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ACP Capacity Development and EPAs

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Coercion or Engagement? Economics and Institutions in ACP–EU Trade Negotiations

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Introduction

In September 2002, the European Union (EU) and 76 African, Caribbean and Pacific (ACP) countries launched their negotiations on Economic Partnership Agreements (EPAs). This marked the start of the EU and the ACP group's implementation of the radical changes to trade relations agreed in the Cotonou Partnership Agreement of June 2000. This agreement defines EPAs as comprehensive free trade agreements that will replace three decades of generous non-reciprocal trade preferences with reciprocal and WTO-compatible arrangements, at the latest by 2008. A key element of the EPA concept is that, in principle, the agreements should be concluded with ACP regions rather than with single countries, implying that the ACP's own regional integration needs to be enhanced as well.

Though EPAs are not the only possibility that 'Cotonou' provides on future trade relations, it is the most likely option for the majority of ACP countries to choose.[1] ACP countries that are not least-developed countries (LDCs) cannot benefit from the tariff- and quota-free 'Everything but Arms' (EBA) initiative, and will lose some market access if they are 'graduated' to the Generalised System of Preferences (GSP). For the LDCs, the EBA alternative seems only a theoretical option if their non-LDC neighbours opt for EPAs: not to join EPA negotiations would isolate an LDC and almost certainly fracture trade relations with non-LDC regional counterparts. In addition, reciprocal negotiations might offer better opportunities to defend the specific benefits of the commodity protocol preferences that are currently enjoyed by certain ACP countries.[2]

To date, no ACP country has opted out of EPA negotiations.[3] Yet, progress has been fairly limited during the first 20 months of negotiations. EPA negotiations have been divided in two phases: Phase I at the all-ACP level and, since October 2003, Phase II at the respective ACP regional levels. The talks in Phase I concerned mere consultations between the parties on the framework and principles of EPA negotiations. Whereas the ACP group wanted a formal agreement to conclude Phase I, the European Commission rejected this, emphasising that the purpose of the talks was to clarify issues rather than to reach formal agreement. The most substantial disagreement of Phase I concerned the so-called additionality of resources. Whereas the Commission finds that the funds agreed in the 9th European Development Fund (EDF) should suffice to address EPA-related concerns, the ACP pressed for extra commitments so as to safeguard the original allocation of the EDF to non-trade-related areas.[4]

In practice, Phase I and Phase II talks are likely to proceed simultaneously during the remainder of the negotiations as some of the issues on the table touch upon all members of the ACP group. Currently, four ACP regions (ECOWAS, CEMAC, the Caribbean and ESA) have already launched Phase II negotiations with the EU, and two other regions are likely to follow soon.[5]

The aim of this chapter is twofold. First, it seeks to structure the discussion on the economic implications of EPAs for the ACP countries. Though, *a priori*, the economic impact of EPAs is ambiguous, both experience and economic theory suggest that the quality of certain institutions in ACP countries and regions will be a key (if not decisive) factor in deter-

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mining that impact. Therefore, this chapter also seeks to discuss whether the current process towards EPAs is likely to yield the necessary institutional improvements in time. The second section sketches some unique features of EPA negotiations, followed by an exploration of the variety of economic effects that EPAs might have on ACP countries. The next section deals with the question of institutions and trade capacity building, and the way these will be addressed in EPA negotiations, followed by two scenarios towards EPAs: coercion or engagement.

What is special about EPAs?

Since the mid-1990s, bilateral trade negotiations with third parties have been the rule rather than the exception in EU external trade policy. Various types of bilateral trade agreements have been negotiated with countries such as Chile, Mexico, South Africa, various countries in Central and Eastern Europe, and a host of Mediterranean states. Besides EPAs, the EU is currently negotiating new agreements with the Mercosur region and the Arab states united in the Gulf Cooperation Council (GCC). Against this background, it is no surprise that in its 1996 Green Paper, the European Commission proposed to replace the Lomé trade regime of non-reciprocal preferences by a set of free trade agreements between the EU and ACP regions.

Yet despite the proliferation of bilateral trade agreements, there is no real precedent for EPAs. Apart from the fact that the ACP group has economies that are very different from the other EU trade partners, the broad coverage of EPAs as set out in the Cotonou Agreement is reflected in only a minority of EU trade agreements.[6]

First of all, one of the central principles of EPAs is regionalism. The agreements should thus strengthen the various processes of ACP regional integration. This means that besides the common challenges that trade negotiations pose, the configuration and integration of ACP regions add an additional dimension of complexity to EPAs.

Second, the EPA principles of special and differential treatment on the one hand and WTO-compatibility on the other further complicate matters. Other EU external trade agreements have been designed to comply with GATT Article XXIV, but depending on the outcome of the Doha Round, this compliance is a moving target for EPAs.

Third, the economic and social impact of trade liberalisation on the EU trade partner is likely to be larger through EPAs than through any of the previous free trade areas (FTAs) concluded by the EU. Many ACP countries trade primarily with the EU. In contrast to other countries that have more developed and diversified economies (e.g. Mexico and Chile), the majority of ACP countries are still dependent on a handful of export products to Europe. As for imports from the EU, the average level of ACP protection is still relatively high, thus magnifying the overall impact that liberalisation will have on ACP domestic economies, which we will now discuss further.

The economic impact of EPAs

Economic theory leaves little doubt over the question of whether, in principle, economic integration – and trade liberalisation in particular – generates overall positive welfare effects. Once barriers to cross-border economic activity are lifted, this will usually result in a dynamic combination of efficiency gains (better allocation of production factors), increased competition, lower prices, knowledge transfers and ultimately higher economic growth. The success story of European integration is a textbook example in this respect. In addition, some observers claim that Europe's ever-closer economic integration has led to a peace dividend: additional economic growth derived from political and social stability.

Yet economic integration is not a cost-free process. Even in Europe, this is the prime reason why the complete elimination of all internal (technical and non-technical) barriers to trade in goods took as much as four decades. Moreover, to yield the benefits of integration certain basic institutional requirements need to be fulfilled. Whereas in theory 'winners' from a fast move towards integration could directly compensate 'losers', this proves difficult in practice, and requires sophisticated institutions to be developed.

Indeed, it is difficult to liken the economic effects of EPAs between the EU and the ACP to the standard example of European integration. While textbook analyses are extremely useful tools for understanding the various effects of integration, one should not overlook the specificities of so-called North–South integration. With respect to ACP–EU trade liberalisation, the following sections look into some of these specificities.

Static trade effects

Though it is widely recognised that world-wide (multilateral) trade liberalisation is welfare enhancing, the same conclusion does not necessarily apply to liberalisation between a selective group of countries. **'Trade creation'** and **'trade diversion'** are the classic concepts used to explain so-called static welfare effects of regional trade integration. Upon trade liberalisation between an ACP region and the EU, trade diversion is the (negative) welfare change caused by ACP consumers and producers replacing lower cost imports from third countries (the US or Asian countries for example) by higher cost imports from the EU. This substitution can arise if the new tariff-free prices of EU goods are below those of the taxed goods imported from the rest of the world. Though ACP consumers gain from lower prices, economy-wide welfare is negatively affected because the tariff revenue that was previously yielded from third-country imports is now lost. Trade creation, on the other hand, is the welfare improvement that arises because high-cost domestic production in an ACP country is replaced by lower cost production in a regional ACP partner or the EU. Trade creation thus allows partner countries to better exploit their comparative advantage. As markets are opened, both the ACP region and the EU further specialise their production, thereby serving the markets of partner countries with products at lower prices.

Whether overall a net static welfare gain in an ACP region will be the result of an EPA thus depends on whether trade creation outweighs trade diversion or vice versa. The overall welfare effect is more likely to be positive if before EPA formation:

- the ACP region already traded relatively intensively with the EU;
- trade liberalisation towards third countries moves in parallel to EPA liberalisation; and
- both consumers and producers in the ACP region are largely responsive to price changes under an EPA.[7]

Since the Commission initially proposed EPAs, various impact studies have estimated the size of the static effects. The results differed substantially among ACP regions, with trade creation outweighing trade diversion in most cases, but not in all, and with static welfare effects ranging from negligible to substantial.[8]

Competition and economies of scale

Analysing the welfare implications of EPAs solely along static lines, however, has serious drawbacks. Trade reform directly alters the parameters under which domestic markets function: not only does the size of these markets change, also the level of competition is likely to increase because foreign competitors gain enhanced access. More competition, in turn, can lead to positive welfare effects by means of lower prices, more innovation, higher product variability and increased productivity.

As other developing countries, most ACP countries face a lack of competition in many of their domestic markets. Industries tend to have substantially higher concentration ratios than their counterparts in industrialised countries. Administrative barriers, such as establishment requirements and licensing, tend to be high and effectively constrain newcomers from entering the market. Red tape or excessive taxation can impede businesses from stepping from the informal sector into the formal sector. Imperfect financial markets also impede outsiders from obtaining the necessary financial resources to start new competitive businesses. With most developing countries lacking an effectively competition policy, all these factors tend to give excessive market power to incumbent monopolists and oligopolists.

