**The Economics and Politics of Arab Economic Integration**

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## Abstract

Despite repeated attempts at regional integration for half a century, Arab economic relations remain limited and compare unfavorably with other regional blocks. This paper attempts to identify the objective reasons for the slow progress on Arab integration in the past, with a view to offering suggestions for a better future.

It shows that a lack of both economic and political incentives for integration is responsible for the slow progress of Arab integration to date. More specifically, it identifies five main reasons for these limited results: low degree of complementarity among Arab countries; low level of openness; weak private sector role, unwillingness of political leaders to integrate; shortage of commitment institutions, in particular the absence of mechanisms to compensate the losers; and finally the lack of consensus on one state or more to act as a regional leader or leaders.

Looking forward, the paper argues that the future of Arab economic integration seems promising. This view is based on the more favorable internal and external economic circumstances prevailing currently, and on some positive political changes as well. It also shows that without simultaneous efforts to address the still existing barriers and new challenges, Arab integration would remain a hope rather than a reality.

## ملخص

على الرغم من المحاولات المتكررة لتحقيق الاندماج الاقتصادي العربي على مدار نصف قرن تقريبا، إلا أن العلاقات الاقتصادية العربية لا تزال محدودة نسبيا، كما أنها أيضا لا تقارن بما تم إنجازه على صعيد التكتلات الإقليمية الأخرى. وتحاول هذه الدراسة تحديد أسباب بطء مسيرة الاندماج العربي بغية تقديم مقترحات من شأنها تحقيق تقدم ملموس في تلك المسيرة مستقبلا.

وترجع الورقة تباطؤ مسيرة الاندماج العربي إلى نقص الحوافز الاقتصادية والسياسية، محددة خمسة أسباب رئيسية مسؤولة عن النتائج المحدودة التي تحققت حتى الآن، وهي: ضعف درجة التكامل بين الدول العربية؛ انخفاض مستوى الانفتاح والتحرير؛ ضعف دور القطاع الخاص؛ غياب الرغبة والإرادة لدى القيادات السياسية للاندماج؛ عدم وجود مؤسسات إقليمية قادرة على وضع وتنفيذ ومراقبة مشروع الاندماج العربي، وبالأخص غياب آليات لتعويض الخاسرين من عملية الاندماج؛ وأخيرا، عدم التوصل إلى إجماع على ضرورة قبول القيادات السياسية أن يتولى قطر أو أكثر من المجموعة الإقليمية دور الزعامة.

واستشرافا للمستقبل، ترى الدراسة أن مستقبل الاندماج الاقتصادي العربي يبدو واعدا، وتستند هذه الرؤية إلى التحسن الذي تشهده الظروف الاقتصادية حاليا على المستويين الداخلي والخارجي، وكذلك إلى التغييرات السياسية الإيجابية التي تحققت مؤخرا في بعض البلدان. وفي النهاية، تؤكد الدراسة أنه بدون القضاء على القيود الحالية والتغلب على ما يستجد من تحديات، سيظل مشروع الاندماج العربي مجرد "أمل".

*The inability to mobilize the considerable collective human and material resources of a "nation" of more than 200 million people accounts in part for the powerlessness which is the fundamental problem facing the Arabs today.*
*(Edward Said, 1996)*

## I. Introduction

Anyone who has a fair knowledge of the Arab region would realize that the notion of Pan-Arab unity has long been central to Arab culture and history. The Arabs were also among the pioneers calling for regional integration in the early fifties.

However, despite repeated attempts at regional integration for half a century, Arab economic relations remain limited and compare unfavorably with other regional blocks. While regionalism has gained momentum all over the world, Arab regional integration remains merely a " Project". However, this state of affairs is inconsistent with the findings of a number of studies, which show that integration among Arab countries could have positive welfare gains (Hoekman, et al., 1998; Galal and Hoekman, 1997; Konan and Maskus, 1997). It is important, therefore, to explore the reasons for the limited progress to date, in order to determine whether the future will be any different.

This paper aims to identify the most likely reasons behind the slow progress of Arab integration in the past, with a view to offering suggestions for a way forward. More specifically, the paper addresses the following questions: What are the economic and political factors that have stood in the way of integration up until now? How did other regions overcome similar problems? Finally, how can the Arab countries ensure a more promising future for their integration project?

To answer these questions, the paper draws on the economic and political literature on regional integration. The main proposition underlying the analysis is that two sets of conditions must be satisfied for regional arrangements to succeed, namely, the economic and political incentives to integrate. Any economic analysis of regional integration that ignores the political and institutional elements, risks being irrelevant as regional economic integration takes place in a particular political and institutional setting. Similarly, a political analysis that omits the economics of regional integration is misleading. Without a multidisciplinary approach, the study may be ill defined and the analysis may lead to vague policy recommendations (Escribano, 2000; Mattli, 2000).

The Economic incentives are based on insights provided by the standard customs union theory and new regional integration theory (Viner, 1950; Lawrence, 1997; De Melo and Panagaryia, 1993). According to these theories, countries are motivated to integrate if integration is welfare enhancing, or in other words, if it is associated with static and dynamic gains. Political incentives to integrate materialize when political leaders show willingness to integrate and are able to provide the necessary institutions to sustain integration. It is also essential that they accept that one or more members from within the group must play the role of regional leader. Such regional leadership can serve as a focal point in the coordination of rules and policies, and may also help ease distributional problems. (Haas, 1968; Moravcisk, 1991).

In exploring the applicability of the above theoretical framework to the Arab region, this paper first reviews the track record of regional integration in the Arab world to date. It then discusses the extent to which the economic and political incentives were aligned with the goals of Arab economic integration. Lastly, it explores future prospects for integration, and offers some concluding remarks.

## II. The Track Record

There has been no shortage of attempts by Arab countries to build cooperation, alliances or integration during the last five decades. However, little has been achieved so far.

