ADE, IBM, and EPU-Natua (2003).

A noteworthy feature of EU assistance in a number of Mediterranean countries has been the development of programs aimed at facilitating adjustment before trade reforms are fully implemented. These industrial modernization programs provide subsidies to firms (matching grants) for upgrading the production process, and investment in new technologies (hard and

soft—e.g., ISO 9000 certification of management and information systems). Examples are the “Mise à Niveau” program in Tunisia (see Box 1) and the Industrial Modernization Programme in Egypt. Such programs are complemented by initiatives that provide information on market opportunities in the EU and facilitate linkages between EU and MENA firms.

**Table 2. EC Assistance for Private Sector Development (1995-2001, Euro)**

Algeria	Promoting small and medium-sized enterprises	57.0 million
	Modernizing the financial services sector	23.0 million
Egypt	Banking sector reform: Assistance to the Central Bank	11.7 million
	Private sector development program I & II	45.0 million
	Industrial modernization program (excluding budget support)	140.0 million
	EIB Risk Capital	10.0 million
Jordan	Private sector development program	7.0 million
	Industrial modernization program (EJADA)	40.0 million
	EIB Risk Capital	10.0 million
Lebanon	Industrial modernization	11.0 million
	Strengthening institutions in charge of standards and norms	6.0 million
Morocco	Support to vocational training	38.0 million
	Support to employment creation	3.3 million
	Euro-Maroc-Entreprises	21.9 million
	Support to professional associations	5.0 million
	Quality promotion program	15.5 million
	EIB Risk Capital	45.0 million
	Creation of a credit guarantee fund	30.0 million
Syria	Syrian European Business Center I	9.0 million
	Syrian-European Business Center II	12.0 million
	Higher Institute for Business Administration (HIBA)	14.0 million
Tunisia	Vocational Training – MANFORM	45.0 million
	Euro-Tunisie Entreprise	20.0 million
	Strengthening the competitiveness of the economy (subcomponent).	9.5 million
	EIB Risk Capital	90.0 million
<b>Total</b>		<b>718.9 million</b>

Source: ADE, IBM, and EPU-Natua (2003).

Much of what has been done is innovative and potentially relevant to other regional integration processes elsewhere in the world. Unfortunately, information on the impact and effectiveness of these programs is limited. Evaluations of EU assistance efforts under MEDA center mostly on financial accountability and due diligence rather than on economic impact assessment and program impact evaluation. An exception is ADE, IBM, and EPU-Natua (2003), which assesses MEDA assistance against various criteria. However, while providing a useful overview of MEDA support, the assessments offered are qualitative.

**Box 1. The “Mise à Niveau” Program in Tunisia**

The objective of this program was to help Tunisian industry upgrade and ready itself for competition post removal of tariffs on manufactured imports from the EU. The focus of the upgrading effort was comprehensive, covering equipment, management and training. Criteria for obtaining funding included that the firm be in business for at least two years, show growth potential and a promising market, and not have serious economic difficulties. Subsidies are allocated from a special competitiveness fund for material investment: 20 percent and 10 percent of equity and borrowed finance respectively. Immaterial investment can be subsidized up to 70 percent of cost, with a maximum of TD 30,000 (US\$ 40,000) for diagnostic studies. A steering committee (“COPIL”) makes decisions on applications. It comprises 18 members representing different government departments, the Tunisian Business Association, trade unions and the banking sector. Banks and technical centers monitor implementation of the investment projects financed under the program.

Over the period 1996-2002, COPIL approved 1,350 applications for assistance. Total committed investment and approved subsidies reached TD 2,323 million and 360 million (mid-2003). Three sectors account for two-thirds of investment (and subsidies): food processing, construction materials, and textiles and clothing. Approved subsidies represent about 15 percent of committed investment; disbursed subsidies equal 4 percent of total. Disbursements are made in three installments, the first on completion of 30 percent of committed investment. Release of funds is conditioned on financial criteria, including an equity-to-fixed assets ratio above 30 percent and a ratio of long-term resources to fixed assets that is greater than one. A preliminary assessment of the program was made by Lahouel (2003) for the period 1996-2001. Enrolled firms performed better. Sales grew at an annual rate of 11 percent (vs. 8.3 percent for manufacturing value-added); exports rose 16 percent p.a. (vs. 13.5 percent); and employment rose at a faster rate for many sectors, with an overall increase of about 1 percent. While the program appears to have yielded positive results in terms of investment, employment and production, it is not clear to what extent this reflects “selection bias”—firms enrolled in the program may simply be better performers in the first place. A rigorous program evaluation that controls for such possibilities has yet to be undertaken. Such an evaluation would also need to look into other potential benefits—e.g., strengthening of national management consultancies as demand for their services is enhanced.

*Source:* Lahouel (2003).

Summing up, a compelling case cannot be made that the EMP has had a significant economic impact. Although it is always difficult to determine the counterfactual, on the trade front overall non-oil growth was lower in the post-1995 period than in first half of 1990s. Intra-regional (intra-Mediterranean) trade shares have increased somewhat and there has been a (small) rise in intra-industry trade, indicating greater diversification. The net FDI/GDP ratio also rose slightly: from 0.9 percent in the mid-90s to 1.2 percent in 2003. Labor force growth continued to exceed employment growth in most countries—resulting in stagnant or rising unemployment levels in a number of partner countries. Services and investment policy

reforms have been unilateral—to date there has been little movement in terms of commitments that go beyond those that WTO members have made in the GATS. Finally, while the aid impact has likely been positive, there is a lack of rigorous *ex post* impact evaluation.

