The Institutional Challenge of the ACP/EU Economic Partnership Agreements

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The Economic Partnership Agreements between the African, Caribbean and Pacific countries and the European Union should serve as an opportunity to accelerate ACP global and regional trade integration and as an important tool for development and the eradication of poverty. There are, however, a number of preconditions. This article argues that institutional quality plays a key role in successful trade liberalisation. In fact, only countries with high-quality institutions, partly in the form of good government regulation, are likely to benefit from trade. Unfortunately, the vast majority of African countries have excessive regulation that hinders them from taking advantage of trade. The necessary reforms to resolve this problem pose significant challenges, implying major risks for these countries in the EPA process.

1 Introduction

The Economic Partnership Agreements (EPAs) between the European Union (EU) and the African, Caribbean and Pacific (ACP) group of countries, signed in Cotonou in September 2000, established a comprehensive new framework for bilateral economic relations between the EU and the ACP countries. The Cotonou Agreement aims to promote economic growth and development as well as the smooth and gradual integration of ACP states into the world economy. From the perspective of the EU, two main objectives stand out. First, the EU wants to include a perspective that combines politics, trade and development. In fact, the EPAs aim not only to provide improved access for ACP countries to EU markets, to enhance trade in services and to increase cooperation in trade-related areas like competition and investment. Rather, the Cotonou Agreement intends to go beyond these standard features of a free trade agreement by enhancing the political dimension, explicitly addressing corruption, promoting participatory approaches, and refocusing development policies on poverty reduction.

The main argument for this objective is relatively obvious, since the export performance of ACP countries has been far from satisfactory in recent decades. Despite non-reciprocal trade preferences for products originating in ACP countries as part of the predecessors of the Cotonou Agreement, the Lomé I to IV Conventions, ACP countries’ share of the EU market declined from 6.7% in 1976 to 3.0% in 2005 (EU Commission,
Moreover, about 68% of total ACP exports to the EU consists of agricultural goods and raw materials, and some 74% is concentrated in only ten products. Additional preferences on market access alone are not therefore very likely to benefit ACP countries in the future. Among the various reasons for the disappointing export performance and general development of ACP (and other developing) countries, the quality of institutions has been identified as a major impediment, regarding which the EU is willing to assist ACP countries in reform.\footnote{See World Bank (2001), Jütting (2003) and Levine (2005) for surveys. Influential studies are Acemoglu et al. (2001) and Rodrik et al. (2004).}

Secondly, the EU is looking for new trading arrangements with the ACP states that ensure compatibility with the regulations of the World Trade Organisation (WTO). The non-reciprocal trade preferences established under the Lomé Conventions require a WTO waiver, as they are neither restricted to least developed countries (LDCs) nor granted to all developing countries. At the WTO Doha conference in November 2001, the EU obtained what is probably the last waiver for special ACP preferences until the end of 2007. The new agreements would provide for a shift from the system of non-reciprocal trade preferences to EPAs, which are in effect bilateral free trade agreements. This implies that the ACP states would have to open up their markets for EU products within twelve years, scheduled for the period from 2008 to 2020.

According to economic theory, beneficial effects could be expected from lowering trade barriers for the ACP countries, to exploit the well-known gains from exchange and specialisation. This basic outcome may not hold, however, since some of the often demanding assumptions in economic models are not realistic. Borrmann et al. (2006) explored a fundamental prerequisite for successful trade liberalisation, namely, the quality of institutions.\footnote{Institutions can be defined as humanly devised constraints that structure political, economic and social interactions (North, 1990), in order to reduce uncertainties arising from incomplete information about the behaviour of others. Above all, institutions are introduced by the setting of formal rules (laws, property rights) and the development of informal rules of behaviour (customs, traditions). Formal rules are usually designed and made explicit in the constitution, in legislation and in regulations (public institutions) or come into existence by formalised private agreements such as codes of conduct and contracts (private institutions).} Rather than concentrating on the impact of institutions in the development process, they focus only on the role of institutions with regard to the linkage between trade and growth. Their empirical analysis of a sample of 146 countries shows that only countries with good institutions in the form of good (government) regulation are able to benefit from international trade.