### *Extensive Efforts*

At the risk of oversimplification, the period from the end of World War II to the late 1990s witnessed two distinct phases regarding attempts at encouraging inter-Arab economic relations. The first was in the post-independence period, which started after World War II; and the second began with the oil boom in the early seventies. During the first phase, three factors motivated efforts for integration: the establishment of the Arab league in 1945; the United Nations' efforts to promote regional cooperation; and later, the creation of the European Common Market in 1957. These early attempts at Arab regionalism included the Treaty for Joint Defense and Economic Cooperation in the early 1950s. This was followed in 1953 by the Convention for Facilitating Trade and Regulating Trade Transit, and in 1957, by the Arab Economic Unity Agreement. In 1964, there were endeavors to create the Arab Common Market.

Efforts to encourage economic integration during this phase aimed at achieving integration at the regional level relying mainly on trade promotion. While contributing to intra-Arab trade in the 1950s and 1960s, these efforts fell short of meeting the objectives of economic integration. It seems that Arab politicians did not pay enough attention to economics, and focused more on political and military cooperation. Business and commerce were considered the effects, not the causes, of political actions (Sayigh, 1983; Owen 1999).

The second phase, which started with the boom in oil prices in 1973, led to an increase in the flow of capital and labor within the region, and to a lesser extent, an increase in intra-regional trade. The increase in oil revenues coupled with the limited success of economic integration in the first period prompted a search for alternative strategies. The first strategy for integration in the seventies was sought through the establishment of joint projects, with the active involvement of governments. It soon became apparent, however, that this strategy by itself would not achieve economic integration. This gave rise to a strategy of economic integration at the sub-regional level. As a result, the 1980s saw the rise of the Gulf Cooperation Council (GCC), the Arab Cooperation Council (ACC), and the Arab Maghreb Union (AMU) (El Naggar, 1997). A number of observers believed that sub-regional cooperation was more likely to succeed because it involved a smaller number of countries. However, despite the growth of intra-regional trade within these sub-groups, the expansion was limited compared to growth in external trade. It has further been argued that smaller sub-regional groupings may have been partially responsible for delaying the Pan-Arab project (Shafik, 1994).

Because sub-regional blocks did not help much in promoting intra-Arab trade, an attempt to revive Arab integration at the regional level took place in 1981 through the Agreement for Facilitation and Promotion of Intra-Arab Trade. This effort culminated in 1997 in a renewed interest in forming an Arab Free Trade Area (AFTA). Eighteen Arab states joined the executive program of this agreement, which came into effect on January 1, 1998.  This program revived the 1981 Agreement for the Facilitation and Promotion of Intra-Arab Tade. (Zarrouk,1998).

***Poor Harvest***

Notwithstanding these efforts, the outcomes are negligible. Below is a brief review of the development of Arab economic relations in terms of trade and factor movements.

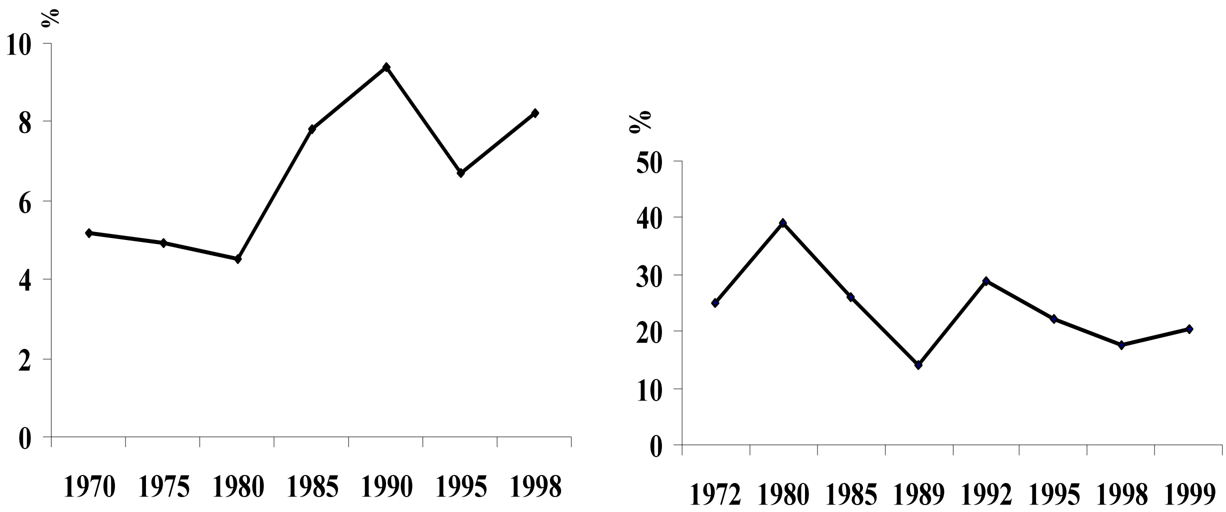
*Intra-Arab Trade*

Figure 1 shows an increase in the share of intra-Arab exports to total exports from 5.2 percent in 1970 to 8.2 percent in 1998. However, the average share of intra-Arab exports to their total exports of nearly 7 percent is far below the corresponding levels in other regions: 60 percent for the EU, 22 percent or ASEAN, and 41 percent for NAFTA (Table 1). Excluding oil exports, the share of intra-Arab, non-oil exports increased to 19 percent on average, a level that is still much lower than the other regional blocks.

**Figure 1. Intra-Arab Exports and Non-oil Intra-Arab Trade**

a. Intra-Arab Exports Share in Total Exports

b. Non-oil Intra-Arab Exports as a Share of Non-oil Arab Total Exports




*Source*: a. IMF, Direction of Trade Statistics Yearbook, several issues.
b. Zarrouk, J. (1992) "Intra-Arab Trade: Determinants and Prospects for Expansion, in El-Naggar, Said(ed.)"Foreign and Intratrade Policies of the Arab Countries, and The Arab League, The Arab Consolidated Economic Report, Several Issues.