## 2. THE EUROPEAN NEIGHBORHOOD POLICY

The 2004 European Neighborhood Policy (ENP) has a three-fold goal: (1) to support the national development strategy of a partner country; (2) integration of partners into (parts of) the EU economic and social structures (“a stake in the internal market”); and (3) to support the implementation of the Association Agreements (CEC 2004). The premise underlying the ENP is to pursue (offer) *differentiated* convergence with EU norms and legislation—the *Acquis Communautaire* (covering competition policy, social norms, environmental requirements, and provisions to support free trade in services).<sup>8</sup> The presumption is that deeper integration (harmonization to converge with EU laws and regulations) will help achieve development, but that it is necessary to recognize differences in capacity and in priorities across countries. The latter is reflected in both the à la carte nature of the ENP framework and the commitment to provide additional aid via a European Neighborhood and Partnership Instrument (ENPI).<sup>9</sup>

The ENP’s explicit recognition of differences in capacity and priorities in the context of bilateral economic cooperation between the EU and its neighbors and the need to complement binding treaties with “soft law”-type cooperation and technical and financial assistance is a unique feature of the initiative. As discussed below, the approach has the potential to inform how differences across countries could be addressed in the WTO. To date, the WTO has relied on the concept of “special and differential treatment” (SDT) for developing countries, involving a mix of preferential access to markets and exceptions to rules for developing countries. This approach has not been very effective in assisting many of the poorer countries to integrate into the trading system. There is little in the way of constructive policy dialogue and engagement to help countries address national trade priorities, and very weak links to

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<sup>8</sup> The *Acquis* spans a large number of policy areas. A good understanding of the costs and benefits of these existing provisions is a precondition for maximizing the benefits of the ENP.

<sup>9</sup> See CEC (2004), Emerson and Noutcheva (2005), Dodini and Fantini (2005) for discussions of the ENP.

development assistance.<sup>10</sup> The ENP comes much closer to recent normative prescriptions on how to link development and integration objectives that have been offered in the recent literature (see, e.g., Hoekman 2005).

The primary (new) focal point or mechanism that will be used to implement the ENP is through an ENP Action Plan. This is agreed (negotiated) jointly with the EU; will cover a 3 to 5 year time span; and will be accompanied by greater monitoring of progress and “tied” or conditional on technical and financial assistance than has been past practice under the EMP. The EMP (i.e., the Association Agreements) will remain the basis of cooperation. Monitoring of the implementation of the Action Plan will take place in the bodies established by the Association Agreement, including (new) specialized subcommittees. The Association Council will remain the central body of the bilateral relationship, including as regards holding a regular political dialogue on subjects of common interest.

### ***Objectives and Instruments***

A standard insight from the economics literature is Tinbergen’s (1952) rule that for each objective, policymakers need to have a distinct instrument (it is very unlikely in practice that it will be possible to hit “two birds with one stone” in policy terms). The ENP has multiple objectives: non-economic as well as economic. An obvious question is whether there are sufficient instruments to draw upon to pursue the various ENP objectives. On the economic front there are two overarching objectives: the development of partner countries (the neighbors) and integration of these countries into the EU system (gradual deeper integration into EU economic/social structures, involving approximation of laws/norms). Instruments include negotiated (bilateral) agreements (treaties) to provide better access to markets for goods, services and factors of production; soft law/economic cooperation; and development assistance and financing. Thus, at this very general level, in principle it would appear that there are a sufficient number of instruments.<sup>11</sup> The problem confronting the EU and partner

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<sup>10</sup> Prowse (2002) describes the evolving status quo on technical assistance; and Prowse (2005) provides a proposal to substantially scale up “aid for trade.”

<sup>11</sup> Accession is not assumed to be an instrument—i.e., is not available. One can argue that from the perspective of partner countries integration into EU structures is also an instrument. Indeed, that is the view taken here, as our interest is to discuss the implications of the ENP for Mediterranean countries. However, from the EU perspective integration is more appropriately regarded as an objective in itself in that a goal is to expand the reach of (elements of) the *Acquis*.



countries is therefore more akin to the “assignment problem” in macroeconomics—what instrument to use for what objective.<sup>12</sup>

Table 3 illustrates the challenge confronting partner countries (and the EU). It maps objectives against instruments, and identifies whether the instruments will have a high probability of achieving the objective. It presumes that the EU attaches importance to both integration and development as an objective, whereas the partner country cares primarily, if not exclusively, about national development—implying that for it, integration is an instrument. As can be seen from the first row, the various ENP instruments the EU has available are all relevant in terms of their potential to help achieve the integration goal, although in practice much will also depend on the national policies that are pursued by partner countries (e.g., implementation). However, it is not at all clear whether the instruments that the EU has available will help achieve development objectives—with the possible exception of market access, this will depend very much on what a specific measure will do in/for the country concerned.

**Table 3. Objectives and Instruments**

Objectives		EU Instruments						National Policies
		Treaties		Soft law		Aid		
		Remove border barriers	Internal market rules ( <i>Acquis</i> )	Economic cooperation	Participation in EU programs	Grants	Loans	
	<b>Integration (EU)</b>	X	X	X	X	X	X	X
	<b>Development (EU and partners)</b>	?	?	?	?	?	?	X

Note: X: effective instrument; ?:effectiveness (sign of impact) uncertain.

There is tension between national development and integration in that the latter constitutes a unique focal point that is defined by existing EU members (even though constantly evolving). The former has no such focal point—both the goal and the measure used to assess progress will be country-specific. Whether an ENP instrument promotes development (i.e., growth, employment creation) will depend on what it does. A major

<sup>12</sup> In practice, of course, there are multiple sub-objectives. Thus, national development will span economic growth, employment, reducing the incidence of poverty, protecting the environment, etc. Whether there are enough instruments at the national level is another question.

question then is whether deeper integration with the EU will help growth, and, more important in the short run, in what areas different types of integration will generate the highest payoffs. That is, from a practical policymaking perspective it is also necessary to know the rank-ordering of policy instruments to determine what instruments to use—i.e., in what areas should the goal be to make binding commitments and in what areas should the focus be on cooperation and aid. On top of this, countries need to decide—in those areas where EU law is considered to be too narrow or inappropriate—what capacity the EU has to assist in improving national economic policies that may diverge from EU law.

Hard law—binding treaty instruments—will involve extending Association Agreements to include new disciplines on market access and on rules—in services, agriculture, and possibly parts of the *Acquis*. It is straightforward to conceptualize how this might work for market access—i.e., reciprocal agreements to provide better access for agricultural and services flows, including the right of establishment (investment).<sup>13</sup> However, there is likely to be limited scope for reciprocity when it comes to EU law (the *Acquis*)—this is essentially non-negotiable. Here the issue is to determine the national payoff to harmonization and the extent to which use can be made of the “recognition” principle. Regulatory convergence (harmonization) may not be beneficial from a national development perspective. It also may or may not be necessary for effective access to the EU market. Indeed, integration (defined by a “stake in the internal market”) may be second-order in terms of payoffs if the associated market access benefits are much smaller than the gains from domestic reform that are not part of/relevant to the EU *Acquis*.