This article applies this finding to the EPAs between the ACP countries and the EU. More specifically, it identifies those ACP countries and regions that are likely or not to benefit from an EPA, given their current institutional setting. The main outcome of this exercise and, thus, the principal finding is relatively straightforward: institutional reform in a considerable number of ACP countries is an indispensable precondition for the success of EPAs and future development in general. This applies in particular to the large majority of African ACP countries, most of which currently have excessive regulation.

Moreover, the article argues that there is insufficient awareness of the real dimension of the institutional challenges stemming from the EPAs. Although the issue
as such is considered in the Cotonou Agreement and in ongoing negotiations, the size and structure of institutional problems and reform requirements are not fully recognised, due to lack of empirical insight. While a thorough and detailed discussion of these challenges is beyond its scope, the article highlights some important policy implications for ACP countries. Above all, it attempts to insert more empirical information into the debate on the advantages and disadvantages of concluding EPAs, on their design and on the commitment to institutional reform of all the stakeholders involved.

The article is structured as follows. The next section reviews the special role of institutional quality in the linkage between trade and growth. It also takes a closer look at the performance of ACP countries regarding their institutional quality and the trade-growth nexus, and discusses the consequences for EPA negotiations. Section 3 explores the implications of the results for institutional reform in the ACP countries and addresses strategies for reform. Finally, Section 4 summarises the main results.

2 ACP linkage between trade, institutions and growth

Based on various theoretical models, an abundant empirical literature has examined the welfare effects of trade (volumes) on income levels and growth rates. If anything, the majority of studies show that trade is positively associated with growth rates. However, this does not apply to all countries. For some, trade has a strong positive impact on growth, whereas for others there is no or even a negative linkage. Based on this finding, the question arises as to what the determinants of a successful integration into the world economy would be. Borrmann et al. (2006) show that institutional quality is one likely prerequisite for a welfare-increasing impact of trade. Using several model specifications, including an instrumental variable approach, they identify those aspects of institutional quality that matter most for a positive (or negative) linkage between trade and growth. Above all, government regulation as an important element of institutional quality is the key to reducing trade-related adjustment costs.

The logic is relatively simple. While trade enhances welfare-increasing specialisation and fosters productivity growth within industries, in turn forcing uncompetitive firms to exit and allowing successful firms to expand, it cannot induce specialisation or discipline firms if factor movement is restricted. In many economies, low institutional quality in the form of excessive regulation prevents, for instance, labour from moving across sectors or firms. In these countries, trade may be less able to serve as an impetus for growth. In fact, it might have a negative impact on growth if the trade-related adjustment costs are larger than the welfare-enhancing gains from exchange and specialisation.

At a more disaggregated level, the results show that a few sub-indicators for regulatory quality are clearly more relevant than others. Above all, this applies to


4. See Bolaky and Freund (2004) and Borrmann et al. (2006).

5. The main source for all regulation indicators is the World Bank’s Doing Business dataset. See World Bank (2006) for details.
market entry regulations (starting a business), the efficiency of the tax system, and labour market regulation.\(^6\) For countries with good scores for these three sub-indicators (as well as the aggregated regulation indicator), trade has a positive impact on growth rates, whereas the contrary can be established for countries with bad scores, that is, excessive regulation. In essence, the results demonstrate that countries with low-quality institutions in the form of excessive regulation do not benefit from trade.

What is more, for all countries it is possible to show whether they belong to the group that possesses a negative or a positive linkage between trade and growth. Depending on the particular indicator, countries with the 30 to 50\% worst scores for regulatory quality fall into the group for which a negative trade-growth nexus can be established. Given these results, we analyse the performance of all ACP countries in terms of their regulatory quality, with a particular focus on the most important indicators of institutional quality. For this exercise, we use the results for ACP countries and all important regulation indicators to determine whether a particular country belongs to the group with a negative trade-growth linkage. In addition to the aggregated indicators for regulatory quality, we use the three most important disaggregated sub-indicators mentioned above to assess the overall quality of regulation in each country.

