

THE EC NEIGHBOURHOOD POLICY: AN ECONOMIC REVIEW

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I. INTRODUCTION

The EC neighbourhood policy is under pressure. The Russo–Georgian war, the confusion in Ukraine, the volatile energy and food prices, etc., are adding stress to the uncertainties surrounding the accession of the Western Balkan countries and Turkey.¹ These difficult circumstances are a strong motive to review in depth the economic foundations of the current neighbourhood policy in order to see whether it suits well the interests of the EC and its neighbors. Such a review requires us to look at the following six key questions (in six sections).

First, what is the challenge posed to the EC neighbours by the current size of the EC body of regulations—the *acquis communautaire* (hereafter the *acquis*)? This question needs to be raised because the EC neighbours are “invited” to fully adopt the–non–negotiable–*acquis* if they want to accede to the EC, or to agree on an “extensive regulatory convergence” towards the EC *acquis* under the preferential relations tabled by the EC since 2006 (Togan, 2008).

Second, has the content of the *acquis* changed in a significant way during the last two to three decades? More specifically, is the current

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¹ In the EC framework, the neighbourhood policy does not cover Turkey and the Western Balkans since they are candidates to EC membership. But, the economic focus of this paper addresses issues common to all the EC neighbours. For a paper focusing on the neighbourhood policy, see Hoekman (2007).

content of the *acquis* keeping the pro-growth focus that characterized the *acquis* during the initial, very successful, decades of the EC? The question is crucial because almost all the EC neighbours (except those from EFTA) are significantly poorer than the poorest current EC Member State — hence they need growth above all, particularly those neighbours with a rapidly increasing population (like the Mediterranean countries).

Third, how have the current EC Member States (ECMS) reacted to the *acquis*? More precisely, is there any robust evidence of a regulatory convergence among the ECMS — beyond the mere legalistic transposition of the *acquis* into national laws? Or, on the contrary, is there some evidence of regulatory competition among the ECMS — with some ECMS trying hard to develop better regulations than others, quite autonomously from the adoption of the *acquis*? Such a question is crucial for the EC neighbours that are often characterized by limited capacity in terms of producing and absorbing regulatory reforms.

Fourth, to which extent is the changing nature of the EC interacting with the above questions? Initially a very homogeneous group of countries, the EC has become a very heterogeneous entity. Which are the consequences of the current and future EC heterogeneity on its relations with its neighbours and on its neighbourhood policy?

Fifth, what are the lessons useful for the EC neighbourhood policy that can be drawn from the available evidence on the regulatory and economic performances of the “transition economies”? Comparing the performances of the transition economies that have acceded to the EC with those of the transition countries that have remained outside the EC gives some insights into the potential gains from redesigning the current EC neighbourhood policy.

Sixth, services constitute the bulk of a modern economy, and services regulations are a key part of the *acquis*. In this context, what is the role of regulations in the services sectors, and their expected impact on shaping the comparative advantages of the trading countries — even

when the imposed regulations are not sound from an economic point of view? Since services regulations differ widely among EC neighbours, this question is very important to get a sense of the full range of the comparative advantages of the EC neighbours in the services sectors, and what should be done not to erode these comparative advantages.

The evidence gathered when examining these six questions suggests that, from an economic perspective, it would be mutually beneficial — for both the EC and its neighbours — to shift the focus of the neighbourhood policy away from the goal of systematic regulatory convergence but towards a mutual evaluation of the regulations of direct and immediate relevance to the most pressing need of the EC neighbors — that is, higher and less volatile economic growth. As underlined in Section VII, such a fundamental move echoes the changes that are required (and indeed emerging) in the EC for solving its own internal problems. This similarity of problems and solutions is crucial since it makes politically easier the evolution of the relations between the EC and its neighbours. A final section concludes with a few brief illustrations of concrete proposals for action.

II. THE SIZE OF THE EC *ACQUIS*: A CHALLENGE FOR THE EC NEIGHBOURS

The core of the “*acquis*” consists of “Regulations” and “Directives”. Regulations are binding laws which are directly applicable in all the ECMS. Directives are also binding acts as to the results to be achieved, but they leave the choice of form and methods to national authorities. As a result, Directives need to be “transposed” into national law before they can be enforced.

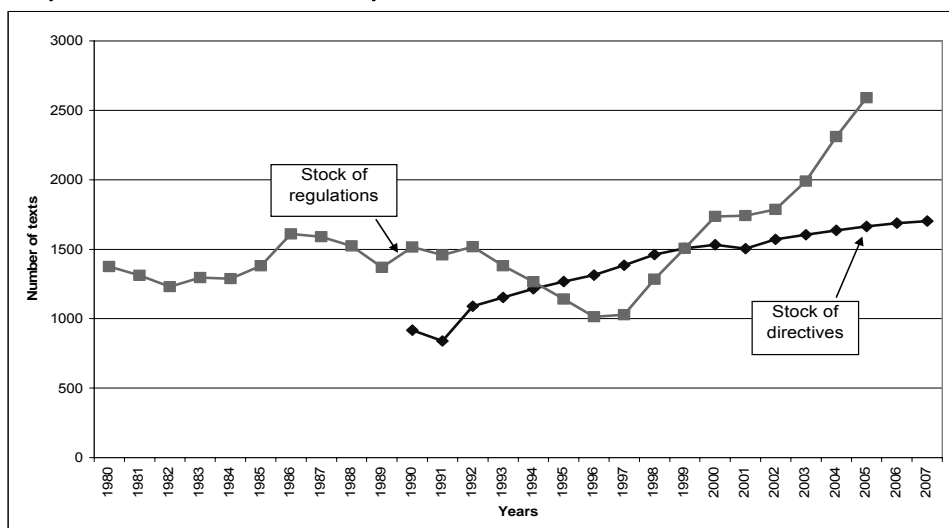
The *acquis* is important for several reasons. First, it is binding on all ECMS, with the Commission closely monitoring the transposition process in each ECMS, and the Court of Justice ruling in case an ECMS fails to properly enforce the *acquis*, or is too slow in doing so. Second, the *acquis* generates a notable share of all the laws and regulations passed