To judge whether intra-Arab trade is too limited, Al Atrash and Yousef (2000) used a Gravity Model to compare the actual and potential levels of trade. Their study indicates that both actual intra-Arab trade and Arab exports to the rest of the world are lower than the model predicted. This implies that there is greater trade potential among Arab countries, as well as between Arab countries and the rest of the world than is actually occurring. This finding does not hold across all industries. In fact, Havrylyshyn and Kunzel (1997) and Devlin and Page (1999) showed that despite the low level of intra-regional trade, some sectors such as chemical, iron and steel industries exhibit a high level of intra-industry trade.

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

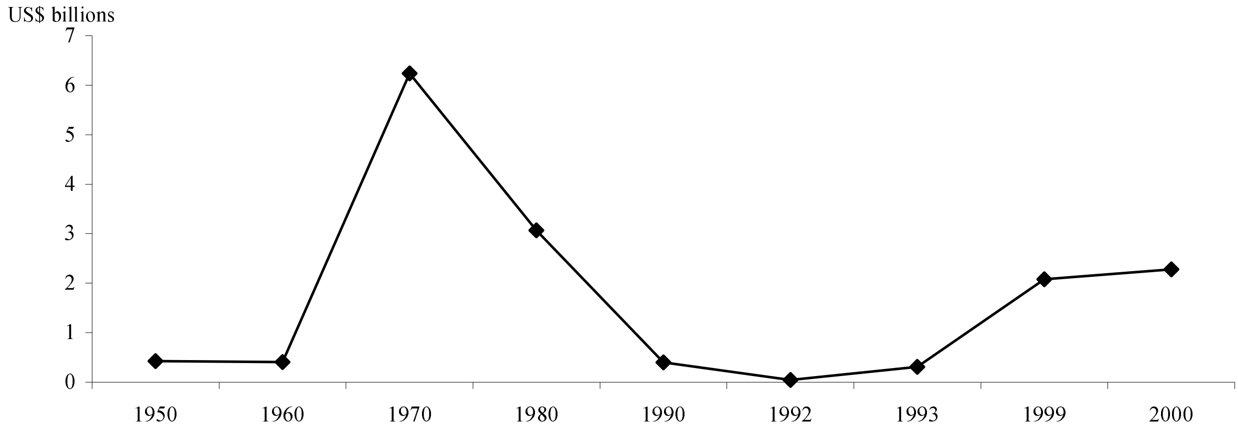
| Regional Block | Intra-Regional Exports As a Share of total Exports | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1970 | 1975 | 1980 | 1985 | 1990 | 1995 | 1998 |
| Arab Countries (AFTA) | 5.2 | 4.9 | 4.5 | 7.8 | 9.4 | 6.7 | 8.2 |
| ASEAN | 19.2 | 21.3 | 22.4 | 20.7 | 20.7 | 26.4 | 22.2 |
| MERCOSUR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

*Source:* IMF, Direction of Trade Statistical Year book, several issues and World Bank, World Development Indicators, CD-Rom, 2001.

*Capital Flows*

Figure 2 shows that intra-Arab capital flows during the period 1950-2000 were very modest, with the exception of the 1970s. Even if we consider the peak period of capital flows in the 1970s, the share of capital flows to oil revenues was only 2 percent. While oil revenues amounted to US$ 279 billion, the total amount of capital flows to the Arab countries did not exceed US$ 6 billion.[1]

**Figure 2. Development of Intra-Arab Private Capital Investments**




*Source:* Al-Monzery (1995).

The low level of intra-Arab capital flows can be traced to a number of factors. The non-existence or underdevelopment of capital markets in the Arab world, and the prohibitive laws and regulations turned many Arab investors to international markets. Non-Arab markets

[1] In four Arab oil exporting countries, namely Saudi Arabia, Kuwait, UAE, and Qatar.

offered a better opportunity to maximize profitability and diversify risk. There is also evidence that excess capital in the region was transferred to foreign banks and financial institutions, with a significant portion invested in gold and silver. El Erian and Fischer (1996) estimated Arab investment outside the region at US$ 350 billion to US$ 600 billion in 1995.

*Labor Mobility*

Labor movement within the region has played a more significant role than intra-regional trade. This is due in part to the fact that obstacles to labor flows have been less severe than those facing trade in goods. This can also be attributed in part to the wide difference in labor endowment across countries. Table 2 shows the share of workers' remittances to GDP in a number of selected countries. It indicates that Jordan, Yemen, Morocco, and Egypt are the biggest suppliers of labor in the region.

Clearly, immigration and its associated capital flows provided a mutually beneficial mechanism for sharing the oil wealth across the region, and for taking advantage of underutilized human resources. However, labor movement did not work as a substitute for greater regional trade for three main reasons. First, labor movements in the Arab region do not enjoy the same degree of mobility found, for example, in the EU, where citizens of one country have the right to work in other countries. Second, the Gulf war and subsequent tensions among Arab countries have led to a reduction in the size of Arab expatriate labor force and hence remittances. Finally, there has been a move in oil rich countries toward replacing Arab immigrants by nationals and cheap labor from Asia, thus weakening an important pillar of Arab integration.

**Table 2.Workers Remittances as a percent of GDP in the Main Labor Suppliers in the Region (%)**

| | 1975 | 1980 | 1985 | 1990 | 1995 | 1999 |
|---|---|---|---|---|---|---|
| Algeria | NA | 1 | 1 | 1 | 3 | 2 |
| Egypt | 3 | 12 | 10 | 9 | 5 | 4 |
| Jordan | 12 | 15 | 20 | 12 | 18 | 21 |
| Morocco | 6 | 6 | 8 | 8 | 6 | 6 |
| Sudan | 2 | 3 | 3 | 1 | NA | NA |
| Tunisia | NA | 4 | 3 | 4 | 4 | 4 |
| Yemen | NA | NA | NA | 32 | 27 | 18 |

*Source:* World Bank (2001a).