The outcome of this exercise can be seen in Box 1. All countries that belong to the group with excessive regulation are marked in italics. For them, the impact of trade on (long-term) growth rates is negative. For the remaining countries, the results show either a positive and significant influence of trade on growth or an insignificant outcome with a positive or negative coefficient for the trade variable.\(^7\) For the six EPA regions, outcomes differ remarkably. Apart from Cape Verde, Gambia and Ghana, all countries in the Economic Community of West African States (ECOWAS) belong to the group with excessive regulation. For the Communauté Économique et Monétaire de l’Afrique Centrale (CEMAC) a similar picture emerges: while only Gabon has an adequate regulatory framework, all other countries fit into the group with excessive government regulation. For all countries in the Eastern and Southern Africa (ESA) group, except Kenya, Mauritius, Seychelles, Uganda, and Zambia, we also observe a negative trade-growth nexus.

There are, however, EPA regions with a better performance. Within the Southern African Development Community (SADC), Botswana, Lesotho, Namibia and Swaziland, which also belong to the Southern African Customs Union (SACU), show relatively good scores, but this does not hold for the others. In the Caribbean region,\(^8\) only Haiti and the Dominican Republic are negatively affected by trade due to detrimental regulation, while in the Pacific region this applies to Kiribati.\(^9\)

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6. Also important, though to a lesser degree, are regulations for trading across borders, enforcing contracts, and market exit (closing a business).
7. We do not report the average scores for the six regions, since there are outliers in almost every region that bias the outcome. For example, the scores for Angola and Mozambique are very low, thereby lowering the average score for all SADC countries.
8. In the Caribbean, the Caribbean Forum (CARIFORUM), which consists of all the countries of the Caribbean Community (CARICOM) except Montserrat, plus the Dominican Republic, negotiates a regional EPA with the EU.
9. Due to a lack of regulation and other data, we could not incorporate 6 out of a total of 14 ACP Pacific countries. See the note to Box 1.
Box 1: Regional EPA grouping and regulatory quality

- ECOWAS (13 out of 16 countries belong to the group with excessive regulation) Benin, Burkina Faso, Cape Verde, Côte d’Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo
- CEMAC (6/7) Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon, São Tomé and Principe
- ESA (11/16) Burundi, Comoros, Democratic Republic of Congo, Djibouti, Eritrea, Ethiopia, Keny, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Uganda, Zambia, Zimbabwe
- SADC (3/7) Angola, Botswana, Lesotho, Mozambique, Namibia, Swaziland, Tanzania
- Caribbean (CARIFORUM) (2/15) Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Suriname, Trinidad and Tobago
- ACP Pacific (1/8) Fiji, Kiribati, Marshall Islands, Papua New Guinea, Solomon Islands, Samoa, Tonga, Vanuatu

Notes: a) Countries in italics denote those with a negative and significant impact of trade on growth due to excessive regulation. The rest show either a positive and significant or a positive or negative and insignificant trade-growth nexus. b) Data are not available for Cook Islands, Micronesia, Nauru, Niue, Palau and Tuvalu.

Overall, the results clearly show that institutional quality (in the form of government regulation) as a precondition for a welfare-increasing impact of trade is of lesser importance in the Caribbean and the Pacific, as the regulatory framework in both regions is relatively good (apart from the three countries for which this does not hold). This is clearly due to the stage of institutional development these countries have already achieved. As a consequence, both regional groupings appear relatively well prepared for EPAs. The large majority of African countries, however, are not likely to benefit from an increasing integration into the world economy with their present institutional setting. They show scores for the most important indicators that fall precisely in the categories of countries that are less likely to benefit from an increase in trade due to EPAs. Exceptions at the country level can be found in southern and eastern Africa, in particular the SACU group within SADC. Unfortunately, the likely impact of the EPAs due to the dismantling of tariff barriers will be much higher in ECOWAS, CEMAC and ESA, since they trade much more with the EU (Table 1). In the light of these results, a reform of the institutional setting becomes even more urgent in these countries.