Clearly, trade reform by means of EPAs could constitute an important step in improving levels of competitiveness in ACP economies. In sectors where domestic conditions are as described above, the mere threat of competition from EU exports might be sufficient to improve the situation. However, removing tariffs is by no means a substitute for a good competition policy. Neither will EPAs as such result in less red tape, a business-friendly fiscal system or well-functioning credit markets. Hence, liberalised trade with the EU can help, but competition levels are ultimately determined by domestic policies. Conversely, should EPAs be introduced while upholding many domestic constraints, competition in some sectors might well decrease as large EU firms, unaffected by local market constraints, corner ACP markets by means of exports or commercial presence.[9]

Economies of scale that can arise as a consequence of liberalised trade are undeniably intertwined with the above. As long as business is conducted in a competitive environment, scale effects provide a net gain to the economy: by means of increased production, average production costs are lowered and consumer prices fall. However, small and relatively closed economies such as those of many ACP countries, might currently be too small to (fully) exploit scale production, for example, because local or regional demand is insufficient or because supply is fragmented over too many small producers. Enlarging markets by means of an FTA might then be a remedy to bring so-called 'unexploited scale economies' to the surface. In theory, EPAs would do exactly that.

Yet, whether enlarged markets can really bring about scale economies for developing countries is still hotly contested.[10] In terms of scale effects related to market access for exports, ACP countries have long enjoyed tariff-free access to EU markets for nearly all of their products. In this respect, if there are still unexploited scale economies, they could only be brought about by enhanced market *entry*, a point taken up in more detail below. In contrast to ACP trade with the EU, the regional dimension of EPAs *does* foresee enlarged markets, as intra-ACP trade is still relatively well protected in the regions.[11] However, the extent to which scale-derived benefits really come about in these markets remains to be seen. In the African regions, for instance, many exports are characterised by non-complementarity towards the exports of regional partners.[12] As export markets lie predominantly outside of Africa, this means that few scale benefits can be expected from liberalised intra-regional trade.

Who benefits? The issue of economic agglomeration

Even if the overall impact of integration is positive, the benefits of integration could be distributed unequally. Scale economies, for instance, are much more likely to be reaped in the larger, more competitive and advanced ACP economies. As differences between individual ACP economies are large, it is not unrealistic to expect **agglomeration effects** – that is, changes in the geographic location of economic activities – to take place when EPAs are implemented. Once intra-regional trade barriers are eliminated under EPAs, strategic considerations could convince businesses in the region as well as foreign investors to establish their production facilities and main offices in one or only a few locations, from which they can serve the entire regional market.[13] Clearly, within ACP regions, qualitative differences in the infrastructure of key business-facilitating areas, such as transport, financial services and telecommunications, can be huge. Consequently, both regional and foreign investors in, for instance, manufacturing, may tend to locate near each other at locations where facilities are best. For an ACP region, internal integration could thus imply that parts of the manufacturing sector will concentrate in the best-developed member state, leading to de-industrialisation of less-developed partner countries.[14]

Because economic agglomeration can benefit some members of an FTA at the direct expense of others, it has the potential to undermine the entire agreement. Where an EPA is implemented there is only one remedy to mitigate the agglomeration effect, and that is to structurally improve the economic infrastructure of the least-developed ACP countries in the region, ranging from enhancing the macroeconomic and legal environment to upgrading transport and communication systems. Hence, once again, mitigating potential costs arising from EPAs depends foremost on the degree to which complementary policies can be successfully pursued by the administrations within ACP countries.

Box 1. Divergence in economic performance – some examples

Whereas the best known case of North–North integration, that of the EU, is a clear example of how integration can lead to economic convergence, there are some examples of South–South integration where the opposite has occurred. The collapse of the Eastern African Community (EAC) in 1977 was partly caused by the dissatisfaction of Tanzania and Uganda over the fact that Kenya reaped a disproportionate share of the gains because it attracted the far greater majority of manufacturing industries and thus expanded its position as the industrial centre of the common market at the expense of the others. In the Central American Common Market (CACM), a similar trend is discerned: Guatemala and El Salvador produced 69% of the region's manufacturing value-added in 1965. This figure rose to 82% by 1996, possibly at the expense of the less-industrialised CACM members Nicaragua and Honduras, whose combined share declined from 31 to 18%. In West Africa, Ivory Coast and Senegal increased their manufactured value added from 55% of the Union Economique et Monétaire Ouest Africaine (UEMOA) in 1972 to 71% in 1997.

Source: World Bank (2000)

Investment and technology transfer effects

But withstanding the above, trade and economic integration aspire to more than changes in trade patterns, the size of businesses and economic geography. **Knowledge spillovers and technology transfer** are considered to bring the most crucial benefits from trade and economic integration, enabling faster economic growth through the accumulation of new knowledge, modern technologies and job-specific skills.

According to a review by the World Bank (2000), the empirical evidence available so far is indeed supportive of the role of trade in stimulating international knowledge spillovers between industrialised and developing countries. It appears that particularly in knowledge-intensive industries, trade between industrialised and developing countries significantly increases productivity in the latter.[15]

In the EPA context, an increase in imports from Europe to the ACP could boost the productivity (and thus global competitiveness) of ACP industries. Whereas currently certain ACP processing firms cannot access the latest, most cost-efficient technologies because of tariffs or strict investment regulations, EPAs could offer new opportunities. Yet to absorb knowledge spillovers, the state of domestic human capital must be constantly improving. In other words, trade-related knowledge spillovers make little sense if education and training are insufficient to enable a country to capture these benefits.

Both trade openness and the transfer of knowledge are often associated with **foreign direct investment** (FDI). Whereas in theory, FDI can be a substitute for exports, the two are often complementary. Because rules on investment are also on the negotiation agenda, EPAs could be assumed to boost FDI. However, as yet, there is no evidence that investment agreements as such boost FDI inflows. Neither is there much clarity on whether regional integration amongst developing countries will affect the inflow of investment. Rather, it is the quality of the national or regional investment environment that seems crucial. Issues such as macroeconomic stability, reliability of public authorities, rule of law and security of property rights form the essential elements of this environment.[16] Hence, also in the area of FDI and technology and knowledge transfers, domestic policies are again crucial for EPAs to have the desired effects.

The fiscal dimesion of EPAs

Though the implications differ widely between ACP countries and regions, the fiscal dimension of EPAs is another issue that cannot be ignored. Trade liberalisation within ACP regions and with the EU implies that fiscal revenues currently obtained from tariffs and duties on imports will disappear over time.[17] In particular, the fiscal revenues of the smaller countries and the LDCs in the ACP group, whose economies are more dependent on trade-related taxation, will be seriously affected – up to 30% in some cases – as demonstrated by estimates made in different impact studies (see Table 1).

It should be noted that for many countries, the impact is likely to be even larger when the ACP's own regional integration processes and liberalisa-

Table 1. Estimates of fiscal effects of EPAs

ACP country	% fiscal revenue loss	% customs revenue loss
SADC		
Angola	3.7	n.a.
Botswana	1.0	6.0
Lesotho	0.4	0.8
Malawi	1.4	6.3
Mauritius	9.3	27.9
Mozambique	5.2	23.0
Namibia	0.8	2.5
Seychelles	29.7	70.0
Swaziland	0.4	0.8
United Republic of Tanzania	8.2	30.0
Zambia	2.0	22.0
Zimbabwe	3.1	18.0
EAC		
Kenya	12.0	82.0
Uganda	16.0	69.0
United Republic of Tanzania	20.0	73.0
CEMAC		
Cameroon	8.2	81.9
Central African Republic	14.9	79.2
Congo	14.1	71.3
Gabon	6.5	51.0
Guinea	5.0	67.0
Chad	18.2	76.7
Pacific		
Papua New Guinea	0.6	2.8
Fiji	0.3	1.4
Solomon Islands	1.4	2.5
Vanuatu	1.4	2.7
CARICOM/Dominican Republic		
Antigua Barbuda	9.5	14.0
Bahamas	n.a.	n.a.
Barbados	0.6	17.0
Belize	1.0	16.0
Dominica	1.4	6.0
Dominican Republic	1.9	19.0
Grenada	2.1	13.0
Guyana	2.6	12.0
Haiti	n.a.	n.a.
Jamaica	0.9	11.0
Montserrat	4.6	10.0
St Kitts and Nevis	2.0	10.0
St Lucia	2.5	15.0
St Vincent and the Grenadines	7.1	17.0
Suriname	n.a.	17.0
Trinidad and Tobago	0.4	16.0

Source: Bilal (2002)

tion towards third countries are taken into account.

There is no doubt that without flanking measures, these large decreases in fiscal revenue will substantially harm ACP countries' budgetary capacities to finance key expenditures in focal development areas, such as education, health and poverty alleviation. Alternative sources of revenue will therefore need to be created. A standard recipe is to replace the taxes levied on imports with an (increased) tax on consumption, labour or capital. Overall, consumers and firms should find such a tax (increase) bearable, as prices of imports would decrease simultaneously.[18]

Yet however large the rationale for fiscal reform, the issue is likely to remain among the more controversial aspects of EPAs. Experience suggests that radically altering the fiscal system is a cumbersome exercise for developing countries because (a) a large part of economic activity takes place outside the realm of the official economy; (b) many developing countries rely heavily on taxation of imports because it is relatively easier and less costly to administer; and (c) some government agencies are considered not strong enough to enforce modern types of taxation.