Analysis aimed at prioritization of policy measures and related actions is therefore critical. A national development strategy in which trade- and integration-related measures are included as part of a country’s overall agenda will be needed to maximize the potential benefits of cooperation. Hard law, soft law (economic cooperation) and financial and technical assistance all need to be clearly mapped in pursuit of national priorities and translated into the ENP Action Plan. Hard law can be very useful and beneficial to overcome political economy resistance to reform, reduce uncertainty and lock in market access. But integration for its own sake or the adoption of the “EU model” will not necessarily be beneficial, and even if it is, may not be a priority at a given point in time. Putting mechanisms

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<sup>13</sup> Although modalities will matter, e.g., a positive vs. a negative list approach to scheduling in services, and the reach of safeguard instruments. We return to this below.

in place to generate information and analysis of the impacts of different options, *ex ante* to inform the design and content of the Action Plan and *ex post* to assess results, is therefore needed. The absence of effective mechanisms that do so is one of the weakest elements of the evolving status quo. Addressing this lacuna will require joint action by the EU and partner countries. The EU can help ensure that this gets done through both technical/financial assistance and making cooperation conditional on the existence and effective function of national mechanisms that do this. Such support will be required in many MENA countries given both the absence of such mechanisms and a history of limited consultation on economic policy. But the main burden lies with the MENA partner countries.

### **3. DEFINING AND ATTAINING PRIORITIES: STRATEGIC OPTIONS AND ISSUES**

A first priority for each partner country government is to determine what its specific objectives are, i.e., its development strategy. Based on this, the various elements of the menu offered by the EU should be mapped to meet the development objectives. The end result should be one set of national priorities for trade-investment-integration-related policy and associated investment needs, as an integral part of the overall national development strategy. A possible model to generate this information is the one that is emerging from the Integrated Framework for Trade-Related Technical Assistance (IF) and the Poverty Reduction Strategy Process (PRSP) in least developed countries—where the IF identifies national trade priorities on the basis of a diagnostic analysis, but the actual action items and resource allocation is determined through the PRSP and related funding allocation mechanisms (see Prowse 2005 for a discussion). In doing this in the ENP context, consideration should be given to where the comparative advantage of the EU lies—there are other international institutions that can also assist in the implementation of elements of the strategy and have ongoing programs that aim to do that.

The process must be based on analysis and involve stakeholders and think tanks, not just government agencies and elements of the business community. Dialogue on national policy and possible reforms and (changes in) public investment allocations can help mobilize the political support needed for change, as well as a sustained focus on implementation. A credible assessment of the likely prospective benefits *and* adjustment costs associated with policy changes can help identify and put in place potential compensating measures, increasing “ownership.” Necessary inputs into such a process include collection and public access to data

on policies and analysis of their impacts. Currently this is sorely lacking. Up-to-date databases on applied import tariffs, prevailing NTBs and their incidence, and service sector policies are not readily available, incomplete and of low quality. Improving basic policy data is needed not only for *ex ante* analysis but for *ex post* assessments to allow for feedback and possible adjustments. This suggests that to be most effective in supporting economic reforms the ENP should also generate accessible and comprehensive information on the activities and impact of the associated processes (e.g., working groups, committees).

What follows provides a brief summary of some of the elements of the broad economic reform agenda that could be put on the table from the partner country perspective. Clearly any such listing will be subjective and the discussion is intended to be illustrative. It relies on “first principles” and the trade-related literature on the MENA region. A distinction is made between trade integration (market access-related) actions—where overall benefits are likely to be unambiguous (even though there will be adjustment costs)—and other domestic regulatory policy reforms and complementary actions and investments.

### ***Focal Points and Tradeoffs***

Because average tariff barriers in MENA countries are higher than in the EU, much of the potential welfare gains from reducing discrimination against foreign goods and services will arise from own liberalization.<sup>14</sup> Reasons why a country imposes trade barriers are numerous. They include infant industry protection, unemployment prevention, balance of payments maintenance, and fiscal revenue objectives. All of these are “second-best” in most circumstances in that a lower-cost (less distorting, more efficient) domestic policy instrument can in principle be identified to satisfy the objective. The persistence of trade policies can be explained by the resistance to liberalization by the owners of and workers in protected industries. Such resistance may also reflect doubts regarding the creation of new employment opportunities. Social insurance and adjustment assistance mechanisms may not exist or provide only (very) partial compensation for adjustment-related losses incurred by workers/households. These realities make complementary reforms to increase the likelihood of realizing the benefits from trade reforms important.

The list of beneficial concomitant reforms can be long and the associated challenges appear rather formidable. This does not necessarily imply there are difficult trade-offs to be

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<sup>14</sup> This sub-section draws on Hoekman and Winters (2005).

made, however—most of the policies are essentially “additive” to those of trade liberalization (market access) in the sense that they do not give rise to trade-offs. The key is credibility that reform will actually occur, and careful attention to the different adjustment needs of various sectors and to the interactions between different parts of the package. Whatever the transition period, credible commitment to the final goal is important, for without it neither current nor potential future activities will look desirable and there may be a diversion of effort into lobbying. As discussed below, the ENP can play an important role in this connection.

