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The institutional challenge of the ACP/EU Economic Partnership Agreements

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The institutional challenge of the ACP/EU Economic Partnership Agreements

Axel Borrmann and Matthias Busse*

Abstract

The Economic Partnership Agreements (EPAs) between the group of African, Caribbean and Pacific (ACP) countries and the European Union could serve as an opportunity to accelerate global and regional trade integration of ACP countries. Moreover, the European Commission intends to use EPAs as a tool for development and the eradication of poverty in ACP countries. To achieve their potential development, however, there are a number of preconditions in ACP countries to be fulfilled. This paper argues that institutional quality plays a key role in a successful trade liberalisation. In fact, only countries with high-quality institutions, partly in the form of good government regulations, are likely to benefit from trade. Unfortunately, the vast majority of African ACP countries have excessive regulations that hinder them from taking advantage of trade. For the necessary institutional reforms to resolve this problem, we will discuss a number of important issues that have to be addressed to enable ACP countries to take full advantage of EPAs.

JEL Classification: F15, O17, P48
Keywords: Economic Partnership Agreements, Trade, Institutional Quality

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1. Introduction

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

The main argument for this objective is relatively obvious, since the export performance of ACP countries has been far from satisfactory in recent decades. Despite non-reciprocal trade preferences for products originating in ACP countries as part of the predecessors of the Cotonou Agreement, the Lomé I to IV Conventions, ACP countries' share of the EU market declined from 6.7 per cent in 1976 to 3.0 per cent in 2005 (EU Commission, 2006). Moreover, about 68 per cent of total ACP countries' exports to the EU consist of agricultural goods and raw materials, and some 74 per cent are concentrated in only ten products. Additional preferences on market access alone are, therefore, not very likely to benefit ACP countries in the future. Among the various reasons for the disappointing export performance and, in general, economic development of ACP (and other developing) countries, the quality of institutions has been identified as a major impediment.[1] In this aspect, the EU is willing to assist ACP countries in reforming their institutional framework.

[1] See World Bank (2001), Jütting (2003) and Levine (2005) for surveys. Influential studies are Acemoglu et al. (2001) and Rodrik et al. (2004)

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

Based on economic theory, we could expect beneficial effects of lowering trade barriers for ACP countries, as nations may benefit from the well-known gains from exchange and specialisation through trade. In reality, however, this basic outcome may not hold, since some of the often demanding assumptions in economic models are not realistic. A recent paper explored a fundamental prerequisite for a successful trade liberalisation, that is, the quality of institutions (Borrmann et al., 2006).[2] Rather than concentrating on the impact of institutions in the development process, Borrmann and Associates focus on the role of institutions for the linkage between trade and growth only. Their empirical analysis for a large sample of 146 countries shows that only countries with good institutions in the form of good (government) regulations are able to benefit from international trade.

This paper intends to apply this main finding to the EPAs between ACP countries and the EU. More specifically, we intend to identify those ACP countries and regions that are not likely to benefit from an EPA, and those which are likely to benefit from it, given their current institutional setting. The main outcome of this exercise and, thus,

[2] Institutions can be defined as humanly devised constraints that structure political, economic and social interactions (North, 1990). They exist to reduce uncertainties that arise from incomplete information concerning the behaviour of other individuals in the process of interaction. Above all, institutions are introduced by the setting of formal rules (laws, property rights) and the development of informal rules of behaviour (customs, traditions). Formal rules are usually designed and are made explicit in the

principal message is relatively straight forward: Institutional reform in a considerable number of ACP countries is an indispensable precondition for the success of EPAs and future development in general. Above all, this applies in particular to the large majority of African ACP countries, most of which have currently excessive regulations. Moreover, we argue that there is insufficient awareness of the real dimension of the institutional challenges stemming from the EPAs. Although the issue as such is considered in the Cotonou Agreement and in ongoing negotiations, the size and structure of institutional problems and reform requirements are not fully recognised due to lack of empirical insight. While a thorough and detailed discussion of the challenges for institutional reforms facing ACP countries is far beyond the scope of this paper, we intend to highlight some principle policy implications for ACP countries. Above all, this paper is trying to insert more empirics into the debate on the advantages and disadvantages of concluding EPAs, on their design and the commitment to institutional reform of all stakeholders involved.