The issue of fiscal revenue is one of the prime examples where EPAs would need to take into account the serious institutional implications of regional integration.

Deep integration

According to the Cotonou Agreement, EPAs aim to go beyond traditional free trade agreements to tackle trade-related regulatory issues such as **sanitary and phytosanitary standards (SPS), technical standards, rules of origin and customs procedures.** These elements will be of crucial importance to ACP exporters as their effective inclusion in EPAs can make the difference between so-called 'shallow' and 'deep' integration.[19]

There is increasing evidence that while direct taxes on trade have been significantly reduced over the past decades, alternative forms of effective protection, mainly through increased regulation, have become the most significant barriers to trade with developed countries. However, compared to tariffs and quotas, this issue is much more difficult to tackle in a systematic way. It is, for instance, difficult to ascertain where trade rules stop being 'fair' and hidden protectionism (whether purposeful or not) emerges.[20]

To address issues of technical barriers to trade (TBTs), standards, and rules of origin, particularly close collaboration and consultation is needed with the relevant private sector actors, because these issues require input of a highly detailed and often very technical nature. In many ACP countries, however, constructive platforms bringing together public and private sector actors are still lacking. Hence, in order to move from free market access to effective free market entry, a lot remains to be done at the domestic policymaking levels of the ACP countries and regions.

Should EPAs turn out to be shallow agreements in practice, the lack of deep integration is likely to seriously restrict any beneficial effects. ACP regional markets are already shallowly integrated. While constraining many of the benefits, unfortunately, a shallow EPA does not necessarily mitigate the costs that integration might bring. The erosion of tariff revenues and the potentially harmful penetration of low-cost EU producers (possibly with monopoly power) will also occur under EPAs that are formed solely around the reduction of tariff barriers. In this respect, the depth of EPAs will be of much greater importance to the ACP region than to the EU.

Trade reform and poverty

In its very first article, the Cotonou Agreement states that it 'shall be centred on the objective of reducing and eventually eradicating poverty'. The first article of the Economic and Trade Cooperation chapter reiterates this principle, but subsequently the term 'poverty' goes unmentioned in any of the more detailed provisions on EPAs. Of course, one could argue that the mere successful implementation of EPAs – that is, agreements that ultimately contribute to ACP economic growth and ACP integration into the world economy – implies a positive impact on poverty alleviation. Yet such an approach surpasses some of the basic insights from economic theory and disregards practical experiences of the effects of trade reform on the poor in developing countries.

Though a few paragraphs certainly cannot suffice to cover the relation between trade reform and poverty, some basic insights can be mentioned.[21] As put forward by Winters (1999), the functioning of markets is the most critical issue determining the impact of trade liberalisation on the poor. The welfare effects of trade liberalisation can be distributed along four major channels: the prices of goods, the prices of production factors (capital, labour), the effects on technology and growth, and the effects on the fiscal balance.

First, trade reform sets off price changes. In general, trade liberalisation increases export prices and decreases import prices. The existence of functional distribution channels (wholesalers, transporters, retailers) determines the degree to which price changes at the border actually filter through to the rest of a country or region. Further, if the diversity and substitutability of the goods consumed is large (and markets function well), overall effects are likely to be positive because the poor can shift their consumption towards goods that have become cheaper.

Second, trade reform may change factor prices. Changes in employment and wages might have serious consequences for the poor. Whether the poor can mitigate costs (e.g. unemployment in import-competing industries) and subsequently benefit from opportunities (e.g. employment in expanding sectors) depends on the functionality of labour and capital markets, as well as the degree to which workers and smallholders can adapt their skills to the new economic environment.

As discussed before, a liberalised trade policy can stimulate economic growth through the import of new technologies and the inflow of knowledge, either via trade in goods, the attraction of FDI, or both. Though there are exceptions, empirical evidence strongly suggests that economic growth tends to benefit the poor proportionally.[22] However, as also mentioned earlier, trade liberalisation can adversely impact the fiscal balance. Whether this affects poor households – and to what extent – ultimately depends on the budgetary and fiscal decisions made by government. Though the poor constitute the largest proportion of the population in nearly all ACP countries, a key question is to what extent the poor can form an effective interest group in the tax-reform process. In developing countries where a small elite dominates the political agenda and the reform process, there is a real danger that the burden of budget cuts or new taxes will be disproportionately shifted towards the poor.

Clearly, the functioning of markets, flanking measures and democracy are the key elements that determine the overall effect of trade liberalisation on the poor. If the markets for goods, labour and credit function adequately, poorer groups will ultimately be better off by means of a generally lower price level and jobs or businesses that earn better wages and higher profits than before. Similarly, the quality of public services in combination with the effectiveness of democracy ultimately determines whether the benefits and costs will be spread equally over society.

Three factors affecting the impact of EPAs

From the above, it is still impossible to discern the impact that an EPA might have on an ACP region. To do so would require detailed analyses at both ACP regional and country levels. Overall, three factors can be said to determine the final outcome of EPAs, should they be concluded:

- the economic characteristics of the ACP region;
- the provisions of the final agreement; and
- the development and enhancement of key institutions in the ACP countries before, during and after EPA negotiations.

As for the first factor, *the economic characteristics of the ACP region*, it is evident that the ACP group is much too diverse to generalise on the overall directions of the aforementioned economic effects. Crude economic characteristics, such as GDP per capita, macroeconomic stability, main income sources and trade patterns with the EU, differ substantially between but also within ACP regions. Inevitably, some countries will be more prone to gain from EPAs whereas for others, the costs, at least in the short run, are likely to be larger.

In contrast to the first factor, which comprises a given set of characteristics that each region has to live with, the second factor, *that of EPA provisions*, is

Table 2. An institutional 'wish list' for EPAs

A	B	C	D	E
Economic impact*	**Positive effect +**	**Negative effect – (maximise B, minimise C)**	**Welfare stimulators**	**Key institutional and organisational requirements**
static effects	• trade creation	• trade diversion	• trade liberalisation towards third countries	• strategic external trade policy
competition effects and scale effects	• lower prices for consumers and producers •job creation • efficiency gains • stimulation of domestic and foreign investment	• threat to previously protected industries • job losses • monopolies cornering regional markets • growth divergence between least and more developed countries in an ACP region	• competition policy • short adjustment processes for firms and workers • improved market access to EU for exporting (scale) industries • improved economic infrastructure and investment environment in least-developed ACP countries	• functional labour and capital markets • rule of law • functional judiciary • competition authority • national and regional infrastructure strategies • improved access to credit for SMEs
agglomeration effects	• centripetal forces: broad geographical distribution of benefits	• centrifugal forces: benefits accrue predominantly to centres of economic activity	• improvement of economic infrastructure	• national and regional infrastructure strategies (see WB on this) • improved private and public access to credit
FDI and technology transfer effects	• growth in FDI • knowledge accumulation • productivity increases	• hub and spoke (investment diversion effect towards EU hub)	• trade and investment liberalisation within ACP regions and towards third countries • improvement of investment environment	• rule of law • macroeconomic stability and reform • social stability • education
fiscal effects	• fiscal reform (trade policy no longer fiscal instrument)	• loss of fiscal revenue due to tariff elimination	• technical assistance for reform • fiscal compensation measures	• competent tax authorities • society conducive to change • rule of law
additional integration effects	• deep integration: from market access to market entry	• shallow integration: few measures beyond duty-free access	• upgrading of customs procedures, certification agencies and public and private sector know-how on trade facilitation • strong EU–ACP co-ordination and co-operation on (removal of) non-tariff barriers • improved rules of origin	• empowerment of business associations • dialogue and trust between public and private sector • competent trade bureaucracies • strong regional organisations

Table 2 (continued)

A	B	C	D	E
Economic impact*	**Positive effect +**	**Negative effect - (maximise B, minimise C)**	**Welfare stimulators**	**Key institutional and organisational requirements**
impact on poverty	dependant on dynamics of B and C		• functional markets for goods, credit and labour • poverty impact analyses by ACP and EU, including informal sector, urban, rural and gender dimensions	• effective democracy • education and training • mainstreaming trade policy into PRSPs and overall development policies

*This table provides a schematic – and necessarily artificial – representation of the variety of economic effects that EPAs could have and their enabling conditions. Genuine classification of effects and conditions is problematic because of strong interrelationships.

in constant flux. The precise details of an EPA will be discussed time and again over the next few years. The extent to which the principle of asymmetry is applied will probably be at the heart of these discussions. Transitional periods, sector exclusions and safeguards can all prevent or eliminate the economic effects discussed above. This can be positive in areas where large costs and only marginal benefits are involved for the ACP. However, excessive flexibility in the implementation of reforms can also evaporate all potential gains. Furthermore, there are important legal challenges to tackle. On issues such as investment rules, contingency protection, dispute settlement, trade-related areas and EU assistance, it is the legal and procedural details, rather than the inclusion of these areas as such, that will affect the impact of an EPA.