Importantly, these results do not imply that African countries will never be able to benefit from increasing market integration with the rest of the world, whether through the EPAs, multilateral or unilateral tariff liberalisation. Rather, they clearly show that the majority of African countries are currently less likely to harness the gains from trade and that a reform of the institutional framework should be an important topic on the EPA agenda. A major institutional reform would not only allow the African countries to
increase the welfare-improving gains from trade through specialisation and exchange. In addition, high-quality institutions would enable them to achieve much greater gains through a direct impact on economic and social development.

Since the beginning of the negotiating process, it has been well known that ACP countries may not all share the same interest in EPAs. In the event that the negotiations are not successful, LDCs of the ACP group could use the Everything but Arms (EBA) initiative of the EU, while non-LDCs would have to switch to the Generalised System of Preferences (GSP). Since the EBA scheme provides duty-free access to imports of all products (except arms and munitions) from LDCs without any quantitative restrictions, the special arrangements for LDCs are far more generous than either the general arrangements under the GSP or the trade preferences which are currently available under the Cotonou Agreement. Apart from important technical issues, such as the rules of origin for the trade preferences, LDC countries may thus be less committed to negotiating an EPA than non-LDCs.

Similarly, institutional quality as a precondition for successful Partnership Agreements might divide the regional EPAs into two groups: one with good regulation that stands to gain from trade liberalisation, and another with excessive regulation that might not achieve any benefits or even observe a decline in growth rates due to EPAs, if they do not reform their institutional setting. To link this issue with the LDC/non-LDC problem, we plot all ACP countries accordingly (Figure 1). Most of the countries with a negative trade-growth nexus are LDCs, and those with a positive (or insignificant) impact of trade on growth are non-LDCs. This outcome could further divide ACP countries within the regional EPA groupings. However, there are a number of countries to which this does not apply, since they are LDCs but have good regulation or are non-LDCs with excessive regulation.

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10. Only three products were not liberalised immediately: bananas, sugar and rice, and these have been or will be given duty- and quota-free access by January 2006, July 2009, and September 2009, respectively. In the meantime, duties on these products are gradually reducing. Moreover, there are duty-free tariff quotas for sugar and rice, which will be increased annually.

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## 3 Implications for institutional reform

In the light of these findings, it becomes clear that institutional reforms are an indispensable part of the EPA agenda and that the EU is right to press for reforms in ACP countries. However, any fundamental institutional change may pose a major challenge for ACP countries, in particular, LDCs with limited resources and fragile political regimes. In this section, we discuss four main aspects of institutional change in ACP countries: (i) the scope of institutional reform requirements; (ii) the framework for related policies; (iii) the available timeframe for the required reforms; and (iv) the selection and design of appropriate strategies. Rather than pursuing an in-depth analysis of requirements at the country level, we outline the broader issues involved as well as highlighting some of the main questions and challenges faced.

The relatively poor performance of a considerable number of ACP countries with regard to the regulatory quality indicators highlights the enormous scope of institutional reform requirements and may dampen the prospects for improvement achievable in the short and medium term. According to the World Bank (2001), policy-makers could become paralysed by the apparent need to undertake ambitious reforms on a wide and ever-expanding front. Even if we narrow the scope and concentrate on those institutions that are directly related to trade liberalisation, we are still faced with a whole host of problems. First, a considerable number of African countries currently possess regulations that clearly demonstrate our main argument of excessive government regulation. A few examples that are important for the trade-growth nexus illustrate the state of business regulation in African countries.¹¹

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¹¹ For numerous further examples, see World Bank (2006).
• Entrepreneurs in Guinea-Bissau have to pay 261\% of (national) income per capita to start a business (plus a minimum capital of 1,029\%); moreover, they have to comply with 17 bureaucratic procedures that take on average 233 days.
• The cost of dismissing a (long-term) employee in Mozambique is equivalent to some 143 weeks’ wages.
• Firms in the Central African Republic which intended to pay their taxes in full would have to part with 209\% of their gross profits, in other words, more than twice their earnings; in addition, entrepreneurs have to spend (on average) 504 hours per year dealing with the burdensome tax procedures.
• To import a product into Niger requires 19 documents and 52 signatures, and takes 89 days to deal with the necessary paperwork and customs inspections.
• The judicial practice for the enforcement of a contract in Burkina Faso involves 41 procedures, takes 446 days, and costs some 95\% of the disputed amount.