To sum up, two observations can be drawn from the above analysis. ***First,*** the pattern of regional integration among Arab countries is quite unusual. In most parts of the world trade in goods acts as the basis for regional integration, while labor mobility usually comes in the final stage. This was observed in Europe, East Asia, and the North American Free Trade Agreement. In contrast, intra-Arab trade was limited, while labor movement has been the most visible element of Arab integration. *Second,* despite remarkable efforts at encouraging economic integration among Arab states, the region remains one of the least integrated in the world in terms of capital and trade flows. Only labor has flowed relatively freely. Therefore, one may argue that the bulk of past efforts seems to have been more focused on drafting agreements and holding summits, rather than on addressing the main barriers to Arab economic integration by trying to create the necessary economic and political incentives. The next section deals with the economic factors behind the limited progress to date**.**

## III. Economic Incentives

Intuitively, one would expect the Arab world to have strong economic incentives to integrate, in view of its rich and diverse factor endowment. The region has a surface of 14 million square kilometers, which is almost equal to that of the EU, and three quarters that of Latin America. It has a population of 5 percent of the world's population. Moreover, the distribution of labor, capital and natural resources is quite uneven. Why then do we observe such a low level of integration? How are economic incentives relevant to answering this question?

The literature on economic incentives has evolved overtime. Traditionally, when most countries were following import substitution strategies with the twin features of protection and state domination, the Customs Union theory focused on the effect of removing tariff barriers on trade promotion, the so-called "static gains". As explained by Viner (1950), the static gains depend on trade creation and trade diversion. Trade creation refers to new trade that can arise from substitution of trade with neighbors for previously produced domestic goods. It implies a shift from a high-cost member to a low-cost member, and hence is welfare enhancing. Trade diversion refers to the geographic shifting of existing trade from a low-cost non-member to a high-cost member, which would affect welfare negatively. Obviously, the desirability of regional integration would depend on the net effect of trade creation and diversion.

In contrast, new explanations of regional integration have evolved at a time when most countries are following more open and outward-oriented strategies, and where the private sector plays the leading role in economic activities. The development of the incentives to integrate regionally resulted in increased emphasis on the potential dynamic gains of integration, which are associated with increased investment, more competition, and productivity improvement (Lawrence, 1977; De Melo and Panagaryia, 1993).

The above gains are neither automatic nor instant. Certain conditions need to be fulfilled to ensure that countries can benefit from regional arrangements, and hence have the motivation to integrate. On the one hand, benefiting from the static gains is more likely when member countries enjoy three conditions. First, their economies have a high degree of complementarity, because this will offer greater room for trade creation. Second, they are large in number because this means a larger market and greater opportunity for trade. Third, they enjoy geographical proximity, because proximity reduces transportation costs, and hence encourages trade. Although, some argue that the telecommunications and communication revolution may reduce the importance of geographic proximity, it does not annul it.

On the other hand, benefiting from the dynamic gains of regional integration requires that countries be more open. Because the lower the tariff barriers, the more intense the competition, the larger the efficiency gains, the lesser the potential for trade diversion, and finally the weaker the opposition to integration. Also, the greater the role played by the private sector, the larger the likely gains. This is because, the more active and dynamic the private sector, the greater the potential for trade promotion, and for forming joint projects. The question is, do Arab countries enjoy both sets of requirements?

***Complementarity among Arab Countries***

Table (3) shows the complementarity index for each Arab country and the rest of the region computed using data from the mid 1990s. The complementarity index measures how well the structure of imports and exports in different countries' match. The value of the index ranges from zero to one hundred. It is zero when goods not exported by one country are imported by the other, and 100 when the export-import shares exactly match. The higher its value, the more likely regional integration is to succeed. Comparing the complementarity index for each Arab country and the rest of the region to those of other regional blocks reveals a very low degree of complementarity among the trade structures of most Arab countries, which is unfavorable for intra-regional trade. This conclusion has been reached by several studies (Al Atrash and Yousef, 2000; Yeats and Francis, 2000). These studies point out that the lack of complementarity among Arab countries was one of the main reasons for the limited trade gains from regional integration because it created a disincentive to integrate.

**Table 3. Arab Countries Trade Complementarity Indices, 1990s**

| Regional Arrangement | Index value | Regional Arrangement | Index value |
|---|---|---|---|
| | **Successful Regional Arrangements** | | |
| European Community (6) | 53.4 | NAFTA | 56.3 |
| | **Unsuccessful Regional Arrangements** | | |
| LAFTA | 22.2 | Andean Pact | 7.4 |
| | **Complementarity between Arab Countries** | | |
| Bahrain & Arab Countries | 17.4 | Libya & Arab Countries | 8.5 |
| Egypt & Arab Countries | 28.0 | Oman & Arab Countries | 25.6 |
| Jordan & Arab Countries | 25.5 | Qatar Arab Countries | 13.6 |
| Kuwait & Arab Countries | 9.6 | Saudi Arabia & Arab Countries | 13.2 |
| Lebanon & Arab Countries | 34.3 | Syria & Arab Countries | 16.8 |
| Yemen & Arab Countries | 5.9 | UAE & Arab Countries | 20.6 |

***Source***: Yeats and Francis (2000).

It is worth mentioning that, according to the classical Heckscher-Ohlin model, the growth of intra-EU trade was not only driven by the high degree of complementarity among EU members as a result of differences in factor endowments. Rather, imperfect competition and product differentiation played an important role (Shafik, 1994). This implies that even with the low level of complementarity among Arab states, there is room for increasing intra-Arab trade if they develop their industrial base and increase diversification and specialization.

***The Large Number of Arab Countries***

Despite the large number of Arab countries and the considerable size of their collective population (270 million), the Arab region's economic size is limited, which may be one of the reasons for the limited progress of Arab cooperation. Added to this, the wide differences in the economic systems and the levels of development across countries impede deeper forms of economic relations even further.