The third factor, *development and enhancement of ACP institutions*, is the most elusive but arguably the most important in determining the outcome of EPAs. In parallel to the EPA negotiations, ACP countries face the overriding challenge of preparing their relatively small economies for free trade with the world's largest economy. As previously argued, being prepared means that the necessary *enabling conditions* are in place once an EPA is implemented. To bring about these conditions, a wide set of institutional reforms is necessary, and sufficient capacity must be in place to adequately manage these reforms. Indeed, from the previous sections, an *institutional 'wish list'* could be compiled with respect to ACP preparations (see Table 2). Yet history shows that the emergence of institutions is anything but an automatic and inevitable process.[23] Moreover, various institutions that ACP countries currently lack have taken decades or more to develop and mature in developed countries.[24] In other words, acknowledging that many ACP countries at present lack the resources, the experience and often the necessary political leadership, the question springs to mind of whether the necessary 'eruption' of institutions and capacities can occur within the relatively short timeframe that EPA negotiations pose. The next section deals with this question.

An institutional race against the clock

From the previous section it is clear that the quality of institutions will be a crucial factor determining the impact of EPAs on ACP countries (Box 4.1). However, in many ACP countries and regions, the institutional framework is currently insufficient to adequately deal with all of the economic effects of EPAs. A key question is thus whether the process of EPA negotiations can sufficiently trigger the improvement of institutions in the ACP countries. That institutions matter for development is now widely acknowledged within the international community. The quality of developing countries' institutions is generally viewed as a crucial factor in realis-

Box 2. Institutions

In the literature, the term institutions is used by a wide range of academic disciplines and applied to a variety of contexts. For the purpose of this chapter it refers to:

formal and informal rules and their enforcement mechanisms that shape the behaviour of individuals and organizations in society.

(Burki and Perry, 1998).

Clearly, this is a broad concept. However, in light of column D in Table 2, it would be impossible to come up with a more narrow and concrete concept that would do justice to the range of conditions that will determine the impact of EPAs. Because both the form and the quality of institutions are dependent on a great variety of factors – (financial) resources being only a minor one – changing the institutional framework of a society is broadly recognised as an elusive and long-term process.

ing a horizon of objectives, whether they concern human rights, peace and security, health and education, the environment or economic prosperity and poverty alleviation.[25]

Institutions as the crux for trade and development

Many observers argue that understanding the conditions that shape institutions is central to explaining international differences in economic performance.[26] With respect to trade policy, an interesting empirical debate has emerged as to whether trade openness or institutional quality better explains a (developing) country's economic performance.[27] Recent work by Rodrik and others suggests that once institutional quality is accounted for, this factor trumps all others – including openness – in explaining international differences in prosperity.[28] In this light, the controversy regarding the proposition of Dollar and Kraay (that openness leads to significantly higher economic growth) is further increased. Rather, it appears not to be *what* a country does that is crucial, but *how* it does it.[29] The issue then moves away from the one-dimensional question of protectionism versus openness towards the multiple dimensions of the trade policymaking process and related institutions.[30]

If the process and institutions related to trade policymaking are indeed so crucial to economic growth and development, EPAs pose much more than just a strategic challenge to the ACP. Before, during and after liberalisation of trade with the EU, complex analyses must be undertaken and difficult decisions made with respect to the functioning of capital and labour markets, public investments in infrastructure, competition and other legislative settings, a new or improved fiscal system, social safety nets, a multilateral trade strategy, the structure, shape and programme of regional integration, and an upgrade of statistical services, customs procedures and technical facilities. Of course, for all of the areas mentioned, reforms are needed – regardless of whether trade is liberalised through EPAs. Yet the key question is whether the EPA process offers a good vehicle to achieve the reform objectives, and if so, whether the timeframe is sufficient to allow the appropriate institutions to develop.

To better concretise the case for institutions, the following sections deal specifically with the trade policymaking process and the related issue of trade capacity-building.

The trade policy process: Best practices from developing countries

If there is no standard formula for the best trade policy with respect to development, then certainly no standard policy process can exist. Each developing country has a unique political, social and economic environment in which the government operates to make trade policy and prepare for international trade negotiations. In this respect, of particular relevance for most developing countries are the financial and human resource constraints that impede the generation of all relevant information and hamper analyses for optimal preparation.

Though a range of literature addresses how trade policy is conducted in developed countries, only in recent years have academics and policymakers from North and South started to give systematic attention to trade policy processes in developing countries.[31] In order to discuss these, it is first necessary to define what is meant by effective trade policymaking. Following Solignac Lecompte (2001a), it can be argued that this is a process that:

- identifies the country's *trade interests*, in the framework of its overall development strategy;
- translates these interests into *policies and negotiating goals*; and
- distributes *roles* – either explicitly or implicitly – and allocates *resources* to implement these policies and promote these interests, reactively or actively, in the various negotiating fora (at multilateral, bilateral and regional levels).

Reviewing the recent literature, the overall picture seems to be that despite impressive progress in certain countries, most developing countries remain unable to live up to the enormous challenges posed by current global trade rules and multiple negotiation fora. Though, naturally, financial and human resource constraints are the suspects most visible to observers, evidence also convincingly points towards a lack of several other elements as hampering trade policymaking.[32] Those that seem most critical to an effective trade policymaking process are leadership, capacity, and inclusiveness and transparency.

Leadership. Political leadership is a sine qua non for a good trade policymaking process. Only when a government clearly recognises the importance of its trade policy, it can prevent the trade agenda from being fully captured by wider political interests. Policymakers and trade officials require not only adequate resources but also sufficient political support in order to embed national trade policy in overall development policy. If a government is to take trade policy seriously, it must allow its officials to deal with vested interests, both within the government administration and in the private sector.

Capacity. To adequately deal with the international trading system, countries need basic capabilities, functioning organisations and competent people within those organisations. The scope of WTO rules and bilateral trade negotiations is so broad that both the development and implementation of trade policy will affect a wide range of government departments. Hence, there is an overriding need for adequate capacity, not only to understand international trade issues and their potential impacts, but also to co-ordinate between relevant departments within the government and to delegate authority amongst government actors.[33]

Inclusiveness and Transparency. The inclusion of non-state actors in formulating trade policy can widen the resources and information available to the policymaking process and channel information on policy implications to stakeholders. An effective consultation mechanism – involving the relevant government agencies, the business sector and civil society through unions, non-governmental organisations (NGOs), and academia – can lessen the burden on government to generate sufficient information. Inclusion can also create the necessary degree of *transparency* and *legitimacy* for trade reform.

Though easily adopted in principle, experience suggests that initiating genuine dialogue between government and non-state actors is difficult in practice. For example, private enterprises in developing countries are seldom aware of their stakes in trade agreements, and their relations with government authorities are often characterised by discontent and mistrust. Clearly, the development of a successful public–private consultation mechanism, in which government and non-state actors both recognise the potential value-added, can be achieved only with time.[34]

The donor dimension: TCB as a hype?

Donors and international organisations have increasingly recognised the capacity constraints facing developing countries in the field of international trade. Consequently, trade capacity-building (TCB) programmes aim to support trade-related institutions in those countries. Yet, it is only since the launching of the Doha Round in 2001 that TCB has been at the top of the international trade

Box 3. Trade capacity building

Although institutions (as defined in Box 2) are crucial to the impact of EPAs, the concept seems too broad and elusive to form a concrete target for development co-operation agendas.[a]

Instead, recipient government authorities and donors have narrowed their focus on those organisations that they perceive to be the most important through their direct impact on the wider institutional framework. Within the specific area of trade policy, we have clearly identified some of these organisations, such as government ministries, regulating and enforcement authorities, judicial bodies, regional organisations, private sector entities, universities, and civil society representatives. Obviously, the ultimate objective of co-operation and assistance is to build the capacities to research, debate, design, negotiate, implement and regulate trade and trade-related policies. In this respect the term *trade capacity building* is often used.[b] This paper defines trade capacity-building as:

'a process by which individuals, groups, and organisations enhance their abilities (individually and collectively) to perform tasks, solve problems and both set and achieve objectives in the field of trade and trade-related policymaking and implementation'.

[a]Over the past decade, some bilateral donors have incorporated *institutional development* as a cross-cutting objective in their co-operation and assistance programmes; however, there remains substantial ambiguity over what this means in practice.

[b]*Capacity development* or *capacity enhancement* are other terms often employed by international institutions and donors. Neither is necessarily more suitable than another. ECDPM is currently carrying out a study to shed light on the semantic confusion around and operational meaning of concepts such as capacity. This paper uses *trade capacity-building* because it occurs most frequently in the debate on ACP–EU trade negotiations.

agenda. The Doha Declaration clearly spells out that 'technical co-operation and capacity-building are core elements of the development dimension of the multilateral trading system' (Art. 42).

Table 3 shows that the increased attention for developing countries' trade institutions has led to substantial contributions from donors in TCB-related activities (see also Box 4).[35] Evidently, developed countries have a clear interest in devoting resources to these initiatives. Without the strong provisions for assistance to developing countries' trade institutions it is unlikely that the Doha Round could have been launched. For the WTO itself, TCB programmes are crucial because the non-participation of many developing countries constitutes a direct threat to the credibility and legitimacy of the organisation.