Though these are admittedly extreme examples, they give an impression of the fact that African business regulation can have a sometimes severe impact on economic activities. Given such a regulatory framework, it is not surprising that firms have to remain small in order to hide in the informal sector. This does not allow them to achieve economies of scale which would in turn enable them to benefit potentially from export opportunities abroad or to compete with more efficient foreign firms in local markets. In sum, to reform such detrimental business regulations poses quite a challenge.

Secondly, the different areas of government regulation are partly interrelated. For example, in addition to administrative procedures and costs, market entry conditions include a large number of issues such as property rights (access and transfer), competition law (rules for mergers, acquisitions, pricing), taxation (level and structure, incentives), financial market regulations (collateral requirements, protection of creditors), or openness (rules for trade, financial services). This calls for an integrated approach and would imply a comprehensive institutional reform agenda.

On the other hand, Aron (2000) and Rodrik (2004) note that institutional transformation on a large scale is rarely an indispensable prerequisite for getting growth started even in poorer countries. Rather, there seems to be a need for achieving an initial surge in growth rates that may be obtained with minimal changes in the institutional setting. What is more, both Aron and Rodrik argue that there is a need to differentiate between stimulating economic growth and sustaining it. Effective institutions of high quality appear much more important for the latter than for the former (Rodrik, 2004; Hausmann et al., 2004). Hay et al. (1996) share the view that less costly and more rapid reforms could be better than comprehensive, expensive and time-consuming reforms. Also, the experience of the World Bank (2001) shows that moderate progress in the component parts can contribute effectively. However, even a reduced reform agenda remains a great challenge, in particular for the large number of LDCs among the ACP countries, given the nature of their institutions.

As to the framework conditions, it is not the low level of institutional development alone that is a burden for reform. What matters probably more is the fact that a country’s institutional setting is shaped by a combination of history, economic structure, political system and culture (ECA, 2005; IMF, 2005). Consequently, institutions tend to be persistent over time, although not immutable. They typically change incrementally.
rather than in a discontinuous fashion. In contrast to formal rules, which may be changed abruptly by political and judicial decision-making, informal institutions are much more difficult to penetrate by deliberate policies. However, informal constraints like customs, traditions and codes of conduct cannot be completely excluded from the reform agenda when, for example, increases in economic performance and efficiency call for the formalisation of many informal economic activities. Informal rules have to be respected, since they form a large part of a country’s social capital and do much to compensate for the deficiencies of formal institutions. Building bridges between existing formal and informal institutions is an effective way of enhancing the success of formal institutional reforms (World Bank, 2001).

In this context, an important question is how to initiate institutional change despite the inertia of existing formal and informal institutions. Above all, whether more efficient institutions can be introduced depends largely on the interests of those with the power to devise new institutions and of those expected to accept, adapt to and enforce the new rules (Anderson, 2005; WTO, 2004). In fact, this is a classic example of the political economy of reform. The general commitment of political leaders to good governance and their willingness to use their political weight in support of reform are crucial to an effective impetus for institutional reforms. Institutional improvements can only be harnessed if the top has fully recognised their importance (Szepesi, 2004). If political leaders are committed to reforms, then trade liberalisation could provide an additional external impetus and might help them to lock in their reform programmes.12

However, we cannot take such a commitment for granted, least of all in the case of African ACP countries. It has been the dominant interest of a considerable number of African leaders to make best use of the status quo for their own benefit rather than to improve governance. This explains much of Africa’s low level of institutional development and, as a consequence, poor socio-economic development. On the other hand, ACP governments decided to start EPA negotiations with the EU and have not been taking advantage of alternative and less demanding trade regimes as offered by the Cotonou Agreement.