More importantly, the divergence in the levels of development works against deepening economic relations among Arab countries. The differences in per-capita income in the region are over twenty-one fold, with Sudan having the lowest per capita income (US$ 610) and Kuwait the highest (US$ 12,710). This gap reaches only ten-fold and five-fold within the NAFTA and the EU respectively (Shafik, 1994). This wide income gap in the Arab region means that the distribution of the gains and losses from integration would be uneven across countries, thus increasing opposition to integration. At one end, poor countries fear being marginalized. At the other, rich countries, primarily oil producing countries, are not motivated to share their wealth with poor Arab members without assured returns (Alanso-Gamo et al., 1997)

***Geographic Proximity***

Arab countries are geographically close, with most having common borders. Yet, high tariff barriers, the lack of adequate infrastructure and different means of transportation all increase the cost of trade between these countries and erode the comparative advantage of proximity. In contrast, proximity in the cases of the EU and NAFTA, played an important role in activating intra-regional trade, due to non-existent tariffs coupled with the availability of an intensive and diverse network of infrastructure.

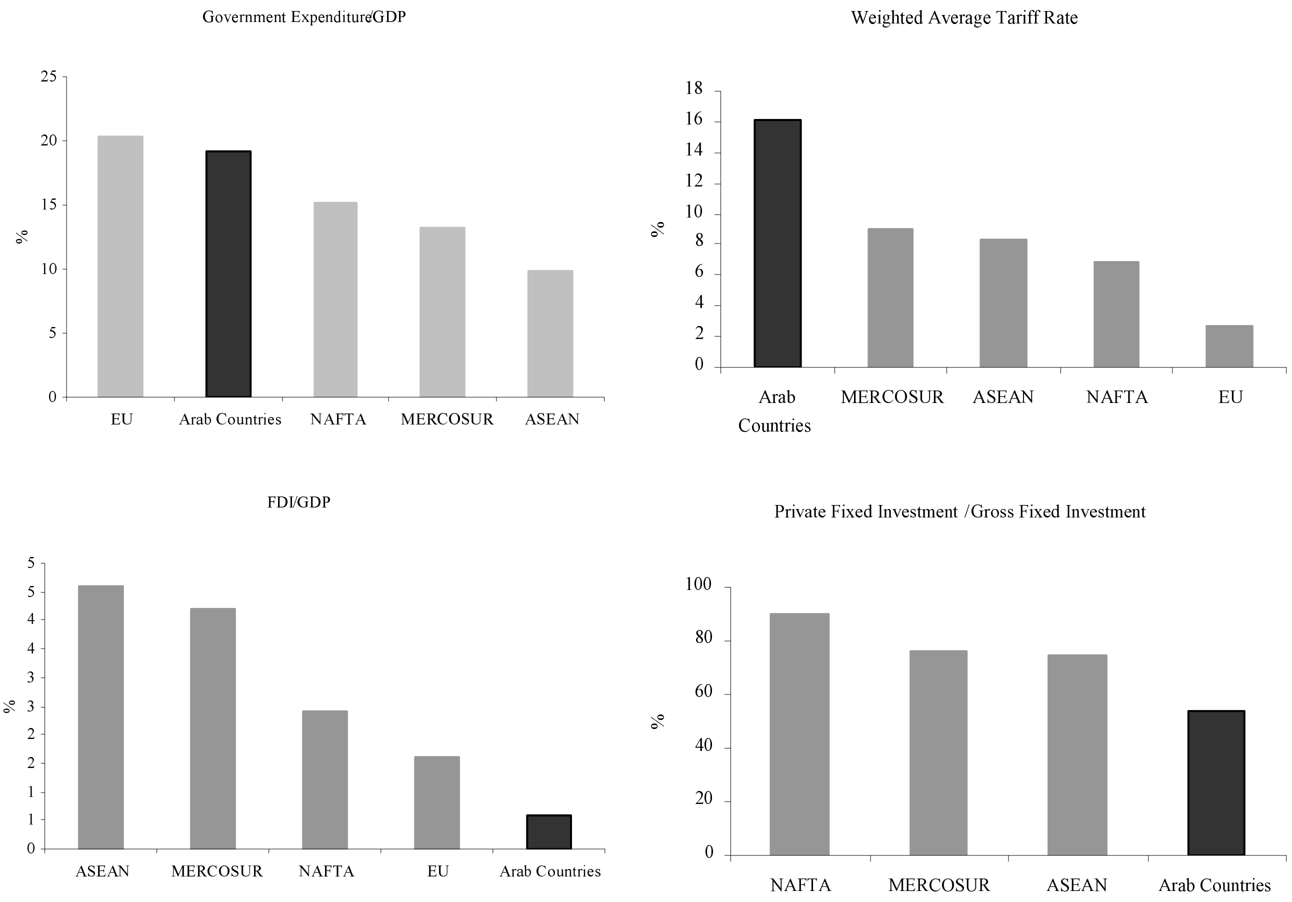
***Openness***

Arab economies are highly protected both in absolute terms and relative to other developing countries. Although most of them have stepped up their liberalization efforts since the mid 1980's through unilateral, multilateral and regional trade agreements, the average tariff for the region remains much higher than that of other regions (Figure 3). Also, non-tariff barriers are extensive in many countries in the region (Zarrouk, 1998). The high level of protection, a legacy of the import substitution strategy pursued following independence in most Arab states, has had important implications. It makes integration undesirable because it means a loss of tariff revenues, which came to be a main source of revenue.[2] Industries, which survived under high walls of protection, are likely to resist integration because they are inefficient. Furthermore, high levels of protection reduce firms' incentive to trade, since profits are often higher in sheltered markets. Finally, exports receive low priority, even with foreign exchange being a scarce commodity (Hoekman, 1995).

In contrast, for both the EU and NAFTA, openness has preceded regionalism. The low level of tariffs meant that trade diversion was minimal under regional agreements. In the EU, tariffs had already been eliminated under the common market agreement in the 1950s and 1960s. Before the NAFTA, average tariffs on Mexican goods entering the US were about 4 percent and were about 10 percent for US goods entering Mexico. In addition, considerable efforts were exerted to eliminate quotas, in both experiences. (Shafik, 1994)

[2] Because Tariffs in most Arab countries account for a sizeable share of government revenue nearly 20 percent on average for the period, governments were reluctant to give up this stable source of financial resources

**Figure 3. Selected Indicators for Arab Countries and Other Regions (Average 1995-99)**




*Source:* World Bank (2001).