by the ECMS. Estimates of the magnitude of this share differ substantially from one ECMS to another — from 80 percent in Germany (Herzog and Gerken, 2007) to roughly 35 percent in France (Hispalis, 2005). Such differences can be explained by several factors, such as different legal regimes (federal vs. centralized), different propensities to legislate among the ECMS, etc. Third, the *acquis* transposition procedures offer the opportunity to lobbies in the ECMS to attach, to the national laws transposing the Directives, additional provisions useful for their narrow interests — the “gold-plating” of the *acquis* (Bertelsmann Foundation, 2006).

Last but not least, the *acquis* is of considerable importance to the EC neighbours. For those seeking accession to the EU, it is a non-negotiable package that they must incorporate into their own legislation prior to accession. For the neighbours that are negotiating some kind of “preferential” economic relations with the EC, the *acquis* is constantly used by the Commission as a reference point — the anchor for “extended regulatory convergence” — meaning that the EC neighbours are invited to mimic large pieces of the *acquis* in their own legislation. In both cases, the EC neighbours will have no chance to influence the *acquis* they will ultimately have to abide by, since they are not involved in the EC decision process before their own accession.

For all these reasons, it is important to have a sense of the size of the *acquis* and of its evolution over time. Such information is surprisingly difficult to get. Official data on the number of Regulations and Directives are incomplete and sometimes inconsistent (even when coming from the same official source). Such a situation reflects two well-known flaws in EC governance: a very complex decision-making mechanism and a persistent difficulty to put together a transparent system.

Graph 1. The Size of the EC *Acquis Communautaire*



Source: Messerlin (2007).

That said, Graph 1 provides the best available estimates of the “stock” of Regulations and Directives at the end of each year. Based on these estimates, the annual (compound) growth rate of the *acquis* was roughly 3% during the 1990s, compared with an annual GDP growth rate of 2 % for the EC-15 for the same period. From 2000 to 2007, the *acquis* annual growth rate was roughly 5.5%, compared with 2.2% for the EC-15 GDP. In sum, the gap between the two growth rates has more than tripled (from 1 to 3.5 percentage points) between the two decades.

III. THE CONTENT OF THE EC *ACQUIS*: PROFOUND CHANGES

The mere count of the number of Regulations and Directives constituting the *acquis* is not sufficient to answer the key question of the capacity of the EC neighbours to absorb the *acquis*. Such an answer requires a sense of the content of the *acquis*, particularly of its increasing or decreasing capacity to meet the most pressing demands of the EC neighbours.

In this perspective, this section classifies — admittedly in a very crude manner — Directives according to their dominant goal from an economic

perspective: pro-competition or norm-setting.² Pro-competition Directives primarily aim to improve access to ECMS markets, as best illustrated by the Treaty provisions, Regulations and Directives dealing with competition issues. Such Directives are expected to decrease prices and/or to increase the variety of the products and services supplied to the European consumers. By contrast, norm-setting Directives primarily impose norms of different kinds — technical, on safety, on labor skills, on market conditions, etc. Such Directives are expected to often be cost-increasing and/or competition-inhibiting. For instance, norms on market conditions may impose constraints (information requirements) costly to implement, and they may also have ambiguous or, possibly, anti-competitive effects (rules imposing price transparency may contribute to generate price collusion). If such costs can be happily paid by the richest ECMS, they can be a drag on the growth of the EC neighbours since almost all of them have a lower income per capita than the poorest ECMS.³

Using this criterion, Table 1 presents the breakdown of the EC Directives in force in 2007. When classifying a Directive into one of these two groups is too difficult, the Directive in question is classified as “mixed”. Table 1 presents the results by breaking down the whole *acquis* in ten regulatory topics (from Competition to Justice and Home Affairs). It also gives a rough indication as to the sharing of competence between the EC and the ECMS for each of these topics.

² Such a classification has been made only for the Directives. Regulations are a much more complex set of texts which should be split into those setting basic rules and into those managing the day-to-day life of the EC. Moreover, there is a huge turnover in Regulations: during the last decade, for every 100 Regulations adopted every year, there are, on average, roughly 60 regulations that are cancelled (Messerlin 2007).

³ For instance, there is a positive correlation between the demand for environmental norms and income level.