Governments have to build support for policy reforms and their implementation. In virtually any country the most powerful interests will need to be assuaged, unless reforms are implemented in the context of major economic crises. Such compensation through the careful design of complementary policies is not just a matter of sordid logrolling. Although any single efficiency-enhancing reform will hurt someone, if enough of them are packaged together, negative effects will be netted out and many more people and interests will obtain a net gain. This is one of the major reasons for proceeding on a broad front. Important areas for attention include:

- *Infrastructure support.* For example, farmers need to be able to reach major market centers at reasonable cost and firms need access to a reliable and efficient power supply. In poor countries transportation (logistics) and transactions costs are often a multiple of any tariffs exporters face. This helps explain the more limited participation of poor countries in the process of international specialization as noted previously.
- *Credit markets.* Access to finance is a critical input, both in terms of new start-ups and expansion of existing plants. For example, achieving minimum consignment size might entail hiring draught power or seasonal labor, but this is not possible without credit.
- *Labor markets and mobility.* The primary vehicle for spreading the benefits of increasing labor demand widely is labor mobility. If markets are segmented and/or distorted, benefits will be reduced.
- *Incentives to establish new businesses.* Cumbersome regulations for establishing new firms, constraints on access inputs (e.g., utilities), restrictions on physical expansion or labor recruitment and separation, can curtail the willingness of entrepreneurs to start or expand operations.

In sum, the benefits of trade liberalization depend in part on other policies and institutions being supportive. Openness can help induce improvements in these dimensions by making them more “visible” and creating incentives to fix problems. However, additional investments and reforms will be required to address many of the constraints. As discussed below, development assistance and mechanisms for monitoring impacts can help ensure

reforms are implemented in an effective and equitable manner. Trade agreements can help by providing focal points, but a precondition is that policies and assistance (investments) are directed towards national priorities, and that meaningful *new* market access opportunities are created.

#### 4. POSSIBLE ELEMENTS OF AN “ACTION PLAN”

Assuming the objective of the ENP is to maximize the development impact of cooperation offered by the EU, an “Action Plan” is likely to include a focus on market access, pro-competitive regulation, and measures to improve the domestic investment climate.

Concretely, for purposes of discussions the following could be considered:

- Full opening of the EU market for agricultural exports from MENA partners. The US has shown that this is possible—agriculture is included in its recent FTAs with Australia and Central America.
- Removal of the threat of contingent protection in the EU market. An example to emulate here is the Canada-Chile FTA which abolished the reach of this instrument on bilateral trade flows.
- Reciprocal liberalization of trade and investment in service industries, including a substantial expansion in access to the EU market through mode 4 (temporary movement of service providers).
- Implementation of market access opening on a MFN basis by partner countries, to enhance the gains from trade and reduce trade diversion costs.
- Actions to lower the prevalence and incidence of nontariff barriers to trade (NTBs) in both the EU and MENA partners.
- Bolstering domestic institutions to enhance the contestability of markets and to address market failures.
- Improving general economic policies that are ‘domestic’ in nature (in that there are few if any direct international spillovers associated with the policies—i.e., the EU is not affected). The agenda here revolves around the business environment— such as the legal regime, company law, private sector development and labor market regulations—and the supply-side issues noted above (e.g., infrastructure, finance).

##### ***4.1 Market Access Objectives and Instruments: Hard vs. Soft***

Experience suggests that stable, certain market access requires hard law—binding reciprocal commitments. The EU and the Mediterranean countries have already embarked down that path through the EMP. Additional access to agricultural and services markets will also need to be locked in through a binding and enforceable treaty instrument. This is needed for both MENA and the EU as there is strong domestic political opposition to liberalization in what are deemed to be sensitive industries.

*Agriculture.* Liberalizing access to the EU market is a key potential source of gain for Mediterranean partners (and EU consumers). As noted above, in 2004 an agreement was reached in principle to liberalize trade in agriculture on a reciprocal basis. This would appear to allow emulation of the recent US FTAs with Australia and Central America, which cover virtually all agricultural products—although transition periods for the most sensitive items are very long (up to 20 years). There is a danger for Mediterranean producers associated with opening up to EU imports *if* EU production stays subject to production subsidies and external EU barriers remain high. There is a tradeoff between better access to the protected EU market (good for exporters to the EU) and artificially low prices of imports (which benefits Mediterranean consumers, but hurts the Mediterranean producers of the commodities involved). Adoption of non-trade distorting support policies by the EU (decoupled income support) is first best for the world as a whole, but not necessarily for partners—preferential access to the distorted market is valuable to their producers, and it is good for consumers to have access to subsidized EU products. However, domestic import-competing farmers may be hurt if a country opens up to the EU while it still offers production subsidies to common agricultural policy (CAP) beneficiaries. This suggests care needs to be taken in the design and sequencing of market opening commitments by partner countries where agricultural products are concerned. In some cases it may make sense for governments to condition opening of specific product markets on multilateral (WTO) commitments by the EU to remove trade-distorting subsidies.

*Antidumping and safeguard threats.* In the past, the approach taken by the EU in this area has been to link deeper integration by partner countries and the removal of contingent protection. Safeguards should not be needed by the EU given the small size of MENA partners and the fact that EU barriers for manufactures have been mostly removed. The premise on antidumping appears to be that in the absence of effective—and common—rules and disciplines on state aids and given continued barriers to trade imposed on EU imports by MENA partners that prevent arbitrage (during the transition period to preferential free trade), the antidumping instrument should not be removed. This is not a very compelling argument, especially given the very weak economic basis for taking actions against “dumped” imports and the rather arbitrary way antidumping tends to be applied.<sup>15</sup> At the least, antidumping should be abolished upon the completion of bilateral free trade. More rapid unilateral removal

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<sup>15</sup> There is a huge literature on this—see e.g., Finger (2002).

of antidumping by the EU would provide a strong signal that integration is seen as a pro-development tool. A similar argument applies to partner countries—suggesting that efforts initially could be directed towards replacing antidumping with a general safeguard mechanism along the lines of Article 19 of the GATT. As noted by Finger (2002), the advantage of the latter is that consideration has to be given to the effects of an action on the economy as a whole, allowing all affected parties—including importers—to be given a voice in any decision.

*Services.* The case for lowering services costs and improving quality in MENA is well-known (Hoekman and Messerlin 2001; Mueller-Jentsch 2004). High service-related costs imply an effective “tax” on other sectors, reduce international competitiveness and are a disincentive for investment across all industries. Regulations restricting entry may not only raise marginal costs of operations, they also result in rents (prices exceeding costs). Consumers and enterprise users pay the price of services policies that restrict competition (Konan and Maskus 2005). MENA countries also have “offensive” interests in improving access to the EU market, especially for mode 4 type of provision.