### *Private Sector Participation in Economic Activity*

While the review of successful regional blocks illustrates the importance of the private sector in the integration process, the role of the private sector in the Arab world remains limited, and governments continue to dominate economic activity. The large size of the government, measured by the share of government expenditures to GDP, has had the effect of crowding out the private sector (Figure 3). Furthermore, the shortcomings of the institutions and legal framework for investment led to a lack of transparency, high transaction costs, and uncompetitive business sector.

Besides its limited size and weak competitiveness, the private sector may also have found integration within the region unappealing. For example, in most countries the business environment remains less hospitable than elsewhere. Local markets are also more attractive than in neighboring countries, due largely to protection.[3]

In contrast to the absence of business interest in Arab economic integration, private enterprises played an important role in the process of integration in Europe and America (Mattli, 2000). In the EU, private firms supported the Treaty of Rome. A group of Europe's largest firms have helped in revitalizing the integration process in Europe, leading to the Single European Act. Large European firms argued that a fragmented Europe deprives them of the economies of scale they needed to be competitive.

Similarly, in the case of NAFTA, governments brought business into the negotiating process but in a well-designed and clear way. The Government decided that all tariffs will be removed and all quotas will be abolished. The private industries prepared position papers as part of the negotiations that analyzed the timing and sequence of such liberalization. Big business organizations in NAFTA, including the National Association of Manufacturers, the National Retail Federation, the Business Roundtable and the US Council for International Business expressed support for deeper integration, by asking for extending the agreement to encompass various guarantees, for example regarding the availability of foreign exchange, expropriation and dispute settlement (Lawrence, 1996).

Combining all the above elements, it is clear that Arab countries did not have enough economic incentives to seek regional integration. The low degree of openness, low level of complementarity, and limited role of the private sector are the main reasons for the disincentives to integrate. But, economics is not the only driving force for integration, politics is just as important. The next section deals with the political side of integration.

## IV. Political Incentives

This section examines whether the political incentives work in favor or against Arab economic integration. More specifically, it attempts to answer the following question: Is the lack of political incentives one of the reasons that prevented economic integration among the Arab countries?

[3] Furthermore, several studies have shown that many factors were at work to reinforce the slow progress of Arab integration. One was the debt crisis that hit a number of Arab countries during the 1980s as a result of falling oil prices. This hit Egypt and Jordan particularly badly as they relied heavily on Arab aid, and migrant remittances (Owen,1999).

According to the political science literature on economic integration, three main conditions are necessary for integration to materialize (Haas, 1968; Moravcisk, 1991). First, political leaders must be willing to integrate. Second, they should be able to provide an effective regional institutional set-up to resolve any problems that may accompany integration. Finally, they must accept voluntarily that one or more members of the group will act as regional leader or leaders. These three conditions are explained below.

*Political leaders must be willing to integrate*. Leaders' willingness to integrate requires that the potential benefits, in terms of retaining political power or improving re-election chances, are more than the expected costs of integration. In other words, political leaders are likely to encourage integration if it enhances their legitimacy without too much loss of sovereignty.

*Political leaders should be able to provide an effective regional institutional set-up*. This condition is met when the leaders are able to establish supra-national regional rules, policies and organizations that are responsible for formulating and monitoring policies, as well as resolving disputes**.** The main mandate of such regional institutions would be to pursue integration, mobilize the support of different countries and ensure the enforcement of the regional rules.

*Political leaders must accept voluntarily that one or more members of the group will act as regional leader or leaders*. Regional integration schemes may go beyond the removal of border barriers (shallow integration) and may include efforts to adopt common regulations and policies (deep integration) such as common rules of origin, common commercial policies, and common investment codes. These requirements often give rise to coordination problems, especially when states have conflicting interests and views about the appropriate course of action. The best solution for this problem is to agree on the leadership of one state or more, whose membership is or are perceived to be important for the agreement to stand. The leader or leaders can serve as a focal point in the coordination of rules, regulations and policies. This focal point can also help ease the distributional tensions through side-payments, for example.

Available evidence supports this theoretical framework. Countries that successfully integrated satisfied these three conditions. Therefore, it seems plausible to attribute the slow progress of Arab integration to the lack of all three conditions. This is explored below.

***Political Will***

The decision to integrate implies by itself a sacrifice of a certain degree of political autonomy. Therefore, for integration to be politically desirable, its potential benefits to the leadership and its constituencies, in terms of retaining political power or increasing the chances of re-election, must outweigh its expected costs. In the Arab region, it seems that the benefits of integration are likely to be less than the costs. In the case of the benefits, the economic gains associated with integration are likely to be relatively small, which may explain partially why leaders were not so eager to integrate. This differs from what took place in the EU and NAFTA, where the leaders saw the economic gains to be significant. For example, the European countries adopted the Single European Act in response to slow European economic growth in the early 1980s. Similarly, Canada and Mexico turned to the United States when their economies were in trouble (Mattli, 2000). More importantly, as Escribano (2000) points out, because most of the Arab leaders are not freely elected, they do not necessarily see the integration welfare gains, if any, as the main way to stay in power.

As for the expected costs, the fear of losing sovereignty is considered the main obstacle to integration. According to Hudson (1999) and Sayigh (1999), the political ruling elites in the Arab world with their vested interest in maintaining their influence within individual states were less than supportive of integration projects. This delay in the pursuit of economic integration is often derived from the conviction that to be effective, economic integration must be accompanied, sooner or later by political integration. For the elite this would mean losing their privileged position as a class. [4]

Another important explanation for the high cost of integration is that integration often leads, in the short and medium terms, to some transitional costs, which could result in social pressures that are too costly from a political point of view. Tariff cuts, widening external imbalances, downsizing of import substitution industries, and rising unemployment, are some examples of the costs of adjustment. Although in the long run benefits may outweigh short run costs, it seems that the long term may prove longer than politicians are willing to admit. This is true in all regional experiences, but may be more pronounced in the Arab region due to the significant need for adjustment so countries can benefit from integration. The absence of

[4] In addition, Sirageldin (1998), and Escribano (2000) have cited other political reasons that discourage Arab governments from seeking integration. Among these factors are internal unrest, fragmentation and a lack of mutual trust.

mechanisms to compensate those that lose out from integration exacerbates the problem for political leaders.