One explanation of this apparent contradiction could be that the institutional implications of the EPAs have in general been systematically underestimated or misunderstood as a policy challenge arising only in the long-term future, which hardly affects current political leaders in ACP countries and their privileges. Another interpretation could be that political leaders anticipate an enlarged inflow of foreign aid providing opportunities for both development work and their own self-interest. In fact, ACP countries have frequently reminded the EU that its financial support is part and parcel of the EPA project. Moreover, they argue that their general need for financial support in order to implement the EPAs exceeds the current financial commitments of the EU, and they expect the EU to substantially increase the volume of its aid.

However, there are good reasons to doubt that a large sustained or even increased volume of aid would automatically have positive effects on the development of good public institutions in ACP countries. On the contrary, a review of the literature reveals an aid-institutions paradox, which suggests that the current aid system may even at the very least undermine the development of effective state structures if the current delivery

12. This is a standard argument in the literature on regional integration; see, for example, Devlin et al. (2000).
modalities are not substantially reformed (Moss et al., 2006). States which can raise a substantial proportion of their revenues from the international community (which is the case in many African low-income countries) are less accountable to their citizens and under less pressure to maintain popular legitimacy. They are therefore less likely to have the incentives to cultivate and invest in effective public institutions.

Even if the modes of aid delivery were improved, reforms are unlikely to survive or be implemented if they are set up only in response to external pressures (due to the EPA process) and designed and implemented without the ownership of those whose interests would be directly affected (Birdsall, 2005). It is important, therefore, to involve all possible public and private stakeholders in the reform process. In the area of trade reform, for instance, developing countries which have broadened their policy-making processes by engaging in open and inclusive consultations with the private sector have generally performed better than those where such consultations have been absent (Fukuda-Parr et al., 2002). Ownership is of particular importance when institutional reforms are required which affect the interests of those engaged in the informal sector. Once stakeholders find themselves adequately involved in the planning and implementation of new rules, a promising basis for institutional change can emerge (Szepesi, 2004). However, as the Poverty Reduction Strategy process shows, it is still difficult to establish real ownership in African countries (Booth, 2003).

In addition to the often less favourable framework for institutional reform, ACP countries are under considerable time pressure. Substantive EPA negotiations started only in 2004. The agreements should enter into force at the beginning of 2008. There is then an implementation period from 2008 to 2020. Nevertheless, there is considerable time pressure during the transitional phase, as the institutions have to be in place before or at the time of the actual trade liberalisation. Needless to say, institution-building – in particular in a less developed environment – takes time, due to the scope of institutional deficits and the framework conditions, as discussed earlier. North (1990: 60), for example, notes that ‘creating a system of effective enforcement and of moral constraints on behaviour is a long, slow process that requires time to develop if it is to evolve – a condition markedly absent in the rapid transformation of Africa from tribal societies to market economies’. It is most uncertain whether profound institutional change and development can be rapidly achieved and sustained. Recent case studies on Latin America suggest that, where trade institutions malfunction, building up new ones from scratch to eliminate past problems (so-called ‘big-bang’ reforms) does not lead to improvements in practice (Szepesi, 2004).

The design and timing of the EPA liberalisation schedule, in particular the length of the transitional phase, therefore deserve special attention. There is an ongoing debate on the definition of an appropriate length for this phase. In fact, the legal aspect of the conformity of the proposals submitted with WTO rules, limiting this phase to 10, 12, 15 or more than 18 years, plays a notable role. It appears, however, that a solely legalistic discussion of this issue is misleading, since the timing of the EPA process should be designed according to the objectives of the two projects, the capacity to cope

13. In a submission to the WTO, the ACP proposed a transitional phase of more than 18 years (WTO, 2004).
14. See Borrmann et al. (2005) for an overview; other main studies on this issue are Mathis (2002), Onguglo and Ito (2003) and South Centre (2005).
with the required structural adjustments, the resources available to prepare for the hard and soft infrastructure needed to make the best use of the new trading environment for growth, and the ability to master the political and administrative problems of related institutional reforms. EPAs could apparently be an enormous challenge, in particular for the least developed countries within the ACP group, and there is an obvious risk of overstraining them by an excessively tight time schedule.