There are incentives for domestic agents in MENA countries to support services reform, especially in sectors that provide inputs into production/consumption and that affect large segments of the population (e.g., finance, transport, health and education). Reform may be met with political resistance by those that capture the rents associated with barriers to entry and competition, and by workers concerned with the potential loss of not only jobs but also the benefits that are associated with (public sector) employment. Committing to a specific reform path by extending the EMP agreements to services therefore can be helpful. In deciding what and how, a number of questions arise: Where do political economy constraints to autonomous reform presently bind? What can be done through the ENP to address these constraints (issue linkages, aid for adjustment)? How should ENP commitments be structured? And what regulatory preconditions should be satisfied for liberalization of a sector to be feasible/beneficial and have these been met?

While in principle pursuit of market opening through trade agreements can be motivated on the standard political economy grounds (if there is not enough of a domestic constituency to support autonomous reform), there may not be sufficient export interests, or alternatively, these may be concentrated in “sensitive” services sectors—i.e., mode 4. The scope for the EU



to make concessions on mode 4 access is likely to be quite limited given the political sensitivity associated with labor movement and the small size of MENA markets. The latter implies that the EU may find it difficult to make a compelling case that market access gains in MENA partners are “worth” the price of mode 4 “concessions.”<sup>16</sup>

Mobilizing EU groups that attach value to the attainment of development objectives, such as NGOs, may help. However, absent meaningful additional access to the EU, MENA governments will also find it more difficult to argue in favor of own reforms. Absent real progress on services (mode 4), the pressure to move on agriculture will be greater. As discussed below, the experience at the WTO suggests that efforts to link the market access agenda to “deeper integration” of regulatory regimes is unlikely to be effective in mobilizing the political economy forces needed to support additional reforms in MENA economies.

There are also potential downsides of *quid pro quo* market access bargaining insofar as partner countries are already pursuing unilateral services reforms—driven by a desire to improve international competitiveness. Putting bilateral or regional services opening on the negotiating table may slow down desirable reforms if governments perceive more open markets as a bargaining chip. To date the actual *additional* liberalization in PTAs—not just the EMP—has not matched the promise. Fink and Mattoo (2002) note that in the case of telecommunications and financial services, the GATS has in fact achieved a higher level of bound liberalization than that on offer in most PTAs. Thus, making significant progress on services will require serious political engagement on both sides.

In 2005, a framework protocol for negotiations on services was agreed in the EMP context (CEC 2005b). This envisages employing the GATS structure, i.e., a positive list approach to determining the sectoral and substantive coverage of commitments. The objective is that negotiated commitments will apply on a regional (Euro-Mediterranean) “MFN” basis—i.e., parties will undertake not to discriminate among the countries that have EMP agreements with the EU, but may do against other countries. The protocol also calls for “progressive alignment” with the *Acquis* in the area of services. This is consistent with the ENP if interpreted as allowing for a differentiated adoption of EU laws on services; however,

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<sup>16</sup> Of course, this ignores the economics of mode 4—which is likely to benefit both sides—and the history of migration into the EU from the region. However, recent EU debates and developments—in particular the furor around the Services Directive and the No vote on the draft EU constitution in France and the Netherlands do not suggest optimism is in order.

the language also can be interpreted as a hard harmonization goal, to be reached over time (progressively).

An obvious question is what parts of the *Acquis* provide a good focal point for domestic reforms in MENA countries, and in what areas adoption of the *Acquis* (harmonization or approximation of laws) is a precondition for contesting the EU market. As the *Acquis* on services and related policies (investment, labor markets, and social policy) is far-reaching, it is beyond the scope of this paper to go through all of the relevant areas—that is something that needs to be done at the country level. Given the magnitude of the task, there are economies of scale—undertaking a common assessment of what exactly the *Acquis* means in terms of requirements and the likely implications for implementing institutions is a task that can be undertaken jointly by all Mediterranean partners.<sup>17</sup>

The protocol envisages *reciprocal* liberalization on a regional MFN basis. As discussed above, it is an open question whether the traditional mercantilist dynamics that drive such negotiations will work in services. A process that emphasizes the benefits of changes in policies and focuses on exploring alternative options and that provides more credible assurances that adjustment costs will be taken seriously—through assistance and income support, for example—may well be more productive in the medium run than an emphasis on harmonization of the EU model. This is not to say much of the *Acquis* is not relevant or valuable, just that this needs to be assessed on a case-by-case basis. This may have implications for the achievement of the regional MFN objective, but only insofar as adoption of common regulatory standards is a precondition for being able to contest a market. Determining where this is the case should therefore be assessed and analyzed.

A positive list approach to scheduling commitments has the advantage of allowing flexibility in terms of what sectors to include and what types of commitments to make. A major disadvantage is that it generates only limited transparency of policy. Governments are only required to list those areas where they make commitments—traders and investors will not be able to discern from the schedules what policies apply in sectors, modes and activities that are not scheduled. A positive list type scheduling approach would usefully be supplemented by a comprehensive documentation (listing) of all applicable policies across all

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<sup>17</sup> There is an ongoing project under the auspices of the Economic Research Forum (ERF) network led by Professor Subidey Togan of Bilkent University to undertake such an exercise for a number of Mediterranean countries.

services sectors and modes of supply. This will generate a substantial increase in transparency, and facilitate efforts to assess the effects of the status quo policy set. A negative list approach to determining the coverage of a trade agreement—as was done in NAFTA—automatically generates such transparency: exceptions to the rule (e.g., market access, national treatment) must be listed. The end result in policy terms of a negative list may be the same as a positive list—as countries will exclude “sensitive” sectors and activities under either approach—but transparency is much greater. Given uncertainty regarding the complementary actions that may be needed to support market opening, including in the area of regulation for efficiency or equity reasons, there is much to be said for a positive list approach. However, the proposed parallel transparency exercise would greatly enhance the value of regional cooperation on services.