The paper is structured as follows: The next section reviews the special role of institutional quality for the linkage between trade and growth. In addition, we take a closer look at the performance of ACP countries regarding their institutional quality and the trade-growth nexus, and discuss the consequences for EPA negotiations. Section 3 explores the implications of the results for institutional reform in ACP countries and addresses strategies for reform. Finally, Section 4 summarises the main results and concludes.

2. The Linkage between Trade, Institutions and Growth in ACP Countries

Based on various theoretical models, abundant empirical literature has examined the welfare effects of trade (volumes) on income levels and growth rates. If anything, the majority of studies show that trade is positively associated with growth rates.[3] However,

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constitution, in legislation and in regulations (public institutions) or come into existence by formalised private agreements such as codes of conducts and contracts (private institutions).

[3] See Yanikkaya (2003) for a review of the extensive literature. Prominent studies are, for example, Dollar (1992), Sachs and Warner (1995), Frankel and Romer (1999), Dollar and Kraay (2002), Irwin and

this does not apply to all countries. For some countries, trade has a strong positive impact on growth, whereas for other countries there is no or even a negative linkage.[4] Based on this finding, the question arises as to what the determinants of a successful integration into the world economy would be. In an extensive empirical analysis, Borrmann et al. (2006) show that institutional quality is one likely prerequisite for a welfare increasing impact of trade. Using several model specifications, including an instrumental variable approach, those aspects of institutional quality are identified that matter most for a positive (or negative) linkage between trade and growth. Above all, government regulations as an important element of institutional quality are the key to reducing trade-related adjustment costs.

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

At a more disaggregated level, the results show that a few sub-indicators for regulatory quality are clearly more relevant than others.[5] Above all, this applies to market entry regulations (starting a business), the efficiency of the tax system, and labour market regulations. For countries with good scores for these three sub-indicators (as well as the aggregated regulation indicator), trade has a positive impact on growth rates, whereas the contrary can be established for countries with bad scores, that is, excessive regulations. In essence, the results demonstrate that countries with low-quality institutions in the form of excessive regulations do not benefit from trade.

Terviö (2002), and Noguer and Siscart (2005). A critical view can be found in Rodriguez and Rodrik (2000).

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

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

The outcome of this exercise can be seen in Figure 1. All countries that belong to the group of countries with excessive regulations are marked in italics. For these countries, the impact of trade on (long-term) growth rates is negative. For the remaining countries, the results show either a positive and significant influence of trade on growth or an insignificant outcome with a positive or negative coefficient for the trade variable.[6] For the six EPA regions, the outcome differs remarkably. Apart from Cape Verde, Gambia and Ghana, all countries of the Economic Community of West African States (ECOWAS) belong to the group of countries with excessive regulations. For the Communauté Économique et Monétaire de l'Afrique Centrale (CEMAC) a similar picture emerges: While only Gabon has an adequate regulatory framework, all other countries fit into the group of countries with excessive government regulations. For all countries that belong to the Common Market of Eastern and Southern Africa (COMESA), except Mauritius, Seychelles, Uganda, and Zambia, we also observe a negative trade-growth nexus.

[5] The main source for all regulations indicators is the World Bank's Doing Business dataset. See World Bank (2005) for details.

There are, however, EPA regions with a better performance for the regulation indicators. Within the Southern African Development Community (SADC), Botswana, Lesotho, Namibia, and Swaziland, which also belong to the Southern African Customs Union (SACU), show relatively good scores for the regulations indicators. Yet this does not hold for the remaining SADC countries. In the Caribbean region,[7] only Haiti and the Dominican Republic are negatively affected by trade due to bad regulations, while in the ACP Pacific region this applies to Kiribati.[8]

Figure 1: Regional EPA Grouping and Regulatory Quality

ECOWAS (13 out of 16 countries belong to the group of countries with excessive regulations)
Benin, *Burkina Faso*, Cape Verde, *Côte d'Ivoire*, Gambia, Ghana, *Guinea*, *Guinea-Bissau*, *Liberia*, *Mali*, *Mauritania*, *Niger*, *Nigeria*, *Senegal*, *Sierra Leone*, *Togo*

CEMAC (6/7)
Cameroon, *Central African Republic*, *Chad*, *Republic of Congo*, *Equatorial Guinea*, Gabon, *Sao Tome and Principe*