Table 1. The EC Directives and their Dominant Content, 2007

Topic	Competency	Directives (stock in 2007)		Annual growth 2007/2000	Share by dominant content [a](%)		
		number	%		pro-com- petitive	norm- setting	mixed
1 Competition	shared EU-National	10	0,6	0,0	100	0	0
2 Internal Market	EU (National)	169	9,9	2,7	44	29	27
3 Transport & Energy	shared National-EU	157	9,2	5,0	19	19	62
4 Enterprises	shared National-EU	490	28,8	0,5	5	93	2
5 Environment	shared National-EU	129	7,6	-1,4	3	97	0
6 Health & Consumer Protection	shared National-EU	583	34,3	1,2	0	100	0
7 Taxation & Customs Union	National (EU)	67	3,9	0,4	7	93	0
8 Employment & Social affairs	National (EU)	62	3,6	1,3	20	80	0
9 Statistics (Eurostat)	EU (National)	11	0,6	-1,1	0	0	100
10 Justice & Home Affairs	National	21	1,2	9,7	70	30	0
Total		1699	100,0	1,2	9	83	8
1-2 Initial economic programme	various	179	10,5	2,5	48	27	25
3-8 Expanded econ. programme	shared National-EU	1488	87,6	1,0	5	90	5

Source: EC Secretariat General, (3 July 2007).

The broad-brush picture suggested by Table 1 is quite surprising. Directives that qualify as clearly pro-competitive represent only a small minority — roughly 10 percent of the whole *acquis communautaire* — while those with a dominant norm-setting function are largely dominant — roughly 80 percent. Despite the limits of the classification exercise undertaken in Table 1, this imbalance seems too large to be easily reversed.

Of course, this result based on the mere number of Directives needs to be qualified by the coverage of the Directives in terms of economic activities. Pro-competitive directives tend to have a wide coverage in terms of activities involved, as best illustrated by the provisions on competition policy which are enforceable in the whole economy, except when otherwise specified (services of public interest, some parts of agriculture, etc.). However, such Directives are also hard to enforce, as best illustrated by the never-ending competition cases which often consist in confirming decisions taken in previous cases. (Indeed, this legal feature was one of the main motives behind the Services Directive.) By contrast, norm-setting Directives tend to have narrowly-defined goals, as best illustrated by the Directives on the size and position of rear-view mirrors in motor vehicles. But enforcement may be less

problematic — all the more if their (hidden but true) goal is to exclude new entrants. Moreover, a notable number of norm-setting directives cover vast manufacturing sectors: for instance, the REACH Directive on product safety covers a very wide range of chemical products.

Table 1 deserves a few additional remarks. The core economic program defined for the first decades of the EC by the initial Treaties corresponds mostly to Topics 1 and 2. Hence, it appears to be largely dominated by pro-competition objectives, all the more because a notable share of the norm-setting Directives in Topic 2 define the rules for the recognition of diplomas within the EC that were required for attempting to open markets in professional services. This dominance of the pro-competitive Directives in the early stages of the history of the EC is an essential observation to keep in mind when examining the neighbourhood policy and the strong growth needed by the EC neighbours (see Section VII).

Topic 3 (transport) has a predominantly mixed outcome for several reasons. The Treaty of Rome provisions on transport reflect the high level of regulation in all the initial ECMS in the late 1950s. The Treaty aimed to freeze the fragmentation among the ECMS markets generated by these heavy regulations, with the hope to harmonize later the ECMS regulations — that is, to substitute a (also probably heavy) regulated EC framework to the ECMS ones. Topics 4 to 6 are overwhelmingly driven by norm-setting objectives, in particular technical norms in Topic 4 (motor vehicles, capital goods, cosmetics, chemicals, and pharmaceuticals) and safety norms in Topic 6 (which has a strong agricultural component). Topics 7 to 10 are largely dominated by the competence of the ECMS, except the Directives on the customs union.

IV. REGULATORY CONVERGENCE OR REGULATORY COMPETITION?

Has the huge effort to develop the *acquis* led to some observable and economically meaningful convergence among the ECMS legal regimes? Table 2 tries to answer this question by using the Economic Freedom

indexes available from 1970 to today (Fraser Institute, 2007). It presents the (unweighted) average indexes for the various cohorts of acceding ECMS,⁴ and the (unweighted) average indexes for the various groups of EC neighbours as defined in this paper: Turkey, West Balkans, Eastern Europe (Belarus, Russia, Ukraine), Caucasus, the Mediterranean countries (involved in the Mediterranean Union) and the Golf countries. Finally, Table 2 presents the simple average Economic Freedom index for a reference group of countries considered to be the most active players in regulatory reforms (Australia, Canada, Chile, Hong Kong, Japan, New Zealand, Norway, Singapore, Switzerland and the United States).

Table 2 shows two main results — both crucial when reviewing the neighbourhood policy. First, certain EC cohorts which have been at the forefront of the regulatory reforms during a given period have become laggards in the following periods — and vice-versa. A first illustration is provided by the cohort EC1958 which exhibits regulatory indexes better than those of the reference countries in 1970s, but which slips behind three cohorts in 2004 (the reference countries, the cohorts EC1973 and EC1995). This relative decline started in the mid-1970s when the *acquis* was taking shape, and it deepened during the years 1985–1995 when the *acquis* begun to be massively expanded. Other illustrations of such evolutions are the cohort EC1973 which lagged much behind in the 1970s and which is almost on par with the reference countries in the recent years, and the cohort EC2004 which has caught up the cohort EC1981, mostly because of the Baltic countries (see below). Finally, it is interesting to note that the Golf countries have an Economic Freedom index better than the cohort EC1958.