Indeed, this could be the basis—a concrete product—of an ENP services monitoring and policy dialogue/assessment body. Such a body could be tasked with both the “translation” of the *Acquis* in economic policy terms for MENA countries, and provide a forum to discuss the results of the negative list transparency exercise for MENA countries' own services-related policies. The work of any such ENP body should be open to participation by—and draw on inputs from—independent regional think tanks and research entities that have both an interest in improving economic policy in the region and the requisite analytical capacity. An alternative model would involve a central secretariat to support the work of the proposed body. In practice, a combination of the two models might be most effective—an independent regional “hub” institution that provides research support to a network of national think tanks and governments and works with them to provide the analysis that feeds into the deliberations of ENP bodies (e.g., working groups, technical committees). Given the public good nature of knowledge and research, and the importance of full independence from political pressures such a regional “hub” institution should have financial independence—ideally through an upfront endowment that is sufficient to cover set-up and core running costs. Covering core costs will allow a dedicated focus on supporting the objective of identifying good policies and monitoring impacts. Absent such core funding, any think tank-type institution will (have to) focus on survival, which will almost invariably imply competing for consultancy contracts as opposed to providing a public good.

*NTBs.* The focus in the EMP has been on harmonization in areas such as customs administration and product standards. In part, this will be a necessary condition for access to

EU—providing assurance that rules of origin have been met and that goods meet EU standards. Domestic regulations (NTBs) can segment markets (impede foreign firms from competing with national ones) either intentionally or as a side effect. For example, administrative requirements may be duplicative or redundant: tax authorities in a MENA country may require data very similar to that demanded by EU customs officials—but in a different format, imposing additional transaction costs (spillovers) on enterprises. Much of the agenda here does not need to revolve around harmonization or ‘approximation’ of laws. A greater priority is information and analysis to identify the costs of the status quo, options that can be explored to satisfy EU regulatory concerns at least (lower) costs, provide such information to affected stakeholders, and monitor progress/performance. This in turn will be facilitated by clear benchmarks and timeframes to attain them so as to increase accountability.

As in the case of services liberalization (and regulation more generally—see below), information and analysis is needed. Progress on removing NTBs will be facilitated if there is a large constituency supporting this objective. Better and widely-disseminated information on the effects of NTBs— such as whether they achieve their purported objective; who pays and how much; are government agencies doing what they promised—can help keep attention focused on the issue. Monitoring of progress on NTBs can be facilitated by indices that capture key aspects of the policies concerned. An example that has developed recently is the overall trade restrictiveness index (OTRI) (World Bank and IMF 2005). This allows the conversion of NTBs into a uniform tariff equivalent. With regular monitoring of the incidence of NTBs, and thus changes over time, the OTRI is one way of distilling progress (or the lack thereof) into one number. Currently, regular updating and tracking of NTBs does not occur, making it impossible to use the methodology for monitoring purposes.

A complement to a more regular monitoring exercise is to consider strengthening mechanisms to address NTB-related constraints to market access. As mentioned previously, the dispute settlement and enforcement dimensions of the EMP agreements are largely diplomatic in nature, although there are provisions for (state-to-state) arbitration. Institutions such as an “ENP Ombudsman,” an ENP “small claims court” (Nordström 2005), or a fast-track, “light” dispute settlement procedure might be considered as vehicles to provide the private sector with direct and rapid channels to raise purported instances where NTBs are being applied excessively strictly, arbitrarily, and so forth. Ideally such mechanisms would be

less focused on a legalistic approach—determining who is “right”—and more on problem-solving.

*Non-discrimination.* Application of market access liberalization reforms by MENA countries on a MFN basis would be beneficial to these countries themselves and to the rest of the world. The EU’s Mediterranean partners have already committed to completely remove all tariffs on imports of manufactures from the EU. While it would arguably have been better to pursue MFN-based liberalization, without necessarily moving to zero duties—e.g., target a 5 percent uniform tariff—this is not permitted by current WTO rules. Thus, MENA partners will need to pursue this on a unilateral basis and/or through the WTO. The EU can support the extension of ENP reforms on a nondiscriminatory basis by MENA countries by offering assistance to deal with the associated adjustment costs and helping to prepare industries for greater competition. To some extent, current EU assistance is already doing that; what is lacking is strong advocacy for the extension of liberalization on a MFN basis.

One option that could be considered, as far as trade in goods is concerned, is to revisit the discriminatory liberalization commitments that have been made to the EU if they are linked to MFN reforms. Given that Article 24 of the GATT is largely a dead letter for practical purposes (Mavroidis 2005)—and that none of the EMP agreements have ever been approved or rejected by the WTO Committee on Regional Trade Agreements—the political downsides of reopening the FTA commitments may not be that large. Thus, options are not completely off the table if there is willingness on the part of the Euro-Mediterranean partners to push the WTO envelope and seek to revisit the language of Article 24 of the GATT (and Article 5 of the GATS). Doing so can be defended on the basis of development arguments. The downside is that this approach precludes integration into the EU Single Market, and thus also the abolition of instruments of contingent protection. A better solution is therefore to continue to lower external trade barriers against the rest of the world in parallel with the implementation of the EMP agreement. Multilateral, MFN-based liberalization that involves a move to more uniform, non-zero tariffs is likely to produce *larger* gains than preferential liberalization that entails removing all tariffs on only a small subset of trading partners. Multilateral liberalization opens the market to the largest number of competitors and gives consumers maximum choice. It also leads to a less complex policy regime than a preferential arrangement, implying lower administration costs for the government and lower transactions costs for the private sector.

The same line of reasoning applies to services—with the major difference that there is no need to reopen past deals as there are none. The focus on regional MFN in the protocol is better than a purely bilateral one, but far from first best. Services policy reform and market opening is much better pursued on a MFN basis, for the same reasons as for trade in goods.

#### ***4.2 Pro-Competitive Domestic Regulation***

In an environment characterized by limited competition in key network services industries—energy, telecom, transport—a weak financial sector, and extensive cross-subsidization and transfers, trade liberalization needs to be complemented by measures to harden budget constraints. Pro-competitive regulation can play a major role here. Much of this agenda is covered by the *Acquis*—e.g., disciplines on state aids, competition policy, and incentives for investment—as such policies (or their absence) may affect market access. Whether EU disciplines are appropriate should be determined on a case-by-case basis, bearing in mind that they stress market access issues (the externalities implied by national policies in these areas). The need for measures to expand competition is clear-cut. The limited stock of inward FDI in the Middle East is in striking contrast to the situation in Central and Eastern European (CEE) countries: foreign investors either perceive the attractiveness of locating in MENA to be limited or perceive the barriers to FDI as prohibitive. In practice, the answer is likely to be a mix of these two factors. A long history of red tape, state intervention, limited and slow privatization, and a high-cost services environment will lower the interest of an investor, especially in light of the fact that the CEE countries now offer an alternative location.