Moreover, TCB programmes seem important to ensure that developing countries stay involved in the trade liberalisation process and remain willing to enter into negotiations on issues that they originally perceive not to be in their interest. For instance, in 2002 one-third of the world total TCB activities concerned the so-called 'Singapore issues' (investment, competition, government procurement and trade facilitation).[36] Interestingly, it is exactly these issues that most developing countries are reluctant or unwilling to negotiate in the Doha Round, as was demonstrated by the breakdown of the WTO Ministerial Meeting in Cancun. Hence, TCB programmes can also serve as a buy-out to obtain concessions from developing countries in multilateral or bilateral trade negotiations.[37]

The European Commission has been among the main driving forces of TCB programmes. Though support in this area features throughout the EU's external relations agenda, EU support for TCB is most ambitious with respect to the ACP group. Since its initial 1996 Green Paper, which initially proposed reciprocity, the Commission has stressed that EPAs should go beyond just free trade. Consequently, provisions stressing capacity building for both regional and domestic ACP organisations recur throughout the Cotonou Agreement.[38] Yet the

Table 3. Trade-related technical assistance (TRTA) and capacity-building (CB) commitments in 2002 (US$ million)

Main donors	Trade policy and regulations[a]		Trade development[b]		Contributions to multilateral TRTA/CB providers or programmes[c]	
European Commission	292	41%	419	59%	0.8	0%
France	5.3	5%	112.8	93%	1.6	1%
Germany	9.0	12%	65.5	84%	1.2	2%
Japan	16.1	31%	34.8	67%	1.5	2%
Netherlands	2.6	10%	22.4	82%	2.3	8%
Switzerland	8.7	12%	55.7	79%	5.9	9%
United Kingdom	18.3	33%	35.2	63%	2.7	5%
United States	177.8	29%	437.7	71%	1.5	0%
World total	712	33%	1383.4	65%	34.6	1%

Source: WTO/OECD TRTA & CB Database (2003).

[a]Concerns programmes in areas such as trade education and training, regional integration, agriculture, services, competition policy, investment rules, SPS, TBTs, TRIPs, customs procedures and trade negotiations.

[b]Concerns programmes in areas such as business support services, public–private networks, trade finance, market analysis and trade promotion.

[c]WTO, Integrated Framework (IF), Joint Integrated Technical Assistance Programme (JITAP), and the International Trade Centre (ITC).

agreement did not go so far as to commit additional funds for countries negotiating EPAs. To date, the Commission has stressed that the 9th EDF already reserves a considerable sum for this purpose, mostly via its Regional Indicative Programmes (RIPs).[39] As an exception to the rule, a € 20 million Programme Management Unit (PMU) was set up to facilitate preparatory work for EPA negotiations by ACP actors. This PMU is in addition to an earlier committed € 10 million to support ACP participation in WTO negotiations.

Since the regional dimension constitutes an important element of EPAs, it receives special attention in the support programmes. In this light, the Commission introduced the so-called 'toolbox' into the negotiations. Under the toolbox heading 'the elements relevant for successful ACP regional economic integration' are to be discussed. The Commission stresses that discussions 'will not end up with a recipe for a 'one-size-fits-all' integration process but should reflect on the building blocks of regional economic integration and the relationship to regional negotiations of EPAs'.[40] To complement the discussions under the toolbox heading with concrete support measures, in July 2003 the Commission approved an all-ACP € 50 million support programme called Trade.Com. During EPA negotiations, this programme is to support the ACP regions in their preparations both for the negotiations and for the implementation of EPAs (see Box 4).

TCB programmes and institutions

Whereas both attention and funding for TCB activities have increased, there is as yet no systematic evidence that TCB programmes actually result in the development of appropriate institutions and sustainable capacities for trade policymaking. Indeed, most initiatives are relatively new and their full impact remains to be assessed. Yet the literature on institutional development in general and some case studies on TCB in particular may already offer some preliminary insights.

Characteristics of institutional development

Many observers have asked the question of how institutions develop and, consequently, how such a process can be supported by outsiders – donors and international institutions. To what extent can these outsiders actually influence the development of institutions in the first place? To date, surprisingly little research has been done that systematically distinguishes between the impact of internal and external factors on institutions. With respect to the

Box 4. The EU and trade capacity-building

The apparent importance that the Commission attaches to trade-related assistance is certainly not to the ACP group. Over the past three years, some €2 billion has been spent on TCB for developing countries.a In many national or regional assistance programmes, considerable funds have been explicitly reserved for this purpose. In addition to direct bilateral support, the EU has taken a lead role in various multilateral TCB initiatives aimed at developing countries.

EU funded trade capacity-building programmes*

Beneficiary	TCB fund/source[b]	EU trade-related funding (€ million)	EU trade-related funding as % of total (EU) funding
Multilateral initiatives			
LDCs	Integrated Framework	5.5	60%
Developing countries	Doha Development Trust Fund	12	63%
All ACP			
ACP group	Trade.Com (part of 9th EDF)	50	100%
ACP group	PMU	20	100%
ACP group	Doha Round	10	100%
ACP regions[c]			
Central Africa	RIP 2002–07	14–16	25–30%
West Africa	RIP 2002–07	118	50%
Eastern and Southern Africa and Indian Ocean	RIP 2002–07	100–120	45–55%
Southern Africa (SADC)	RIP 2002–07	35–45	35–45%
Pacific	RIP 2002–07	9	31%
Caribbean	RIP 2002–07	43–51	75–90%
Non-ACP countries[c]			
Paraguay	NIP 2000–06	21.7	42%
Uruguay	NIP 2002–06	5.4	29 %
Chile	NIP 2000–06	6.4	19%
Bangladesh	NIP 2002–06	49	9%
Vietnam	NIP 2002–06	6	6%
Thailand	NIP 2002–04	5	50%
Non-ACP regions[c]			
Andean Community	RIP 2002–06	0.7	5%
Central America	RIP 2002–06	44.7	60%
Mediterranean	RIP 2002–04	10	11%

*The table is illustrative and does not present all EU support in the TCB area. In the case of the ACP, National Indicative Programs (NIPs) may also include funding that is trade-related.

[a]EC (2003a)

[b]NIPs: National Indicative Programme; RIP: Regional Indicative Programme

[c]In some NIPs and RIPs, trade-related capacity-building support is included in allocations that serve a wider purpose; here only NIPs and RIPs that reserve funds explicitly for support to regional integration and/or trade-related capacity building are included.

Box 5. Trade.Com and EPAs

In July 2003, the European Commission approved the Trade.Com programme for ACP countries. According to the Commission, Trade.Com will focus on 'creating the necessary capacities in ACP countries to benefit from increased trading opportunities'. The programme comprises three main components:

- strengthening of local trade policymaking, research and training capacities in the ACP countries;
- establishing a network of ACP experts through a so-called 'Hub and Spokes' programme (in addition to regional senior trade advisers, funding will be provided for local and regional trade fellows); and
- pilot projects to address urgent institutional and supply-side constraints in the areas of technical standards and sanitary and phyto-sanitary (SPS) requirements.

Trade.Com will be financed from regular EDF funds. It will become operational in 2004 for a period of six years, thus covering the entire EPA negotiation period and beyond.

specific role of donors, however, several case studies suggest that they have often failed to incorporate institution-related issues successfully into their programmes.[41] Some would argue that in most cases it is mainly the context (the macroeconomic environment) that prevents external assistance from having a (sustainable) impact on institutions. However, here too concrete evidence is lacking.[42]

There is a large body of literature on the conditions that support or strengthen institutions.[43] Given the broad scope of the subject, it is not surprising that many of these conditions are interdependent and mutually reinforcing. In full acknowledgement of this, a non-exhaustive and necessarily artificial classification of some of the basic insights follows below.

A long-term and evolutionary process. Institutions cannot develop overnight or through one-shot initiatives or projects. One organisation cannot develop another. Rather, the development of institutions concerns an endogenous process that requires the stakeholders involved (e.g. public officials, non-state actors and donors) to continuously learn from each other, gain experience, and adapt their working methods along the way.

There is no magic bullet for creating or strengthening institutions. In particular in the area of trade, it has become abundantly clear that each case is *sui generis*. For instance, relatively successful institutions, such as those establishing European integration, are not easily copied by others. To be effective, institutions need to complement local conditions. 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' reform) does not lead to improvements in practice.[44] Incremental change, by building on existing capacities and structures, however imperfect these may be, is more likely to yield benefits over time.

Political leadership. The willingness of leaders to use their political weight in support of change is crucial. Admittedly, the improvement of institutions is often a bottom-up process, originating from the roots of society. Politicians are sometimes late arrivals in such processes. Yet their role is crucial, since improvements in institutions can only be harnessed once the top has fully recognised their importance.

Ownership. Government and non-state actors are owners of a process when they feel it empowers them and serves their interests.[45] If organisations, laws or procedures are established only in response to pressures from outside, they are unlikely to survive or be implemented. Once actors feel they have a stake in the successful establishment of organisations or the effective implementation of rules and procedures, a basis for positive institutional change can emerge. The literature shows that when stakeholders come into policy processes with open minds, the final decisions are more appropriate and more likely to be implemented than if some stakeholders adopt preconceived positions from the beginning. This suggests that policy conditionalities fixed *a priori* are likely to be counterproductive.

Inclusiveness. In many cases, institutional change is pursued in a context of policy reform. To prevent a (reformed) public sector organisation from operating in an isolated environment, it is important to involve non-state stakeholders in the reform process. In the area of trade reform for instance, developing countries that have been able to broaden their policymaking processes by engaging in open and inclusive consultations with the private sector have generally performed better than countries where such consultations have been absent.[46]

The involvement of donors

Though the concept remains elusive for many, building sustainable institutions has acquired a firm place on donors' lists of top priorities. Nonetheless, the donor community's record with respect to effective support for good institutions remains dismal. In a review of the literature, SIDA (1995) concluded, '[I]t is clear that aid agencies perform badly at institution building. They are bureaucratic institutions that are financially accountable to their own governments and taxpayers. They are outsiders to the country they are trying to help and their understanding of the local context is limited'.