Examples of these costs are indicated in Table 4, which shows the significant weight of those groups most likely to oppose integration in the Arab world. These groups seem to have the power to block attempts to open up regionally. They include import-substituting industrialists (measured by the low share of manufactured exports to total exports as a proxy), bureaucrats responsible for fiscal sustainability (measured by percentage of import duties to tax revenues as a proxy), and employees in the government and public sector (measured by the unemployment rate as a proxy).

**Table 4. Selected Indicators for the Arab Region and Other Regions (%)**

| Indicator | Countries | Average (1995-99) |
|---|---|---|
| **Manufacturing exports/total exports (%)** | Arab Countries | 24 |
| | EU | 82 |
| | NAFTA | 75 |
| | MERCOSUR | 31 |
| | ASEAN | 66 |
| **Import duties/tax revenue (%)*** | Arab Countries | 30 |
| | EU | |
| | NAFTA | 2 |
| | MERCOSUR | 6 |
| | ASEAN | 15 |
| **Unemployment/total labor force (%)** | Arab Countries | 22 |
| | EU | |
| | NAFTA | 6 |
| | MERCOSUR | 8 |
| | ASEAN | 4 |

*Source*: World Bank (2001).

### *Regional Commitment Institutions*

Commitment institutions refer to the array of rules, policies and organizations that are hierarchically superior to domestic law and directly applicable to members in the regional arrangements. Their main responsibility is to monitor and enforce the regional integration obligations, in order to improve compliance with the rules of integration. The availability of such institutions in the Arab region is reviewed below.

#### *Regional Monitoring and Enforcing Institutions*

Although there are many Arab regional organizations (e.g. Arab Economic Council, Economic and Social Council, Organization of Arab Petroleum Exporting Countries, Arab Labor Organization, Arab Institution for Investment Guarantee, and the Arab Fund for Social and Economic Development), the region lacks effective institutions to deal with the formulation, implementation, and monitoring of necessary rules, laws, and policies for regional integration to take place. In contrast, member states in the EU established supra-national institutions, such as the Commission of the European Communities and the European Council (the executive authority of the EU), the European Parliament (the legislative authority), and the European Court of Justice (the Judiciary authority). These institutions have played a major role in the development and success of the EU (Hoekman and Messerlin, forthcoming).

It seems that the problem in the Arab region is the existence of too many organizations with insignificant roles, capacity and hence results. Although this is not the real barrier to integration, since countries did not have the economic and political incentives to integrate in the first place, the absence of an effective framework of institutions may inhibit any attempts to speed up the integration process in the future.

Of course the Arab countries formed the Arab League many years ago. However, the League's efforts to foster economic integration have been generally not very effective (Hudson, 1999). The League is not a supra-national organization like the European Commission. It lacks the legal and political authority to override the sovereign autonomy of the member–states. In fact, the preamble of the League Charter assures the sovereignty and independence of the member states. Furthermore, it is a relatively small organization encompassing about one thousand employees, compared to 20 thousand employees of the European Union in Brussels alone. In addition, the League does not have the institutions and the related mechanisms of collective policymaking required for regional conflict resolution.

*Compensation Mechanisms for Protecting the Losers*

Neither the 1981 agreement on the Facilitation and Promotion of Intra-Arab Trade nor the 1997 AFTA agreement provides effective compensation mechanisms among Arab states. This led a number of countries to refrain from liberalizing their trade. Evidence from other regional blocks supports this finding. The Latin American Free Trade Area Association and the Andean Pact eventually collapsed due to disagreements regarding how costs and benefits of the arrangements were being shared. In addition, the non-existence of mechanisms to deal with the distribution of gains within each country, have also hindered efforts for Arab regional integration.

In the EU, an important element of success has been the use of instruments to compensate the losers from integration. Two types of instruments for compensation were used (Shafik, 1994). The first was used to compensate losers within countries. One example is the Common Agriculture Policy (CAP). It was used to compensate the agricultural sector, which was expected to lose from integration. Germany, Britain and the Netherlands were net contributors to CAP, while France, Italy and Ireland were the main beneficiaries. The second device was used to compensate losing countries or regions. Examples of these institutions include the European Investment Bank (EIB) and the European Social Fund (ESF), which were intended to assist less developed regions, as well as help areas affected by industrial decline and high unemployment. The major beneficiaries were Portugal, Spain, Greece and Ireland.

As far as NAFTA is concerned, there were no financial compensation schemes for Mexico. Instead, Mexico was granted more time to adjust through a more gradual phasing of trade liberalization. For example, while the US was supposed to eliminate tariffs on many products immediately, Mexico was given a period of up to five years to eliminate tariffs on some products.

***Regional Leadership***

According to Hudson (1999), the Arab region lacks uncontested regional leadership. This lack of leadership has also crippled the Latin America Free Trade Association, the ASEAN and the Andean Pact. For the Arab region Egypt partially played such a role in the 1950s and 1960s, however the accountability of this role declined significantly following the signing of the peace treaty with Israel in the late 1970s.

Since then, several other Arab countries seem to believe they qualify to play a leading role. They include Iraq, Syria, and Saudi Arabia. Iraq was emerging as a potential core state but after its defeat in the Gulf war the possibility of it assuming the role of regional leader, was lost. Syria enjoys the position of a leading power in the Western Fertile Crescent, but its relatively low level of development prevents its from acting as a regional leader. Saudi Arabia has a special position among the Gulf States, but not among the region as a whole.

In contrast, the existence of one or two regional leaders among the member states, was one of the key reasons behind the success of EU and NAFTA (Mattli, 2000). Their respective leaders were Germany and France, and the United States. The regional leaders in the two experiences served as focal points in the coordination of rules, regulations and policies.