COMESA (11/16)
Burundi, *Comoros*, *Democratic Republic of Congo*, *Djibouti*, *Eritrea*, *Ethiopia*, Kenya, *Madagascar*, *Malawi*, Mauritius, *Rwanda*, Seychelles, *Sudan*, Uganda, Zambia, *Zimbabwe*

SADC (3/7)
Angola, Botswana, Lesotho, *Mozambique*, Namibia, Swaziland, *Tanzania*

Caribbean (CARIFORUM) (2/15)
Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, *Dominican Republic*, Grenada, Guyana, *Haiti*, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago

ACP Pacific (1/8)
Fiji, *Kiribati*, Marshall Islands, Papua New Guinea, Solomon Islands, Samoa, Tonga, Vanuatu

Notes: Countries in italics denote nations for which we obtain a negative and significant impact of trade on growth due to excessive regulations. For the remaining countries, we find *either* a positive and significant *or* a positive or negative and insignificant trade-growth nexus. Data for the following ACP Pacific countries are not available: Cook Islands, Micronesia, Nauru, Niue, Palau, and Tuvalu.

Overall, the results clearly show that institutional quality (in the form of government regulations) as a precondition for a welfare increasing impact of trade is of lesser

[6] We do not report the average scores for the six regions, since there are outliers in almost each region that bias the outcome. For example, the scores for Angola and Mozambique are very low, thereby lowering the average score for all SADC countries.

[7] In the Caribbean, the Caribbean Forum (CARIFORUM), which consists of all the countries of the Caribbean Community (CARICOM), except Montserrat, plus the Dominican Republic, negotiates a regional EPA with the EU.

[8] Due to a lack of regulation and other data, we could not incorporate 6 out of a total of 14 ACP Pacific countries. See the notes below Figure 1.

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

Table 1: ACP Imports from and Exports to the EU, 2004

ACP Region	Imports from the EU in % of total imports	Exports to the EU in % of total exports
ECOWAS + Mauritania	33%	23%
CEMAC + Sao Tome & Principe	56%	30%
COMESA	30%	29%
CARIFORUM	19%	18%
SADC	26%	29%
ACP Pacific	13%	12%
Total ACP	26%	23%

Source: EU Commission (2006).

Importantly, these results do not imply that African countries will never be able to benefit from an increasing market integration with the rest of the world, either through the EPAs, multilateral or unilateral tariff liberalisation. Rather, the results clearly show that the majority of African countries are *currently* less likely to harness the gains from trade and that a reform of the institutional framework should be clearly the most important topic on the EPA agenda. A major reform of institutions would not only allow the African countries to increase the welfare improving gains from trade through

specialisation and exchange. In addition, high-quality institutions would enable them to achieve much higher gains through a direct impact on economic and social development.

Since the beginning of the negotiating process, it is a well-known fact that ACP countries may not share the same interest in EPAs. In case the negotiations are not successful, LDCs of the ACP group could use the Everything but Arms (EBA) initiative of the EU, while non-LDCs would have to switch to the less generous preferences of the Generalised System of Preferences (GSP). Since the EBA scheme provides duty-free access to imports of all products (except arms and munitions) from LDCs without any quantitative restrictions,[9] the special arrangements for LDCs are far more generous than either the general arrangements under the GSP or the trade preferences which are currently available under the Cotonou Agreement. Apart from important technical issues, such as the rules of origin for the trade preferences, LDC countries may thus be less committed to negotiating an EPA than non-LDCs.

Similar to the distinction between LDCs and non-LDCs, institutional quality as a preconditions for a successful EPAs might divide the regional EPAs into two groups: one with good regulations that stands to gain from trade liberalisation, and another with excessive regulations that might not achieve any benefits or even observe a decline in growth rates due to EPAs if they do not reform their institutional setting. To link this issue with the LDC/non-LDC problem, we plot all ACP countries accordingly (Figure 2). Most of the countries with a negative trade-growth nexus are LDCs, and those with a positive (or insignificant) impact of trade on growth are non-LDCs. This outcome could further divide ACP countries within the regional EPA groupings. However, there are a number of nations for which this does not apply, since they are LDCs but have good regulations or are non-LDCs with excessive regulations.