The specific field of trade seems to be no exception in this respect: it has proven to be difficult to have a lasting impact as a donor. Moreover, the large number of TCB programmes have the additional disadvantage of possible double agendas and the risk of so-called 'biased aid'.[47] Except for this point (which applies specifically to the area of trade), the recent spurt of literature and case studies on donor involvement in institution building tends to confirm some general insights on how donors can stimulate or fracture the development of institutions.

Absorptive capacity. Unfortunately, the countries most in need of assistance in institution building have the most difficulties in using assistance effectively. Because the institutional bases in these countries are amongst the most fragile, it is all the more difficult to stimulate sustainable development from the outside. Additionally, in countries where the fewest government resources can be committed towards institution building, ownership and accountability are likely to remain low, and there is a serious chance that donor and recipient will enter into a downward spiral of aid dependency. LDCs constitute a particularly difficult case for donors. As UNDP put it, the LDCs' 'weakness also inhibits their ability and confidence to get into the driving seat, choose the direction in which to travel, and acquire and absorb appropriate resources that will be needed on the journey.'[48]

A demand-driven agenda. Where donors dominate the identification, design and implementation of programmes, recipients tend to adopt passive attitudes, resources are allocated inefficiently and aid-dependency increases. Although recipients are also often motivated by short-term interests, a donor-driven agenda tends to further bias the allocation of assistance towards activities that can, in a short time span, result in more tangible outputs. Without adequate needs assessments, programmes can divert capacities to areas of lesser local concern, decrease ownership and limit accountability on the recipients' side. Though the very involvement of donors will always complicate the intersection between demand and supply, by definition the genuine development of institutions is a process driven by local stakeholders.

Accountability. Donors can bias responsibility. The link between a government recipient and donor often takes precedence over the government's relationship with its citizens, which should be the cornerstone of a demand-driven process. Where actors are not very accountable to the actual stakeholders they serve, external assistance can undermine the opportunities for nationals to express their interests and priorities.

Flexibility. The circumstances under which institutions can be built or improved differ significantly by country and sector. 'One size fits all' programme designs tend to undermine flexibility, which is needed at the implementation level to adjust efforts to local circumstances.

Capacity depletion. Donors can attract competent personnel away from local organisations to the detriment of sustainable institution-building. By directly or indirectly raising salaries and improving career prospects, donors can disturb the allocation of human resources in specific areas of policymaking, reducing continuity in the very institutions they are trying to assist. Personal skills are often upgraded through technical assistance and capacity-building programmes; but organisational learning is low because trained personnel switch to better-paid jobs. In particular, where projects are short-term, staff that benefited from training and education tend to leave organisations once projects are terminated.[49]

EPAs as drivers of institutions?

With respect to the impact that EU-funded TCB programmes might have on the relevant ACP institutions during EPA negotiations, the analysis above suggests some reservations.

Short-term. The timeframe in which EPAs are negotiated biases both donor and recipient priorities towards the short-term demands of trade negotiations: quick fixes and ad hoc solutions are required. For example, where there is a lack of local expertise, non-ACP consultants will likely be hired to provide various analyses and studies. Though these can be used directly as inputs in the negotiations, they seldom contribute to local policymaking capacities. Hence, there is an inherent danger that support programmes will quickly revert to backstopping of urgent capacity gaps, while ignoring their primary causes. Whereas the immediate negotiation process could run more smoothly with such direct support, a short-term approach could backfire once policymakers have to implement the agreement.

Supply-driven. Both the initial idea of EPAs as well as the current negotiation process have been predominantly driven by the European Commission. During negotiations on the Cotonou Agreement, many ACP countries responded to the idea of reciprocity with lukewarm enthusiasm.[50] Subsequently, the ACP group largely took a defensive and reactive stance during the first year of the negotiations. Though this cannot be generalised to every individual country, it is undeniable that many ACP countries have yet to fully endorse the ideas of reciprocity, domestic flanking measures and institutional reform.

Marginalisation of the national level? TCB support is likely to focus on the ACP regional levels, where bi-regional negotiations will take place. Yet it will be at the national levels that the bulk of policy reform will have to be done before and during the implementation of EPAs. As discussed, without significantly upgrading national trade policy institutions, ACP regions are unlikely to benefit from EPAs. Moreover, if national-level policymakers and politicians are marginalised in the EPA process, the negotiations are more likely to break down at critical stages.[51]

Lack of stability. Finally, in certain countries and regions, even the most basic enabling conditions for the development of trade-related institutions (or of institutions in general) are currently not in place. In various parts of West Africa and Eastern and Southern Africa, civil unrest, political instability and, in some areas, military conflict have eclipsed difficult but important policy issues such as trade reform on the policy agenda.[52] Some islands in the Pacific have also recently been contending with political turmoil. It is hard to imagine that their governments would currently be ready to fully engage themselves in reforming their trade institutions. Whereas other types of EU support might be most welcome, starting TCB programmes in countries where ownership and accountability is temporarily non-existent would be nothing short of a waste of resources.

Coercion or engagement: Two scenarios towards EPAs

An important aspect about EPAs is that the institutional 'wish list', as identified in section earlier, would hold true regardless of whether the ACP and the EU had agreed to reciprocity in the Cotonou Agreement. The current international trade environment demands substantial reforms from developing countries. Whether these reforms come about because of domestic, regional or multilateral factors is less relevant once it is acknowledged that trade policy and its related institutions *must* be improved, if only for the sole purpose of development and poverty alleviation.[53] In this sense, it could be argued that the ACP can use EPAs and the accompanying EU assistance as a convenient vehicle to implement much-needed trade policy reforms.

On the other hand, it can also be questioned whether the concept of EPAs is suitable to deliver the required reforms. Arguably, trade-related institution building should basically be viewed as increasing ACP capacities to autonomously determine what policy direction is most suitable for their development. Yet the EPAs predetermine the direction of ACP trade policy (opening domestic markets *vis-à-vis* the EU). A related issue is that of sequencing. Whereas few disagree that trade policy reforms are necessary, a key question is whether up to 2008 and beyond the most pertinent needs will be addressed in the appropriate order and without skipping crucial steps in the process.

Taking into account the aforementioned insights on institution building and combining these with the experiences of other countries and regions that have been involved in trade negotiations with large trade partners, two different scenarios for EPAs can be envisaged.

Scenario I: A political economy of engagement

Recent case studies confirm that the mere involvement in trade negotiations can set off a range of positive externalities that affect policymakers and their institutions. In a case study of South Africa, Bilal and Laporte (2004) note that South Africa actively sought a new and progressive trade relationship with the EU, and it viewed trade negotiations as complementary to its overall development strategy in the post-Apartheid era (see Box 6). Under the influence of various regional and hemispheric negotiations, trade policy has also arisen on the agenda of the small countries in the Caribbean, pushing the pooling of resources at the regional level in order to deal with their considerable capacity constraints.[54] Hence, the urgent need to prepare input for trade negotiations can provide a necessary stimulus to organise policy processes more effectively, to better define economic and development policies, and ultimately to improve policy implementation. This also applies with respect to the intra-regional integration process. According to Bouzas (2004), the initial stages of Mercosur's integration process were characterised by the increased exposure of less experienced policymakers from the smaller member states (Uruguay and Paraguay) to their better equipped counterparts (Argentina and Brazil).

In this sense, (regional) trade negotiations can set off a political economy of engagement: domestic policymaking institutions improve as a consequence of the external policy agenda. As politicians and their policymakers become more exposed to the practices and policies of other countries, they will gain in their own leadership and policymaking capacities. Moreover, international negotiations provide an important incentive to review the strengths and weaknesses of domestic economic policy. Experience suggests that particularly in countries involved in democratisation processes with increasing participation of non-state actors (the business community, civil society and academia), policymaking institutions are likely to improve when exposed to external negotiations. Throughout Latin America, for example, democratisation and an increased demand for legitimate policymaking transformed trade policymaking processes throughout the 1990s. Opaque links between the public sector and a select group of large (import-competing) industries have been slowly replaced by more transparent and participatory policy processes.[55]

Seen in this light, EPAs could constitute an important stimulus to national and regional ACP institutions. This would affect not only trade policy *vis-à-vis* the EU, but also economic policy with respect to regional partners, important third-country markets, and multilateral partners. EPAs would then provide the often missing link between trade policy and ACP countries' integration into the world economy and, perhaps more importantly, between trade policy and their overall development policies.

Scenario II: EPAs through coercion

In the previous scenario, the EPA negotiation process would lock in an ACP's commitment to trade liberalisation, domestic flanking measures and institutional reform. Yet for this to happen, the

Box 6. South Africa: A precedent in institutional development?