⁴ The cohorts are the initial EC founding countries (EC1958: Belgium, France, Germany, Italy, Luxembourg, Netherlands) the countries acceding in 1973 (EC1973: Britain, Denmark, Ireland) in 1981–1986 (EC1981: Greece, Portugal, Spain, treated as one cohort) in 1995 (EC1995: Austria, Finland, Sweden) in 2004 (EC2004: Estonia, the Czech Republic, Greek Cypriot Administration of Southern Cyprus, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia) and in 2007 (EC2007: Bulgaria, Romania). Table 2 includes the two intermediate years 1990 and 2000 in order to have roughly similar time span between observations) get a better view of the evolution.

Table 2. A look at relative regulatory performances, 1970–2006

Cohorts of ECMS	1970	1975	1980	1985	1990	1995	2000	2004	2006
Groups of countries									
A. The successive cohorts of ECMS									
EC1958	7,22	6,64	6,84	6,99	7,43	7,27	7,53	7,37	7,34
EC1973	6,91	6,29	6,60	6,97	7,52	7,94	8,11	7,88	7,95
EC1981	6,41	5,28	5,91	5,71	6,27	6,86	7,15	7,28	7,14
EC1995	6,44	6,01	6,53	6,78	7,17	7,26	7,66	7,48	7,58
EC2004	--	5,74	5,29	5,03	5,27	5,64	6,52	7,10	7,22
EC2007	--	--	--	4,90	4,41	4,23	5,02	6,06	6,56
B. The main groups of EC neighbours									
Turkey	4,00	4,12	3,83	4,93	5,04	5,73	5,77	6,12	6,36
West Balkans	--	--	--	--	4,12	4,39	6,01	6,13	6,53
Eastern Europe	--	--	--	--	--	4,00	4,82	5,65	5,71
Caucasus	--	--	--	--	--	--	--	6,07	6,52
Mediterraneans	5,01	4,75	4,55	4,81	4,92	5,72	6,26	6,27	6,49
Golf countries	--	--	6,13	6,84	6,32	6,84	7,06	7,20	7,55
C. The "reference" countries									
The whole group	7,17	6,79	7,35	7,51	7,92	8,05	8,09	7,96	8,03

Source: Economic Freedom indexes (Fraser Institute, 2007).

Notes: Each row refers to a constant cohort of the newly acceding ECMS or to various groups of EC neighbours or reference countries. For instance, the cohort EC1973 includes Britain, Denmark and Ireland (for a description of all the cohorts, see footnote 5). Figures are the simple averages of the Economic Freedom indexes available for each individual country included in the cohort or group. The shaded area highlights all the cohorts that are part of the EC at a given year. Economic Freedom indexes are not available for all the countries of the cohorts EC2004 and EC2007 and of the groups of EC neighbours for all the years.

Second, more than two-thirds of the improvements in the regulatory regime of the Central European ECMS (cohort EC2004) occurred between 1990 and 2000, that is, before the full adoption of the *acquis* in these countries. This result is so critical to assess the current neighbourhood policy that it requires more evidence (to be provided by Section V).

That said, it is interesting to have a sense of the source of the remaining differences between the various cohorts. For instance, a more detailed database (World Bank, 2007) on regulatory performance of the cohorts EC2004 and EC1958 shows that, contrary to a widely-shared belief, the usual major culprit of bad governance in the cohort EC1958 — labor markets — is not alone and, more surprisingly, not even the worst. The

relative performances of the cohorts EC1958 and EC2004 in regulating capital markets and entrepreneurship (starting a business) are as bad as those in the labor market (Messerlin, 2007).

The key lesson from Table 2 is that the widely-accepted hypothesis of an ongoing regulatory convergence within the EC is not supported by the evidence. Rather, Table 2 suggests a dynamic competitive regulatory reform process among the ECMS — before and after their accession. Looking at individual ECMS (rather than cohorts of ECMS) confirms such fluidity in the relative positions of the ECMS (relative regulatory improvements in some countries, declines in others) and the process of regulatory competition (Deutsche Bank Research, 2007). Clearly, such a perspective has huge consequences for shaping the EC neighbourhood policy that are highlighted below (see Section VII).

V. A FORMIDABLE CHALLENGE TO THE EC: ITS HIGH HETEROGENEITY

What has been the main driving force behind the size and growth of the EU *acquis*, and its increasing norm-setting component? The most frequent answers rely on the following well-known political economy factors. The potential supporters of pro-competitive regulations, who tend to be large groups of consumers, are hard to mobilize, and large coalitions are hard to sustain because they are rapidly undermined by free-ride behavior. In sharp contrast, “mono-issue” lobbies unable to win their case in their own ECMS have strong incentives to go to Brussels (the EU Commission or Parliament) to try to get the norms that they did not succeed at getting at home.

However, if such explanations can explain the intra-EC dynamics of regulatory reforms, they fail to explain why the EC is insisting so much on extensive regulatory convergence from its neighbours, if only because the EC neighbours do not participate in the design of the *acquis* before accession.