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

Figure 2: Linkage between the Trade-Growth Nexus and the LDC Status of ACP Countries

	LDC	Non-LDC
Positive and/or insignificant trade-growth nexus	Angola, Cape Verde, Gambia, Lesotho, Samoa, Solomon Islands, Uganda, Vanuatu, Zambia	Antigua and Barbuda, Bahamas, Barbados, Belize, Botswana, Dominica, Fiji, Gabon, Ghana, Grenada, Guyana, Jamaica, Kenya, Marshall Islands, Mauritius, Namibia, Papua New Guinea, Seychelles, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Swaziland, Tonga, Trinidad and Tobago
Negative and significant trade-growth nexus	*Benin, Burkina Faso, Burundi, Central African Republic, Chad, Comoros, Congo (Dem. Rep.), Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Guinea, Guinea-Bissau, Haiti, Kiribati, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Sudan, Tanzania, Togo*	*Cameroon, Congo (Rep.), Côte d'Ivoire, Dominican Republic, Nigeria, Zimbabwe*

Notes: See Figure 1.

3. Implications for Institutional Reforms

In view of these findings, it becomes clear that institutional reforms are an indispensable part of the EPA agenda and that the EU is right in pressing for reforms in ACP countries. However, any fundamental change in an institutional setting may pose a major challenge for ACP countries, in particular to least-developed countries with limited resources and fragile political regimes. In this section, we discuss five main aspects of institutional change in ACP countries: (1) the scope of institutional reform requirements, (2) the framework for related policies, (3) the available time frame for required reforms, (4) the selection and design of appropriate strategies, and (5) the amount and quality of external support for reforms. Rather than pursuing an in-depth-analysis of institutional reform requirements at the country level, we intend to outline broader issues involved as well as to highlight some of the main questions and challenges faced.

The relatively poor performance of a considerable number of ACP countries for the regulatory quality indicators highlights the enormous *scope of institutional reform requirements* and might dampen prospects for improvements achievable in the short and medium terms. According to the World Bank (2001), policy makers could become paralysed by the apparent need to undertake ambitious reforms on a wide and ever-expanding front. Even if we narrow the scope and concentrate on those institutions that are directly related to trade liberalisation, we still face a whole host of problems, which are partly interrelated and which call for an integrated approach. For example, market entry conditions, which we identified earlier as a priority area for reforms, include a large number of issues such as property rights (access and transfer), competition law (rules for mergers, acquisitions, pricing), taxation (level and structure, incentives), financial market regulations (collateral requirements, protection of creditors), openness (rules for trade, financial services), administrative procedures and costs to start a business. Regulations of market performance show a similarly complex pattern. Here again, competition law matters as well as labour market regulations, environmental and technical standards and provisions, the law and enforcement of contracts, trade supervision, customs clearance, to mention just a few issues. Last but not least, conditions for market exit are relevant too, such as insolvency law, right of cancellation, social safety, and so on.

Thus, EPAs would imply a pretty large institutional reform agenda. However, the question remains as to how broad and integrated a strategy for institutional change should actually be and whether partial reforms could also be promising, taking into account the often limited political and administrative capacities of poor countries. Aron (2000) and Rodrik (2004), for example, note that institutional transformation on a large scale is rarely an indispensable prerequisite for getting growth going, not even in poorer countries. Rather, there seems to be a need for achieving an initial surge in growth rates that may be obtained with minimal changes in the institutional setting. What is more, both Aron and Rodrik argue that there is a need to differentiate between stimulating economic growth and sustaining it. Effective institutions of high quality appear much more important for the latter than for the former (Rodrik, 2004; Hausmann et al., 2004). Hay, Shleifer, and Vishny (1996) share the view that less costly and more rapid reforms

could be better than comprehensive, expensive, and time-consuming reforms. Also, the experience by the World Bank (2001) shows that even moderate progress in the parts can contribute effectively. However, even a reduced reform agenda remains to be a great challenge, in particular for the large number of LDCs among the ACP countries, given the nature of institutions.

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

In this context, an important question is how to initiate institutional change despite the inertia of existing formal and informal institutions. Above all, whether more efficient institutions can be introduced largely depends on the interests of those having the power to devise new institutions and of others, who should accept, adapt to and use the new rules (Anderson, 2005; WTO, 2004). In fact, this is a classical example for the political economy of reforms. The general commitment of political leaders to good governance and their willingness to use their political weight in support of reforms is crucial for an effective impetus for institutional reforms. Institutional improvements can only be harnessed if the top has fully recognised their importance (Szepesi, 2004). Trade

liberalisation could provide an external impetus and may help politicians to lock in their reform programmes.