Administrative barriers to FDI, monopoly provision of services, state-owned enterprises, and slow privatization all reflect political decisions. The question is to what extent the ENP can assist countries in pursuing a pro-competitive regulatory agenda to support market opening. As noted, there is much in the *Acquis* that relates directly to pro-competitive regulation, but the focus of EU rules in this area is on policies (or the lack of policies) that may impede the realization of a single integrated market and constrain the use of policies that may segment markets and generate negative spillovers.

An effective, general competition authority to discipline enterprises, including dominant public firms, can have high payoffs. However, the Turkish experience suggests that even in a context of possible accession, progress can be slow. One reason for this is that a key requirement (precondition) for sectors such as network services industries or the financial sector is appropriate

regulation to ensure efficiency, to guard against systemic risks, and to achieve social or equity objectives (e.g., universal service obligations). Thus, competition needs to be balanced by other concerns—there is tension between the need for competition and market disciplines and government policies to address market failures.

A solution that is increasingly proposed in the context of trade agreements is greater “policy flexibility”—see e.g., Rodriguez-Clare (2004), Rodrik (2004), Hoekman (2005). The rationales for intervention vary, and may include coordination failures, the need to assist firms to “discover” what activities are profitable and external effects. Although the case for trade policies to address such market failures is very weak, what types of domestic policies might be most appropriate and effective may not be obvious, suggesting that experimentation and learning should be encouraged (Rodrik 2004). The challenge—illustrated repeatedly over time and across countries—is “government failure”: getting interventions wrong and not being able to end support due to a lack of credible exit mechanisms (i.e., capture by rent-seeking groups) (Noland and Pack 2003). International cooperation (trade agreements) potentially can help by creating institutional mechanisms to help identify effective and efficient (good) policies to attain specific goals, and by increasing the transparency of policies and their effects (outcomes) through joint monitoring.

Regular formal interactions on trade and related policies could provide a framework for assisting governments to assess whether instruments are achieving stated objectives. If made public and disseminated effectively in the countries concerned, the results and findings may help to increase the public profile and understanding of the benefits and costs of the specific policies concerned. An enabling-cum-consultation-cum-transparency mechanism could also help improve communication between the development and trade communities. The background analysis and discussions could help identify where development organizations (EU, bilateral, multilateral) might help governments attain their objectives.

The implication of the foregoing argument is that there is a presumption that MENA countries should not necessarily adopt the *Acquis* in this area “as is.” Although much of the *Acquis* arguably makes sense from an economic perspective, it is premised on the existence of functioning markets and complementary (regulatory) institutions. The type of tension alluded to above between pro-competitive regulation and the perceived need for governments to intervene to address market failures or achieve equity objectives apply to the EU as much as

to the MENA countries. The EU makes allowance for regional development aid programs, such as support for R&D and SMEs. It may well be that this is also appropriate in MENA countries, but this is something that needs to be assessed on a country-by-country basis, as is the case when it comes to the regulatory *Acquis*.

A necessary condition for undertaking binding commitments in a regulatory area, whether motivated by international spillovers (market access) or domestic political economy objectives or constraints, is experience with the policy. Countries need to be “comfortable” with an issue and knowledgeable about the implications of proposed rule-making. One lesson that can be drawn from the discussion in the WTO on competition policy disciplines is that this minimum comfort level often did not exist (Hoekman and Saggi 2004). Mechanisms such as those involving voluntary exchange of information and peer review may be a precondition for governments (stakeholders) to identify where formal cooperation (rules) is beneficial. In the WTO context, one result of the failed effort to launch negotiations was a strengthening of voluntary fora for cooperation. An example is the International Competition Network—a forum for competition enforcers and lawyers to collaborate on guidelines for, and assessments of, national competition regimes. Similar bodies could be envisaged as a first step towards determining what parts of the *Acquis* to adopt.

Such voluntary international cooperation may help improve domestic policies and performance. It can also help generate information on the size and distribution of the costs and benefits of the status quo and reduce the uncertainty regarding the possible repercussions of a subsequent engagement to undertake binding commitments. Mention was made above of the weaknesses of data on NTBs. The lacunae are an order of magnitude greater for competition policy. To what extent are markets contestable? How large are barriers to entry, sunk costs, etc.? What type of merger control and approach to vertical restraints make sense? The acid test for the inclusion of binding disciplines on regulatory issues in trade agreements is whether benefits outweigh costs. Formal mechanisms to exchange information on good practices and develop rules of thumb for pro-competitive regulation may be more effective from a development perspective by enhancing the ultimate ownership of the specific norms that are adopted.



### ***4.3 Other Forms of Domestic Regulation***

The same types of arguments apply to regulatory harmonization that is not focused on the functioning of markets (conditions of competition). Much of what is in the *Acquis* may be useful and constitute a good focal point for domestic reform. But this will need to be determined on a case-by-case basis, calling for the same type of analysis, *ex ante* and *ex post*, as proposed earlier for other areas. Given that (by definition) the rationale for cooperation (harmonization) in these cases is not to address possible international negative spillovers, the rationale for negotiating hard rules and disciplines in a trade agreement format must be premised on the existence of significant *domestic* political economy problems that impede unilateral action in the area concerned. However, incentives for international enforcement will be weak if there are no spillovers, implying that in such cases a key element of the agenda must be the establishment of *domestic* enforcement mechanisms. The argument that a particular set of policies is important for “development” and should therefore be covered in a binding agreement is not compelling. Virtually any policy domain can be argued to be important for development. In practice, a mix of hard and soft law options may be most appropriate. In the case of the latter, it is important to ensure accountability of governments through effective analysis, monitoring and feedback mechanisms.