An alternative explanation is that the *acquis* expansion is used as the way to deal with the EC mounting challenge – its much higher heterogeneity in a global context where heterogeneity is seen negatively (Milward, 1992) rather than positively (Bhagwati and Hudec 1996). Table 3 provides a simple heterogeneity index of the EC, namely the ratio of the GDP per capita of the richest to the poorest ECMS (GDPs per capita are calculated in US dollars at the purchasing power parity exchange rates (World Bank, 2008)). Table 3 shows the evolution of this index from 1975 until 2005 for the various EC configurations (from the EC6 to the EC27) and for the EC neighbours defined as one group.⁵ Table 3 presents results which exclude and include Luxembourg for reasons explained below.

When Luxembourg is excluded from the calculations, Table 3 provides several important results in terms of level and evolution. The ever-enlarging EC started as a very homogeneous entity until the 1970s, before seeing its heterogeneity doubling in 1981 (with Greece's accession) and then doubling again in 2007, with the Bulgarian and Romanian accessions. To give a sense of perspective, the corresponding ratio of heterogeneity was 2.5 in the US for the year 2005.

A second important result from Table 3 is that the various EC configurations have not seen any convergence in the range of their GDPs per capita — with the exception of the configuration EC9 which mirrors the Irish rapid growth.

⁵ Contrary to the cohorts of table 2, the configurations in Table 3 include all the ECMS. For instance, the configuration EC9 includes the nine ECMS, while the cohort EC9 includes only the three newly acceding ECMS. The PPP have been heavily revised by the World Bank in 2007. However, changes for Table 3 are minimal, except from Bulgaria (EC27) which is credited from a substantial upward revision of its GDP per capita.

Table 3. The evolution of the EC heterogeneity, 1975–2007

EC configurations	1975 (EC6)	1981 (EC9)	1986	1990	1995 (EC15)	2000	2004 (EC25)	2005 (EC27)
A. Excluding Luxembourg								
EC6	1,2	1,1	1,1	1,1	1,1	1,1	1,1	1,3
EC9	2,1	1,9	1,9	1,5	1,3	1,2	1,4	1,4
EC12	2,1	1,9	2,0	1,7	1,7	1,7	2,0	1,9
EC15	2,1	1,9	2,0	1,7	1,7	1,7	2,0	1,9
EC25	3,9	2,7	2,6	3,1	4,4	3,6	3,3	2,9
EC27	3,9	3,8	3,9	3,6	4,4	4,9	4,8	4,1
B. Including Luxembourg								
EC6	1,6	1,3	1,4	1,5	1,6	2,3	2,5	2,5
EC9	2,7	2,1	2,1	2,1	1,9	2,3	2,5	2,5
EC12	2,7	2,1	2,2	2,3	2,5	3,3	3,6	3,5
EC15	2,7	2,1	2,2	2,3	2,5	3,3	3,6	3,5
EC25	4,9	3,0	2,9	4,2	6,5	7,3	6,0	5,3
EC27	4,9	4,3	4,2	4,8	6,5	9,8	8,7	7,5
C. Including EC Neighbours								
exc. Lux	11,9	12,2	16,3	17,4	17,7	21,6	22,5	28,1
inc. Lux	15,7	15,9	19,1	23,5	25,9	43,4	40,5	41,4

Source: World Development Indicators, World Bank.

Notes: Figures present the ratios of the lowest GDP per capita to the highest one for a given configuration. Each row presents these ratios for a constant EC “configuration” over time. Any configuration includes all the ECMS for the whole period: for instance, the configuration EC25 includes all the 25 ECMS from 1975 to 2007. The shaded diagonal cells illustrate thus the successive EC enlargements from 1975 to 2007. The year 2007 is based on a revised PPP dataset which has no significant impact on the comparability of the results, except for the configuration EC27 which would exhibit a ratio of 8.6 with the non-revised data.

When Luxembourg is included, the EC heterogeneity is substantially larger. More importantly and surprisingly, it markedly increased since 1985–1995 for all the EC configurations up to the configuration EC15 included — mirroring the strong increase of Luxembourg’s GDP per capita compared to the GDP per capita of the “old” ECMS. Luxembourg’s high growth reflects its trade specialization in (financial) services (including in terms of inward labor movement, in contrast with most other ECMS) and its better regulatory performances (the Economic Freedom index for Luxembourg is the highest of the ECMS indexes until the early 1990s, and then among the three highest indexes until 2007).

Whether Luxembourg is excluded or not, the EC25 and EC 27 configurations show some convergence — but starting in 1995 for the EC25 and 2000 for the EC27, that is, before the accession of these ECMS, a point examined in more detail in the next section.

VI. A WORRISOME PRECEDENT FOR THE EC NEIGHBOURS?

Results from Tables 2 and 3 reveal the massive challenge that the current neighbourhood policy, based on the ultimate goal of regulatory convergence, may impose on EC neighbours. These results are important enough to be cross-checked by comparing in more detail the regulatory and economic evolutions of the EC neighbours since the early 1990s. The data needed for accomplishing such a task are available only for the “transition economies” for which there are two consistent sets of data — one on the economic performances and one on the regulatory performances (EBRD, 2008).

As a result, Table 4 allows us to compare the economic and regulatory performances of the transition economies which have acceded to the EC in 2004 and in 2007 with the corresponding performances of the “other” transition economies (from former USSR and Yugoslavia) which have not joined the EC. Since the Baltic countries come from exactly the same economic and political background (former USSR) than most of the other transition economies, they have been chosen as the reference group, and their level of performances has been set at the level 100.