The time required for institutional change also depends to a considerable extent on the choice of an appropriate strategy for reform. Basically, there are three options: imitation, adaptation and innovation. Not surprisingly, the ACP countries might have a preference for imitating models of institutional reform that have been successfully applied elsewhere, thus saving time and resources. Chang (2006) suggests such a ‘catching-up’ framework in which the late-developing countries can import institutions from the developed countries, thereby using ‘better’ institutions without paying the same ‘price’. He argues that developing countries are today enjoying higher standards of political democracy, human rights and social development than were achieved by today’s developed countries at similar levels of economic development, thanks to their institutional imitation.

Any elementary imitation of institutional reforms, however, might not lead to the expected result. Institutions that are, for example, efficient and effective in high-income OECD countries might not work at all in low-income countries that possess fewer interrelated institutions, weaker administrative capacity, much lower human capital levels, and different levels and perceptions of corruption (World Bank, 2001). Rodrik et al. (2004) point out that the institutional setting of a country has to be arranged, above all, in the context of historical trajectories, geography, political economy and/or other initial conditions. There is hardly ever a blueprint for reform, even for countries with similar income levels. Some degree of adaptation is thus required in order to make institutions imported from abroad work (Chang, 2006).

Whether institutions are imported or started from scratch, they should complement those that already exist. Several examples, such as the history of institution-building in Europe or more recent changes in China, illustrate that institutions function well if they support the existing institutional framework, and are suitable for the available human capabilities and technologies (North, 1990, 1994). In addition, this is related to the political economy of the reforms. If new institutions do not enjoy the necessary degree of political legitimacy among the members of the society in question, they are not going to work (Jacoby, 2000).

4 Concluding remarks

There are several important risks attached to the EPA process which apply in particular to Africa. This article has pointed out that EPAs can only be beneficial for ACP countries if the countries’ institutional settings are appropriate. More specifically, only countries with a good regulatory institutional framework are able to minimise the trade-induced adjustment costs and take advantage of export opportunities abroad. While the quality of regulation is relatively good in the Caribbean and the Pacific, many African ACP countries have excessive regulation that hinders them from benefiting from trade
opportunities. It is thus crucial that these countries reform their regulatory setting before or at the time of trade liberalisation in order to achieve the potential development outcome of the agreements.

Reforming the institutional and regulatory setting is an enormous policy challenge for the ACP countries, in particular for low-income countries in sub-Saharan Africa. Given the poor governance in this particular region, we have strong doubts about the ability of governments to reform their institutions fundamentally. Unless the aid delivery system is improved, large sustained or even increased (EU) aid is unlikely to induce the institutional reforms required for a successful EPA process. Moreover, we fear that there is not enough time to cope with the reforms required for successful trade liberalisation, given the low institutional quality in a large number of African countries. This may lead to a situation in which some countries are ready to sign an EPA but others – within the same grouping – are not. Larger or more powerful countries (with good institutions) might then push smaller and weaker ones into an agreement that might not be beneficial for them. Subsequently, countries with low-quality institutions would either suffer from trade liberalisation, or, if they opt out of the EPA process, regional integration would be undermined, which is quite contrary to the intention of the Cotonou Agreement.

Against this background, we argue that the European Commission should consider all possible options for ACP countries in order to provide them with a new framework for trade that is equivalent to their existing situation and in conformity with WTO rules, as stated in the Cotonou Agreement.\(^\text{15}\) Regarding the institutional prerequisites for a successful EPA, we would propose that the European Commission should offer the African ACP countries a fall-back position if they are currently unable to sign an EPA, but use the process to strengthen reforms at a country level. Only when a country has achieved, for example, the required level of institutional development (and met other preconditions as well) should it proceed to sign an EPA with the EU. As indicated, serious risks for African regional integration might be entailed if the four EPA groupings cannot agree on a uniform approach towards a trade agreement with the EU. To sum up, given the diversity of initial conditions in ACP countries and the extensive nature of the task of institutional reform, a high degree of flexibility in the EPA process is essential to achieve the intended pro-development outcome.

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\(^{15}\) See Bilal and Rampa (2006) for an extensive discussion of all scenarios and options for ACP countries.