### ***4.4 Financial/Technical Cooperation and Integration***

Effective development assistance (aid) can do much to help maximize the benefits from both hard and soft law forms of cooperation. In both cases there will be investments needed to strengthen relevant institutions, build capacity and undertake both the up front and *ex post* analysis called for in previous sections. This requires identifying needs and prioritizing them. A major lesson of experience with projects and programs in the trade area (and most others) is that country ownership and leadership at the highest levels are critical factors in ensuring concrete and sustained follow-up in removing constraints to trade expansion. The “flexibility-cum-enabling” mechanisms proposed above could help mobilize this by identifying where specific investments are likely to be needed, but will need to be complemented by a comprehensive diagnostic analysis of factors constraining supply responses and reducing competitiveness. As argued previously, such diagnostics should feed into (inform) the process through which countries determine public investment allocations and policy reform priorities. In many low-income countries this process increasingly centers on Poverty Reduction

Strategy Papers, which form the basis for the provision of donor assistance at the country level. A similar approach could be applied to MENA countries.

As discussed at greater length by Prowse (2005), trade-related funding should be allocated within the context of an overall country development program and an agreed macroeconomic policy framework. To some extent this is recognized in the ENP framework, as assistance will be tied in part to implementation of the Action Plan. Thus, the Action Plan must be consistent and integrated with the country's national development strategy. An implication is that it would be desirable to integrate ENP-linked resources into the evolving multilateral mechanisms used to assist developing countries to integrate into the world economy. As a development tool stand-alone specific funds and associated mechanisms are less likely to be effective than integrating the prioritization and resource allocation process into national poverty reduction and development strategies. After all, there is (should be) only one national trade agenda. Technical and financial assistance should be managed accordingly.

## **5. CONCLUDING REMARKS**

Among other things, the EMP (Barcelona Process) provided an opportunity for Mediterranean countries to credibly pursue far-reaching preferential trade liberalization in a gradual fashion. Results to date have been limited, in part because implementation in many countries has yet to bite. The potential of the EMP to promote growth and economic development is limited by the rather narrow scope of the agreements—liberalization is restricted to non-agricultural merchandise trade—and the fact that MENA liberalization will be discriminatory, i.e., in favor of the EU (and other Arab countries), not the rest of the world. The extensive provisions for technical cooperation to improve and align regulatory procedures with those of the EU in areas such as customs clearance and product standards were probably beneficial in reducing transactions costs associated with trade. However, it is not possible to say with confidence what the contribution of the EMP has been in this area.

The recent literature evaluating alternative explanations for the success of countries in attaining and sustaining high rates of economic growth concludes that openness to the world economy is very important, but in itself is not enough. Equally important are an efficient public sector, domestic competition, a well-functioning service sector (i.e., finance, infrastructure and distribution), an educated population, high rates of private saving and investment, a stable macro-economy, and so forth. Most of these factors could not be

“imported” through the EMP; this remains the case under the ENP. However, the ENP offers great potential to assist governments to put in place better policies and strengthen domestic institutions to help achieve some of these desirable outcomes. In part, this will involve better access to key EU markets (agriculture and services) and in part leveraging the ENP “menu” to move forward in improving the investment climate.

The extent to which this potential is realized depends on decisions and political will on the part of both the EU and MENA partners. The EU will need to accept granting meaningful additional access to its markets—especially for agricultural products and services (mode 4). This will require a *quid pro quo* by MENA countries. In practice it is likely that the realization of market access is best pursued through hard agreements—binding and enforceable commitments. Opening access to MENA markets will be beneficial, although account must be taken of the adjustment costs that will result. In the case of agriculture, care is needed to ensure that the net outcome of reciprocity is positive, something that will depend on the extent to which EU farm output continues to benefit from subsidies. In the case of services, it will be necessary to ensure that the regulatory environment and implementing institutions are adequate to achieve both equity and efficiency objectives. Here the EU *Acquis* can be helpful as a focal point.

A case was made above that given uncertainty regarding the desirable form/content of regulation, an ENP “enabling” mechanism could be considered that focuses on helping MENA governments and constituencies determine when the *Acquis* is going to be beneficial/useful, what complementary actions and investments are needed, and generating information on the impact of policies. It is a commonplace that there is no “one size fits all” when it comes to regulation. An innovation that could be pursued by the ENP would be to stress and actively support a “learning” process among the relevant communities and constituencies in MENA countries—regulators, government bodies, the private sector and NGOs. This should focus on sharing experiences and trying to identify what are good practices and policies that might be used to pursue specific development objectives. Rather than focus predominantly on negotiation and implementation of commitments, this would involve constructive engagement that focuses on the achievement of the joint objective: economic growth and development. This should not be too difficult to put in place given the limited emphasis that has been put on enforcement of EMP agreements to date. The diplomatic dispute settlement/enforcement mechanisms that are foreseen by the EMP can be

adapted relatively easily to this approach. Note that the objective should not be to reduce the accountability of governments for outcomes—on the contrary. A weakness of the status quo is that there is not enough accountability—in part the result of limited information, analysis and monitoring of economic impacts.

A specific proposal made in this paper is to establish an independent regional institution that would form the hub of a network of national think tanks and institutes. Such an institution could help fill the gap that exists and that has become much more important to fill with the creation of the ENP. To benefit fully from the ENP, countries must have a clear strategy and identify what elements of that strategy can and should be addressed through the ENP Action Plan. To ensure that implementation of the Action Plan is hitting the desired targets, there must be rigorous, independent *ex post* impact evaluation. To define priorities, up front analysis of the status quo is needed. What do current policies do—who benefits and who pays the price? What are the major constraints that would give the biggest immediate return if addressed? What types of policies and investments are needed to resolve a problem? What flanking measures are needed to address adjustment costs? All of these types of questions, as well as monitoring and assessing outcomes can and should be part of the mandate of civil society groups to address. But factual, objective analysis is a critical input into this process. Government agencies or the EU Commission cannot deliver this, as they are principals in the process.<sup>18</sup> This is one area where a relative small sum of money would have very high social returns—the income from an endowment of €50 million would cover the fixed costs of the proposed regional “hub” research institution.

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<sup>18</sup> Formally, the Commission is also an agent in that it represents the 25 member states, but in practice it is better seen as a principal for monitoring and accountability purposes.

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