At a first glance, Table 4 suggests that the average level of regulatory performances achieved in the new ECMS is — sometimes substantially — higher than the one in all the other transition economies. This observation suggests a strongly positive effect of the EC accession, hence of the adoption of the *acquis* by the new ECMS.

Table 4. The transition economies: regulatory vs. economic performances

	Regulatory performances											
	Average index level				Relative index (Baltics=100)				Annual average growth (%)			
	1989	1994	1999	2006	1989	1994	1999	2006	1989	1992	1996	2002
	1990	1995	2000	2007	1990	1995	2000	2007	1991	1995	2001	2007
EC Member States												
Central Europe	1,5	3,4	3,6	3,7	137	109	105	98	42,8	8,7	1,1	0,5
Baltics	1,1	3,1	3,4	3,8	100	100	100	100	16,9	16,0	2,0	1,1
Bulgaria, Romania	1,0	2,4	3,1	3,5	90	77	91	91	36,3	7,4	4,8	1,2
Eastern Europe and Central Asia												
Russia	1,0	2,8	3,0	3,1	90	92	88	82	8,3	14,9	0,8	0,3
Ukraine	1,0	2,1	2,9	3,1	90	69	84	81	0,0	12,1	3,3	1,3
Belarus	1,0	2,1	1,7	1,9	90	70	51	50	0,0	9,9	-3,1	0,9
Caucasus	1,0	2,0	2,8	3,1	90	65	83	82	0,0	10,0	6,6	1,3
Central Asia	1,0	2,2	2,6	2,7	90	73	77	70	3,8	10,4	2,3	0,7
West Balkans												
Croatia	1,9	2,7	3,2	3,4	170	87	95	89	9,3	7,4	2,4	0,8
Others	1,6	2,0	2,4	3,0	143	66	70	78	5,5	3,9	4,1	3,0
	Economic performances											
	Average real GDP per capita (US\$)				Av. real GDP per cap. (Baltics=100)				Real GDP average annual growth (%)			
	1989	1994	1999	2006	1989	1994	1999	2006	1989	1992	1996	2002
	1990	1995	2000	2007	1990	1995	2000	2007	1991	1995	2001	2007
EC Member States												
Central Europe	2539	4170	5441	14144	na	231	157	123	-5,2	1,8	3,7	4,8
Baltics	na	1807	3468	11465	na	100	100	100	-2,4	-9,5	5,8	8,7
Bulgaria, Romania	2899	1401	1591	5634	na	78	46	49	-7,5	0,0	0,0	6,0
Eastern Europe and Central Asia												
Russia	7119	1992	1568	8002	na	110	45	70	-2,1	-10,1	2,3	6,8
Ukraine	na	716	639	2619	na	40	18	23	-3,5	-14,8	0,0	7,4
Belarus	656	755	1127	4205	na	42	32	37	1,3	-9,8	6,1	8,5
Caucasus	341	308	597	2488	na	17	17	22	-6,6	-16,2	6,5	13,4
Central Asia	1564	454	486	1817	na	25	14	16	-3,3	-9,4	4,6	8,3
West Balkans												
Croatia	5193	3596	4288	11442	na	199	124	100	-9,9	-1,8	3,6	5,0
Others	822	858	1276	3202	na	47	37	28	-6,7	-9,7	6,3	5,1

Notes: The regulatory performances are the simple averages of six indexes (EBRD 2008): enterprise reform, small and large privatization, price and competition, FOREX and trade liberalization, and finally competition policy. The economic performances are also based on EBRD (2008). The groups of countries are as follows: Central Europe (Czech Republic, Hungary, Poland, Slovakia, Slovenia) Baltic states (Estonia, Latvia, Lithuania) Caucasus (Armenia, Azerbaijan, Georgia) Central Asia (Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan, Uzbekistan) and Other West Balkans (Albania, Bosnia–Herzegovina, Macedonia, Moldova, Montenegro, Serbia).

But stopping there would miss four key observations. First, the annual growth rate of the regulatory performances of the new ECMS was much higher during the periods when their membership was still a faraway perspective. The Central European ECMS (as defined in Table 4) have done most of their regulatory reforms between 1989 and 1991 when the EC assessments of the regulatory reforms adopted by these countries ranged from negative to skeptical, and when the EC even pushed, in

some cases, for changes detrimental to the interests of the Central European ECMS.⁶ The Baltic countries completed their major reforms between 1992 and 1995 when their accession to the EC was still a remote perspective. Conversely, the annual growth rate of the regulatory performances for these two groups of countries was much smaller when these ECMS were adopting the *acquis* — despite the fact that these ECMS have still progress to make in regulatory matters, and that their average GDP per capita is still lagging much behind the GDP per capita of the old ECMS.⁷

Second, comparing the growth rate of regulatory performance with the growth rate of the GDP per capita suggests that high economic growth rates have mostly reacted to the big initial domestic pushes in regulatory reforms, with a lag of 3 to 5 years. Indeed, delaying reforms has been very costly in terms of economic growth collapse: the longer the delay, the deeper the initial collapse in terms of economic growth.