It was less costly politically and economically to adapt to this leader's policies. For example, switching to German safety standards was less costly to the EU than switching to Dutch standards. Also, Germany has been the key policy initiator for launching the European Monetary System. This and the calling for an inter-governmental conference on a political union paralleling the proposed EMU were considered the first acts of German leadership in the history of the EU. The existence of a regional leader also helped ease distributional tensions and thus smoothed the path of integration. Germany is by far the largest net contributor to the European Development Fund (EDF), and the European Social Fund (ESF).

The above analysis suggests that the absence of political motivation partially explains why past Arab economic preferential agreements remain wishful thinking or in the 'virtual regionalism' domain. More specifically it identifies three main reasons for limited tangible results in the past: unwillingness of political leaders to integrate; shortage of commitment institutions, particularly the absence of mechanisms to compensate losers; and finally, the lack of consensus on one or more states to act as regional leader.

## V. Looking Forward: Some Concluding Remarks

Whereas regional integration has gained momentum all over the world, the development of Arab regional integration remains limited and compares unfavorably to other regional blocks. This raises concerns about the future of the Arab region. It also triggers the search for an explanation of the reasons behind the unsatisfactory Arab economic integration record in the past.

The Arab region remains the least integrated, whether we look at it in terms of trade or factor movements. Moreover, the lack of both economic and political incentives for integration is responsible for the slow progress of Arab integration to date. More specifically, five economic and political factors can be seen as the main reasons behind the limited tangible results in the past: low degree of complementarity among Arab countries; low level of openness; weakness in the role of the private sector; unwillingness of political leaders to integrate; shortage of commitment institutions, in particular the absence of mechanisms to compensate losers; and finally, the lack of consensus on one or more states to act as regional leader or leaders.

Looking forward, the scene for future Arab cooperation seems more promising. This view is based on the more favorable internal and external economic circumstances currently prevailing, and on some positive political changes.

*On the Economic front,* the last decade witnessed considerable reforms in several countries including Egypt, Jordan, Morocco, Tunisia and Lebanon. Reforms involved significant progress toward trade liberalization through unilateral, multilateral and regional efforts. At present, eleven countries are full members of the WTO, six of which have signed Association agreements. A key benefit of both agreements is their potential role as a commitment device, in harmonizing the countries' domestic laws and standards with international norms. More specifically, the establishment of the Association agreements between the EU and some Arab countries is expected to increase motivation for regional integration among Arab countries to enable them to benefit from the accumulation of rules of origin, as well as overcome the 'hub and spoke' phenomenon.

The reforms also entailed new roles for both the government and the private sector, which will probably have many positive implications. On the one hand, governments will be relieved from carrying out productive activities. This will enable them to concentrate more on getting the fundamentals right, that is, improving the business environment and providing the necessary hard and soft infrastructures, which were highlighted in many studies as a pre-condition to fostering regional integration. On the other hand, the increasing participation of the private sector in economic activities will probably widen the spectrum of regional cooperation. More involvement of the private sector will improve productivity, and increase non-traditional exports. Finally, the possibility of private involvement in regional infrastructure projects could motivate regional arrangements, given that the present lack of infrastructure is considered one of the most critical impediments to regional cooperation.

Equally important, the executive program of the 1997 AFTA agreement has involved, for the first time, commitments by Arab countries to reduce tariff rates by a yearly average of ten percent over a period of ten years. Although each member country is allowed to draw up a list of agricultural and manufactured sensitive products to be protected during a transition period, this is due to disappear in year 2008. The program also called for the elimination of non-tariff barriers and the exchange of trade information. In addition, it proposed guidelines for dispute settlement, the definition of rules of origin, and favorable treatment for the least developed countries (Zarrouk, 1998)

*From the political point of view*, there is a growing understanding in some Arab political circles that it is difficult for any country to isolate itself from the current wave of globalization. Also that the regional integration approach outweighs the individual country approach for participation in the world market. This is evident from the different initiatives to liberalize multilaterally and regionally. Different groups (for example, intellectuals and political parties) in many Arab countries have realized that regionalism carries political weight as a means of increasing the region's collective political bargaining power. It seems that the high educational level of the new generation in several countries has influenced the general attitude and public opinion.

Furthermore, recent changes in some Arab countries have generated great expectations for accelerating liberal political reforms. In Morocco a new government has been democratically elected, this was coupled with the accession of Mohamed VI to the throne. The Prime Minister in the new Cabinet, El Youssefi is the Head of the opposition in Morroco. In Jordan and Syria, more liberal leaderships have come to power with King Abdullah and President Bashar respectively. In Egypt, the latest 2000 election of the People's Assembly has been considered a stepping-stone toward a more democratic regime. In addition, the implementation of structural reform programs in some countries such as Egypt, Morocco, Tunisia, Jordan, and Lebanon has weakened the relative importance of opposing interest groups. All this has created a more supportive political environment to regional integration.

Although the current economic and political contexts for regional integration increase the likelihood of successful Arab integration in the future, much remains to be done for this potential to be realized. Without seriously addressing existing barriers, as well as new challenges, Arab integration will remain a hope rather than a reality. The most important challenges facing the future of Arab integration include further domestic reform, and a strong political will to integrate.

Indeed, the policy implications of the analysis are that Arab countries should work on two tracks in parallel: the domestic and regional. Domestically, efforts should be devoted to liberalization, deregulation and speeding up structural reforms, particularly those affecting private investment. Undertaking such reforms will not only help create economic incentives to integrate, but will also help motivate leaders. Economic reforms would result in larger potential benefits from integration, which would most probably have a positive influence on leaders. While domestic reforms are key to greater Arab economic interaction, several regional measures are also crucial for this process. These include: establishing mechanisms for compensating the losers; strengthening the regional institutional framework; and moving toward greater depth in the AFTA agreement. Finally, it is important to note that without political support, Arab integration will stay in the virtual domain.

In a nutshell, regionalism has become one of the rules governing the economic and political game at the global level. Therefore, Arab countries need to make the choice to integrate. The current economic and political circumstances offer greater potential for success in the future. However, this requires extensive effort. Finally, integration is not an isolated event; it is a long process that needs immediate and continuous action.

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