Between 1995 and 1999, the EU negotiated its first comprehensive trade agreement with an African country, the Trade, Development and Cooperation Agreement (TDCA) with South Africa. A recent ECDPM case study (Bilal and Laporte, 2004) describes South Africa's preparatory process for these negotiations, highlighting a quite impressive performance of South African institutions (both state and non-state) at various levels. In the turbulent aftermath of the Apartheid era, the new South African government managed within a relatively short timeframe to define an overall development agenda for the country, integrate its external trade strategy into this agenda and identify its key strategic interests in the negotiations with the EU. After decades of sanctions, South Africa was a *de facto* newcomer in the international trade system. Devoid of any recent trade negotiation experience, the administration made use of its human resources to the fullest extent, as key administrators from the old regime worked together with the new ANC intelligentsia to prepare for trade talks with the EU. Other crucial elements supporting the administration were the functioning public–private sector platforms by which government, businesses, unions, farmers and civil society representatives critically followed the negotiations and distributed information to their constituencies. Various actors closely involved in the talks acknowledged that the negotiation process itself proved to be a valuable asset for South Africa's institutions.

The South African experience offers food for thought. If four years of experience in TDCA negotiations served to consolidate South African policymakers' trade and development strategies, wouldn't eight years of EPA negotiations provide similar stimuli to ACP countries and regions? Though the short story of the TDCA negotiations may give this impression, there are several reasons to remain sceptical.

First, after South Africa was initially declined access to the Lomé trade regime, the country consciously opted to negotiate a 'development friendly' free trade agreement with its most important trading partner. This deliberate approach was symbolised by the political leadership provided by presidents Nelson Mandela and Thabo Mbeki throughout the process. The South African administration was already engaged in a substantial trade-reform process before negotiations commenced, and in the government's view, an agreement with the EU would complement and harness these reforms. In contrast, many ACP countries have adopted a predominantly reluctant and defensive position the idea of reciprocity.

Second, prior to the negotiations South Africa's external trade policy already formed an instrument of an overarching development strategy, comprising a wide array of (reforming) institutions in the aftermath of Apartheid. In many ACP countries, however, trade and development have yet to be integrated into a mutually supportive framework.

Third, despite the radical changes that took place after the first democratic elections in South Africa, the old economic and institutional machinery was not destroyed by the new government. This meant that despite its inexperience on the international stage, the country was already endowed with a human capital stock and infrastructure quality beyond that of many ACP countries.

countries concerned would have to 'own' the concept of EPAs, like the way that South Africa actively sought new trade relations with the EU, or the Mercosur countries initially were highly committed to their internal integration process.

Yet, should ACP countries be engaged in EPA negotiations primarily for political reasons or because no suitable alternative is available, a different scenario is likely to develop. Instead of proactively engaging in trade policy analyses, consultations with non-state actors and the effective utilisation of TCB funds, countries and regions would adopt a wait-and-see approach, even as negotiations enter into the substance of trade liberalisation. Even if the regional organisations may themselves grow stronger through the EPA process, their efforts to conclude beneficial agreements with the EU will be in vain if politicians and policymakers at the national levels do not get on board. In particular, if strong political leadership in favour of reciprocal trade agreements is lacking, national ACP actors are likely to act only defensively in response to EU proposals.

In consequence, there would be a serious danger that the ACP actors involved in the negotiations concentrate on the more superficial issues, such as additional resources from the EU.[56] Meanwhile, pertinent measures to upgrade domestic and regional trade institutions, both for the negotiations and for the eventual implementation of the agreements, would be omitted or implemented half-heartedly.

Of course, it cannot be ruled out that negotiations would simply break down if a certain ACP region proves insufficiently prepared to commit to an EPA. In particular, the regional dimension could frustrate the negotiations if members of an ACP regional grouping are unable to agree to enhance their own integration and their joint positions *vis-à-vis* the EU.[57] On the other hand, many ACP countries are highly dependent on access to the EU market. It is therefore questionable whether a country, under political pressure from its regional peers and the EU, would be willing to actually walk out of the negotiations at crucial moments.[58]

In this respect, there is a real possibility that even ACP countries that do not see the benefits of reciprocity would ultimately sign EPAs with the EU. In that case, trade relations with the EU are likely to be characterised by three features. First, the effective implementation of the agreements is likely to be cumbersome and restricted to the more superficial measures such as the elimination of tariffs on EU exports. Second, TCB funds available are unlikely to be used to effectively and sustainably improve trade policy institutions because the necessary reforms would not be owned by the recipient country. Third, and as a consequence, the largest benefits of trade liberalisation *vis-à-vis* the EU and its regional partners would not be captured by the ACP country concerned, though the most substantial costs will remain (see Box 7).

Box 7. The costs of non-engagement and superficial agreements

The largest economic benefits of integration are foregone when (regional) trade agreements are overly shallow; that is, devoid of provisions beyond the mere elimination of tariffs. Dynamic effects that are crucial to economic growth, such as increases in domestic and foreign investment, competition, economies of scale and technology transfers, are unlikely to accrue if regulatory issues such as customs procedures, rules of origin, standards and certification requirements are not adequately addressed in the negotiations and implemented afterwards. Because few tariffs and quotas are still in place on ACP exports to the EU, it is in these regulatory areas that most of the economic gains can be reaped. Yet, unlike calls for tariff elimination, addressing regulatory issues requires extremely detailed knowledge of product markets and the procedural constraints currently in place. In order to be sufficiently prepared, human and financial resources will have to be invested in the appropriate studies and in consultations with the private sector.

Within ACP regions, an equal amount of attention will have to be paid to the numerous non-tariff barriers that restrict intra-ACP trade. If instead only defensive positions are adopted within the region and *vis-à-vis* the EU, the result could well be that the gradual elimination of ACP tariffs on EU exports is exchanged for the status quo of (intra-)ACP market access. In that case, certain costs of trade liberalisation (e.g. increased competition from the EU for certain ACP industries and erosion of tariff revenues) will still be incurred, while crucial benefits are foregone.

EPAs as windows of opportunities and risks

If concluded, EPAs will constitute an unprecedented reciprocal free trade arrangement between the world's largest single market and some of the poorest economic regions. Obviously, the ACP group is far too large and diverse to generalise on the impact that such an arrangement would have on its members. Yet for all countries and regions concerned, a crucial question is whether the quality of trade policy institutions and other institutions suffices to optimise the benefits of free trade, while mitigating the costs. On the one hand, the very involvement in EPA negotiations could already have a positive effect on national and regional trade policymaking processes. EU funding to improve trade capacities in ACP countries could then make a further contribution.

On the other hand, if EPA negotiations and the use of TCB funds are driven by EU actors only, few positive externalities can be expected from the negotiation process. Indeed, should ACP countries finally conclude agreements solely because EPAs are considered the least bad of the alternatives, or in response to mere power politics, the costs of non-engagement during the negotiations are likely to be high. Moreover, most of the potential advantages of trade reform will be foregone if agreements and flanking measures are implemented half-heartedly, though the negative social and economic effects that accompany trade liberalisation will still be incurred.

In this respect, by introducing the concept of EPAs, the Cotonou Partnership Agreement offers a window of both opportunities and risks. The latter, however, are to be fully borne by the ACP countries.

Endnotes

1. For an overview of the key trade provisions in the Cotonou Partnership Agreement, see Bilal (2002).
2. In the WTO framework, the pressure on the EU to abolish or substantially alter the commodity protocols is likely to increase. Should ACP countries benefiting from the protocols decide not to open their markets to the EU and choose the non-contractual and non-reciprocal GSP or EBA schemes instead, this would substantially diminish their bargaining power to retain commodity protocol benefits.
3. Of course, countries can always withdraw from the negotiations and opt for an alternative at later stages. In this respect, it is no surprise that even those ACP countries most reluctant to negotiate reciprocity have remained on board so far. The Cotonou Agreement explicitly provides an alternative option for countries 'that decide they are not in a position' to negotiate EPAs (Article 37.6). This alternative is to be examined by the Commission in 2004.
4. See www.acp-eu-trade.org and the series of Trade Negotiations Insights (www.acp-eu-trade.org/tni.html) for the most recent updates and summaries on the ongoing negotiation process.
5. With SADC and the Pacific region, negotiations are planned to be launched in spring 2004 and in September 2004, respectively.
6. According to the Cotonou Agreement, in addition to market access in manufactured goods, agricultural products and services, EPAs will cover many trade-related areas, including competition policy (Art. 45), intellectual property rights (Art. 46), standardisation and certification (Art. 47), sanitary and phytosanitary measures (SPS, Art. 48), trade and environmental considerations (Art. 49), trade and labour standards (Art. 50), consumer protection (Art. 51), food security (Art. 54) and investment (Art.75). In terms of coverage, the recent agreements with Chile and Mexico best reflect the broad scope that EPAs are to have.
7. (i) If the majority of imports already came from the EU prior to an EPA, these imports simply become cheaper for ACP consumers and producers and trade diversion is likely to be small. (ii) Parallel liberalisation reduces the chance that low-cost imports from elsewhere will be replaced by more expensive goods from the EU. (iii) If domestic markets are not responsive to price changes, for example because of a lack of competition among suppliers, the benefits of tariff elimination are likely to be captured entirely by EU.
8. For a summary of the impact studies commissioned by the EC, see McQueen (1999). Gasiorek and Winters (2004) provide a recent assessment on the Caribbean.
9. It is sometimes argued that an open trade policy is the best implicit competition policy a country can adopt. Yet the creation of competition laws and a competition authority can be all the more important once trade and investments are actually liberalised. In particular, where trade patterns are mainly characterised by inter-industry trade (such as ACP–EU trade), liberalised trade can offer possibilities for large EU industries without counterparts in ACP countries to monopolise the latter's markets, and, consequently, abuse this position.
10. For a discussion, see Tybout (2000).
11. Not withstanding the fact that formally various ACP regions have already decided to move towards FTAs and customs unions, achievements so far have been limited. See e.g. Szepesi and Bilal (2003) on SADC.
12. See e.g. Yeats (1998).
13. In theories of economic geography, these strategic considerations are so-called 'centripetal forces': conditions that ensure economic activity are located in one central place. Renowned examples inspired from Porter's management literature (e.g. Porter, 1990, 1998) are *knowledge spillovers*, which make it attractive for firms to locate near each other; *labour market pooling effects*, which encourage firms to locate near the (most sophisticated) labour pool; and *buyer–seller linkages*, which induce firms to locate near the majority of their customers and suppliers. In addition, the quality of economic infrastructure and proximity to distribution hubs (such as seaports, main roads and airports) play a key role in the establishment strategies of businesses. See e.g. Krugman (1990), Puga and Venables (1998) and Venables (1999). Though other forces (so-called 'centrifugal forces) might counter these effects, both experience and theory suggest that for developing countries such as those in the ACP group, EPAs