However, institutional and other reforms are unlikely to survive or be implemented if established only in response to external pressures and designed and implemented without ownership of those whose interests would directly be affected. It is important, therefore, to involve all possible public and private stakeholders in the reform process. In the area of trade reform, for instance, developing countries, which have broadened their policy-making processes by engaging in open and inclusive consultations with the private sector, have generally performed better than countries where such consultations have been absent (Fukuda-Parr et al., 2002). Ownership is of particular importance, when institutional reforms are required, which affect the interests of those living in the informal sector. Once stakeholders find themselves adequately involved in the planning and implementation of new rules, a promising basis for institutional change can emerge (Szepesi, 2004).

In addition to the often less favourable framework for institutional reform, ACP countries are under a considerable *time pressure*. Substantive EPA negotiations started only in 2004. The agreements ought to enter into force at the beginning of 2008, with an implementation period from 2008 to 2020. Still, there is considerable time pressure during the transitory phase, as the institutions have to be in place before or at the time of the actual trade liberalisation. It is an open question, whether the timeframes for trade liberalisation and the required institutional reforms do really match.

Again, institution building – in particular in a less-developed environment – takes time due to the scope of institutional deficits and the framework conditions, which have been discussed earlier. North, for example, notes that “creating a system of effective enforcement and of moral constraints on behaviour is a long, slow process that requires time to develop if it is to evolve – a condition markedly absent in the rapid transformation of Africa from tribal societies to market economies” (North, 1990: 60). Therefore, it is most uncertain whether profound institutional change and development can be rapidly achieved and sustained. Recent case studies on Latin America suggest

that where trade institutions malfunction, building up new ones from scratch to eliminate past problems (so-called "big-bang" reform) does not lead to improvements in practice (Szepesi, 2004).

The design and timing of the whole EPA process should adequately reflect these fundamentals of institutional change. The challenge for ACP countries is to get a clear picture of the size and structure of their institutional reform requirements, to involve all stakeholders in the process as a prerequisite for success and to implement a first package of required institutional reforms well in advance. With the agreements coming into effect, a gradual process of dismantling trade barriers would start, which has to be accompanied by preparatory and synchronous institutional reforms.

Therefore, the liberalisation schedule, in particular the length of the transitory phase, deserves special attention. There is an on-going debate on the definition of an appropriate length of this phase. In fact, the legal aspect of the WTO conformity of submitted proposals, limiting this phase either to 10, 12, 15 or more than 18 years,[10] plays a remarkable role.[11] It appears, however, that a sole legalistic discussion of this issue is misleading, since the timing of the EPA process should be designed according to the objectives of the two projects, the capacity to cope with the required structural adjustments, the resources available to prepare for the hard and soft infrastructure needed to make the best use of the new trading environment for growth, and the ability to master the political and administrative problems of related institutional reforms. Apparently, EPAs could be an enormous challenge, in particular for the least developed countries within the ACP group, and there is an obvious risk of overstraining them by an overly tight time schedule.

The time required for institutional change also depends to a considerable extent on the choice of an appropriate *strategy for reform*. Basically, there are three options: imitation, adaptation and innovation. Not surprisingly, ACP countries might have a

[10] In a submission to the WTO, ACP countries proposed a transitory phase of more than 18 years (WTO, 2004).

[11] See Borrmann et al. (2005) for an overview; other main papers on this issue are Mathis (2002), Onguglo and Ito (2003) and South Centre (2005).

preference for imitating models of institutional reforms that were successfully applied elsewhere, thus saving time and resources. Chang (2005) suggests such a "catching-up" framework, where the late-developing countries can import institutions from the developed countries and thereby use "better" institutions without paying the same "prices". He argues that developing countries today are enjoying higher standards of political democracy, human rights, and social development than what were achieved by today's developed countries at similar levels of economic development, thanks to their institutional imitation.