Third, there is a key difference between the Baltic and Central European (as defined in Table 4) ECMS. The Baltic ECMS exhibit better economic and regulatory performances than the Central European ECMS since the mid-1990s. By definition, such a difference cannot be explained by the *acquis* since it is the same for all the ECMS. Rather, this difference echoes the fact that, when designing their regulatory reforms, the Baltic ECMS have often been inspired by the Nordic ECMS, while the Central European ECMS have mostly looked after the EC founding countries. In other words, the different evolutions of the Baltic and Central European ECMS mirror the better domestic governance observed in the Nordic ECMS compared to the EC founding countries since the mid-1990s (see

⁶ For instance, it took almost two years to the EC to shape the framework of bilateral preferential trade agreements (the EC never came up with a truly regional agreement). In several instances (most notably Poland and Romania) the EC pushed hard Central European countries to reimpose higher tariffs than those they adopted immediately after the fall of the Iron Curtain (Messerlin, 2001).

⁷ The EBRD indexes vary from 1 to 4+, where 1 represents little or no change from a rigid centrally-planned economy, and 4+ represents the standards of an industrialised market economy. Countries' size does not affect significantly the results of Table 4.

Table 2) — another illustration of the key role of the ECMS domestic regulations compared to the role of the *acquis*.

Last but not least, Table 4 suggests that, since the beginning of the full adoption of the EC *acquis* by the Central European ECMS, their growth rate does not fare well with those enjoyed in Eastern Europe and Central Asia, whereas the growth rate in the Baltic ECMS is roughly similar to the growth rate in Eastern Europe and Central Asia. This conclusion holds whether, or not, one makes a distinction between energy producers and the other countries from these regions.

These observations suggest that the current *acquis* imposes costs in terms of foregone growth. Reducing the focus of the current neighbourhood policy on the *acquis* has thus the potential to generate additional gains in terms of economic growth — by far, the most valuable goal for the relatively poor EC neighbours.

VII. REGULATIONS AND SERVICES

Services represent a major share of the GDP of all the economies examined in this paper. They are generally activities intensive in regulations, hence the need to better understand the effects of the regulations in services in an international trade perspective. What follows relies on the view (argued in Messerlin, (2007)) that domestic (home) regulations have the capacity to shape the comparative advantages of the home services providers because they are a critical part of the resources endowment available to these services providers. In other words, services providers combine capital, labor and home regulations when providing the desired services before market opening.

If this view is correct, home regulations have the capacity to shape comparative advantages to an extent rarely observed in goods — namely even if those regulations are not economically sound. Such a feature changes dramatically the dynamics of trade liberalization in services,

compared to the one in goods. More precisely, services exporters are not necessarily the driving force for trade liberalization in services that they usually are in goods.

This feature can be illustrated with an important service — the (food) retail sector — which is very sensitive to a specific, easily measurable, type of regulation, namely the constraints imposed on the size of stores that can be opened in any given location. ECMS are imposing different regulations on store size.⁸ Comparing the resulting pattern in retail store size leads to results which would have also been expected in trade in goods. First, the regulations which aimed to protect the “small” domestic retailers against the “large” domestic retailers (such rules do not aim at discriminating between foreign and domestic retailers) did not achieve their proclaimed goal — a result very similar to the inefficiency of protectionist measures observed in trade in goods. Second, restrictive regulations have profoundly distorted the pattern of the large stores segment of the retail sector — inflating the relative share of supermarkets, compared to hypermarkets.

But the constraints on store size have two effects that are generally not observed in trade in goods. First, they shape the comparative advantages of the domestic services providers even if they are economically unsound. For instance, in order to comply with the German regulations, German retailers have been pressed to develop a particular type of supermarket — the so-called “maxidiscounts” which have an average size roughly 97% (!) of the size ceiling under which the German regulations impose no constraint on the stores location. Because of their relative small size, maxidiscounts focus on price competition, and sell a narrow range of basic products at very low

⁸ For simplicity sake, the text focuses on three ECMS similar in terms of population and economic size (Britain, France, and Germany). Britain has a “no retail-specific constraint” approach: the size of the stores depends upon market forces (as assessed by the retail firms) within the broad constraints of a “zoning policy”. Germany has imposed a relatively moderate retail-specific constraint by requiring the agreement of the authorities for building and opening stores larger than 800 square meters. France adopted a similar approach to the German one in the 1970s and early 1980s, but since the mid-1980s it has enforced much tighter constraints, culminating in a law passed in 1994 requiring the agreement of the local authorities (mayors) for building and opening all stores larger than 400 square meters.

prices. The German retailers mastered this technology to the point that they have successfully opened maxidiscounts outside Germany, even in the more strictly regulated French retail market. Indeed, during the last fifteen years, French retailers, except a couple of them, have largely been unable to compete in the maxidiscount segment with the German retailers. In sum, the German economically (moderately) unsound regulations have contributed to the development of certain comparative advantages for German retailers.

Second, successful exporters of services are much less likely to support market opening than successful exporters of goods, as can be illustrated again with the retail case. German successful exporters of maxidiscounts are unlikely to easily accept the abolition of German regulations on store size for the following reason⁹ — the German retailers would have to cut their maxidiscount activities in Germany because of the increasing competitive pressure from new supermarkets and hypermarkets once the German constraints on stores size were abolished. Meanwhile, the German retailers would find it very costly to redirect to other countries the services provided by these maxidiscount stores — that would require the creation or expansion of an entire new network of stores. This is in sharp contrast to what happens in goods where successful exporters of a product could often sell (at limited additional expenses) in more open foreign markets the goods that they could not sell anymore in their more open home markets. In sum, the usual dynamics of trade liberalization in goods (exporting firms pushing for liberalization even if it means the opening of their home markets to foreign competition) may be much weaker in services.