might tip the balance towards a higher rather than a lower degree of economic agglomeration (see Box 1).

14. Except for arguments relaring to infrastructure, the geography of ACP regions could further stimulate agglomeration effects: within integrated ACP regions, economic activity might divert away from land-locked and small island economies towards their more strategically located counterparts.
15. See for instance Schiff, Wang and Olarreaga (2002).
16. See Hallward-Driemeier (2003)., Te Velde (2001) and Te Velde and Fahnbulleh (2003).
17. In the initial phases of EPAs the effect on tariff revenues is less clear. For some products, revenues might temporarily increase as lower tariffs may set off increased demand for imports.
18. Additional advantages of EPA-induced fiscal reform could be that tax revenues become more stable and the trade-distortive effect of import taxes would be eliminated. In the light of multilateral trade liberalisation or other regional arrangements, EPAs could well form a useful incentive to start reforms as soon as possible.
19. A case study that estimates large additional welfare effects of deep integration in a North–South (EU–Egypt) context is Hoekman and Konan (1998). As for rules of origin, some recent case studies of welfare-restricting effects are Brenton (2003) and Mattoo et al. (2002) for North–South trade and Flatters (2002) for South–South trade.
20. With rules of origin, this is slightly easier as quite a strong consensus now exists that when measured against their key objective – that is, preventing trade deflection – the rules are excessively restrictive and overly complicated in many cases. In its Green Paper on rules of origin, the European Commission explicitly acknowledged that at the request of its traders or its member states, ongoing 'maintenance' has been applied to the rules of origin, tailoring them to the needs of trade and industry and the common EU policies (EC, 2003b).
21. Winters (1999, 2002) offers a thorough analysis of the impact of trade reform on poverty. McKay, Winters and Kedir (2000) review case-study evidence.
22. Winters (2002).
23. See North (1991).
24. For a historical overview of the initiation, maturation and full establishment of economic institutions in now-developed countries, see Chang (2002).
25. Yet with respect to economic prosperity and poverty alleviation, notions such as 'institutional quality', 'institutional development' or simply 'institutions' have only recently been given the attention they deserve. Within the free market rhetoric of the Washington Consensus, for example, the pivotal role of institutions was more or less ignored. In the last few years, the World Bank has admitted the omission and radically changed its course. See e.g. Burki and Perry (1998) and the *World Development Report 2002*.
26. See e.g. Djankov et al. (2002). North (1991) offered an important early contribution to the debate on institutions and economic performance.
27. A country case study at the centre of this debate could be the one on Mauritius by Subramanian and Roy (2001) as it applies different theories explaining economic growth to the Mauritian growth miracle.
28. Rodrik, Subramanian and Trebbi (2002) use a model similar to the one by Frankel and Romer (1999) – one which attributes a key role to trade integration as a determinant of economic growth. Rodrik et al. (2002) use several proxies for 'institutional quality' and add these to the model. They find that institutions trump all other variables, rendering 'trade openness' and 'geography' insignificant in explaining growth.
29. In a recent contribution in response to Rodrik et al. (2002), Dollar and Kraay (2003) claim that on statistical grounds, Rodrik et al.'s cross-country variation is not very informative about the partial effects of institutions and trade on long-run growth.
30. In contrast to 'rule of thumb' economics on trade liberalisation, institutions and their accompanying policy processes are by definition context-specific. What works for some countries may well fail for others. See Rodrik (2003) for the wider debate on strategies for economic growth.
31. Recent case studies in which the trade policymaking process is at the centre of attention include Bouzas (2004), Dunlop, Szepesi and Van Hove (2004), Bilal and Laporte (2004), Jordana and Ramió (2002), IADB (2002), Bonaglia and Fukasaku (2002) and Solignac Lecomte (2000a/b and 2001a). The OECD has compiled theoretical and practical insights in OECD (2001).
32. See also Solignac Lecomte (2001a) and Szepesi (2003).
33. A good example of institutional malfunctioning is provided by the case of Argentina (e.g. IADB, 2002).
34. A frequently mentioned example is the Mauritius Joint Economic Council (e.g. Bonaglia and Fukasaku, 2002). On public–private sector dialogue, see e.g. Land (2002).
35. In March 2002, a TCB-pledging conference at the WTO resulted in US$17.5 million, twice as much as was targeted by the WTO Secretariat. From 1999 to 2003, the US has more than doubled its annual TCB funding from $369 million to $752 million (USAID, 2003). The UK has also committed to double its funding between 2001 and 2004 (DFID, 2001).
36. OECD/WTO TRTA & CB Database (2003).
37. See Solignac Lecomte (2003) for a discussion.
38. For instance, Article 44.2 states, 'The Community shall support the ACP States' efforts, in accordance with the provisions set out in this Agreement and the development strategies agreed between the Parties to strengthen their capacity to handle all areas related to trade, including, where necessary, improving and supporting the institutional framework.'
39. The 9th EDF reserves €1.3 billion for regional co-operation and integration, which equals 9.6% of the budget total. While these funds support the regional integration agenda, they are not specifically earmarked for EPAs and can thus be used independent of a region's decision to negotiate an EPA.
40. EC (2003b: p. 7).
41. See e.g. SIDA (1995).
42. In fact, one of the few studies which systematically compares externally steered programmes (by the World Bank) considering different variables – GNP, economic growth, inflation, government expenditure, relative importance of development assistance, population and urbanisation – concludes that the quality of programme design and the implementation process significantly trump the macroeconomic variables in explaining the impact on institutional development in the recipient countries (see Paul, 1990).
43. See, among others, Lopes and Theisohn (2003), Fukuda-Parr, Lopes and Malik (2002), World Bank (2002) and Land (2000). SIDA (1995) gives an annotated bibliography of 75 case studies on institution building in developing countries.
44. Jordana and Ramió (2002).
45. Van der Walle and Johnston (1996).
46. See the case studies as referred to in note 35.
47. Biased trade-related aid is usually seen in the bilateral context in which one party gives support to another party while simultaneously bargaining with that party at the negotiating table – see for instance Solignac Lecomte (2003). In a broader context, one can

argue that any trade-related support programme that is attached to a predetermined policy agenda concerns biased aid –a point advocated by Powell (2002) in relation to multilateral programmes on trade capacity building.
48. Fukuda-Parr, Lopes and Malik (2002).
49. For an insightful case study, see Godfrey et al. (2002) on Cambodia.
50. See e.g. Solignac Lecomte (2001b).
51. See e.g. the case study on trade policymaking in the Caribbean by Dunlop, Szepesi and Van Hove (2004).
52. Ironically, West Africa (ECOWAS) was the first region – together with Central Africa (CEMAC) – to formally launch EPA negotiations with the EU in October 2003.
53. This is only to say that from a development perspective, reform priorities concerning ACP trade policies have not changed because of EPAs. Whether the overall merits of bi-regional agreements such as EPAs outweigh those of reforms derived from multilateral commitments is another question.
54. See Dunlop, Szepesi and Van Hove (2004).
55. Yet the extent to which trade policymaking has changed differs much between the Latin American countries. For country case studies, see IADB (2002).
56. This is not to say that the issue of additional resources itself is not a legitimate one for the ACP to put on the agenda. Yet at the negotiation table, the key question of whether EPAs will ultimately be beneficial trade agreements for the ACP is not resolved by any compensatory funds as such, but by also discussing the substance of the agreement.
57. In this respect, the recent experiences of Mercosur offer useful insights. As long as the internal agenda concerned rather superficial measures, such as tariff elimination, there was a relatively high political commitment to the integration process. Yet after the mid-nineties, when the agenda deepened and negotiations with various external parties commenced, political commitment waned and regional institutions proved insufficiently strong to drive the process forward. See Bouzas and Soltz (2001) and Bouzas (2004).
58. This seems especially relevant for LDCs that in principle could opt for free-market access under the EBA initiative but by doing so would at least partially fracture their own integration with non-LDCs in the region.

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