Any elementary imitation of institutional reforms, however, might not lead to the expected result. Institutions that are, for example, efficient and effective in high-income OECD countries might not work at all in low-income countries that possess fewer interrelated institutions, weaker administrative capacity, much lower human capital levels, and different levels and perceptions of corruption (World Bank, 2001). Rodrik et al. (2004) point out that the institutional setting of a country has to be arranged, above all, in the context of historical trajectories, geography, political economy, and/or other initial conditions. There is hardly ever a blue print for reform, even for countries with similar income levels. Some degree of adaptation is thus required in order to make institutions imported from abroad work (Chang, 2005).

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

Frequently, ACP countries have reminded the EU that its *external support* for institutional reforms is part and parcel of the EPA project. Moreover, they argue that their general need of financial support for implementing EPAs exceeds current financial

commitments of the EU and they expect the EU to substantially increase the volume of aid. While we refrain from contributing to this debate, we would like to emphasise that it is an indispensable precondition for the success of the EPAs that ACP countries have to commit themselves to sufficient investments in their institutional infrastructure. Institutional reforms are a part of their very own responsibility for development and aid might provide just a minor supplement. In addition, we would like to stress that the quality of aid and the way it is used also matter. Aid can affect institutional development in the recipient countries in many ways – positively as well as negatively (IMF, 2005). Empirical evidence on the net effect is mixed. Therefore, donors and recipients should be mindful of the potential effects and seek to ensure both that aid is provided in ways that minimise any adverse risks to domestic institutions, and that the institutional environment in recipient countries is strengthened to make the best use of aid inflows. Both sides should be particularly aware of the risks involved in "blue-print-aid".

4. Concluding Remarks

The EPA process has already gathered substantial momentum in both the European Union and ACP countries. It is encouraging an active debate over the pros and cons of trade liberalisation in ACP countries. This paper intends to contribute to this debate by pointing out that EPAs can only be beneficial for ACP countries if the countries' institutional setting is appropriate. The results show that, in particular, the regulatory quality is important to minimise the trade-induced adjustment costs and to enable ACP countries to take advantage of export opportunities abroad. While the quality of regulations is relatively good in the Caribbean and the Pacific, many African ACP countries have excessive regulations that hinder them from benefiting from trade opportunities. It is thus crucial that these countries reform their regulatory setting before or at the time of trade liberalisation to achieve the potential development outcome of the agreements.

EPAs could offer Africa an important opportunity to accelerate (or even begin) the necessary institutional reforms. Above all, African political leaders could use the EPAs to push through unpopular reforms, as part of a larger reform package. In fact, the tight EPA schedule and deadlines offer an excellent opportunity for reforms, since they may lock in these reforms by making them more credible to donors and international investors alike. Moreover, EPAs may contribute to the strengthening of regional integration in Africa, thereby accelerating trade and related reforms. Overall, conditions for reforms are relatively favourable for a development-oriented outcome of the EPA negotiations, as the EU intends to assist ACP countries, offering substantial financial and technical assistance.

Nevertheless, there are several important risks attached to the EPA process, which apply in particular to Africa. We have pointed out that the quality of the institutional setting in Africa is relatively low. In particular, the large number of African countries with excessive regulations will not be able to benefit from an increase in imports and will also be unable to take advantage of export opportunities abroad. Whether they are able to cope with the required institutional reforms is not only an open question, it also has to be taken into account at every stage of the EPA process. Given the heterogeneous structure of most regional EPA groupings in Africa, it might well be the case that some countries are ready to sign an EPA but others – within the same grouping – are not. Larger or powerful countries (with good institutions) might then push smaller and weaker countries into an agreement that might not be beneficial for them.

For those ACP countries that are not yet ready for an EPA, the EU should fulfil its promise and examine all alternative possibilities in order to provide these countries with a new framework for trade that is equivalent to their existing situation and in conformity with WTO rules, as stated in the Cotonou Agreement. It might be desirable to offer African ACP countries a fall-back position if they are currently unable to sign an EPA, but use the process to strengthen reforms at a country level. Once a country has achieved, for example, the required level of institutional development (and met other preconditions too), it may well proceed and sign an EPA with the EU. However, this approach might entail serious risks for African regional integration, if the four EPA

groupings cannot agree on a uniform approach towards a trade agreement with the EU. Given the diversity of initial conditions in ACP countries and the task of institutional reforms, a thorough flexibility of the EPA process is well needed to achieve the intended pro-development outcome.

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