VIII. FROM REGULATORY CONVERGENCE TO MUTUAL EVALUATION: BUILDING MUTUAL TRUST

The constraints imposed by the EC *acquis*, the evidence of regulatory competition (not of regulatory convergence) and the specific role of

⁹ Moreover, in this precise case of EC retail, German retailers may feel to have already sufficient access to the foreign retail markets for the specific segment they are good at.

regulations in services lead to three remarks that are useful for redesigning the EC neighbourhood policy.

First, they help to better understand why harmonizing the domestic regulations of the countries negotiating an agreement in services fails so often. Substituting a new common set of regulations to the existing home regulations of the countries willing to open their markets to foreign competition is equivalent to imposing the use of a new legal capital to all the service providers in the countries involved. It erodes or eliminates the existing comparative advantages (including those generated by economically unsound regulations) enjoyed by the home services providers. When equidistant from the existing regulations of the various countries (a condition rarely met in reality) harmonization seems to be non-discriminatory. But this is only *de jure* non-discrimination. Such national treatment may be a severe handicap imposed *de facto* on all the services providers to the extent that it deprives them of the comparative advantages embedded in their home country's regulations.

Second, a similar conclusion can be reached for the mutual recognition "*à la EC*". In the EC, mutual recognition is conditional since it still requires the harmonization of the provisions considered as essential to ensure a level-playing field (the "core" provisions). The need for harmonization is only removed for the provisions that do not pertain to the "core" provisions. The impact of such an approach to mutual recognition depends thus largely on the scope of the core provisions to be harmonized, compared to the non-core provisions. In the EC, this scope is defined by the Directives that are negotiated by the ECMS. The larger the scope, the more the mutual recognition is *de facto* and the less successful it can be (for the same reasons as for harmonization). Negotiating Directives induces the service providers of every ECMS to try hard to include in the core provisions those provisions that, they believe, are shaping their comparative advantages. When each ECMS behaves this way, the final set of "core" provisions tends almost inevitably to be relatively large — hence mutual recognition to be *de facto* close to

harmonization. This tendency explains the considerable disillusion, both within the EU and more broadly in the global trade community, generated by mutual recognition.

What could then be an alternative approach to regulatory convergence for a better EC neighbourhood policy? Paradoxically — at a first glance — the solution can be found in one of the most recent pieces of the EC *acquis* — the Services Directive. This Directive introduces the notion and procedure of “mutual evaluation”. Article 39 states that ECMS should “conduct a screening of their legislation in order to ascertain whether requirements reserving access to certain activities to particular providers exist in their legal systems”.¹⁰ Such a screening requires *ex ante* necessity tests limiting the ability of domestic regulations to create inefficiency and rents, and it also calls for a thorough *ex post* monitoring of the adopted regulations.

The evaluation process is mutual in the sense that each ECMS’s reports are forwarded to the other ECMS which are allowed to comment — a key step for building trust among the partners involved. It is worth noting that mutual evaluation could be done at the level of the whole EC, but also at the level of a subset of “willing” ECMS. In the latter case, mutual evaluation could become a door to a variable geometry approach which would be “reasoned” in the sense that it would be defined on precise criteria related to specific regulations.

It would not be too difficult to expand this notion of mutual evaluation (and the associated procedure) to the relations between the EC and its neighbours. Such a new approach has five positive effects.

First, being based on a more flexible procedure, mutual evaluation has a better capacity to generate a dynamic process of regulatory reforms delivering growth to very different economies than the current rigid, pre-determined and non-negotiable current approach. This is key for the EC

¹⁰ Services Directive, General Considerations, paragraphs 73–74

neighbours for which a “one size fits all” makes even less sense than between all the ECMS since they have reached very different levels of governance, and should cast their regulatory reforms in a very different growth environment.

Second, mutual evaluation is flexible and robust enough to lead to unconditional mutual recognition (by opposition to the current EC conditional mutual recognition). Once the regulations of the partners have been mutually evaluated, the ECMS and the neighbour could agree on the fact that the regulations at stake are of sufficiently similar quality to be recognized by each partner, or on the conditions to be met by those regulations to reach a level of trust high enough to achieve mutual recognition. There is no better way to open the door to transborder (trade or investment) services activities under the responsibility of the regulators involved.

Third, if mutual evaluation rejects the rigidity of the principle of the non-negotiability of an unreviewable *acquis*, it does not give up the principle that the *acquis* could be non-negotiable, once the process of mutual evaluation would have demonstrated the sound foundations of the *acquis*. Such a distinction would have been very useful in the past. For instance, when Austria, Finland and Sweden acceded to the EC in 1995, a review of the CAP would have speeded up the reforms that have been done in the EC since then. In particular, it would not have imposed on Sweden the obligation to give up the reform of its own agricultural policy — but it could have used the Swedish reform as a useful experiment for the new CAP, hopefully demonstrating that an adjustment process can be well controlled, hence removing fears in the rest of the EC.

Fourth, mutual evaluation would provide a balanced solution to the possibility that future additions to the *acquis* could hurt the long-term interests of EC neighbours. It could be the case that current ECMS promote Regulations or Directives that would be detrimental to some EC neighbours’ interests (including as an indirect way to make more difficult their accession). By contrast, mutual evaluation would provide the

opportunity to spell out the good (and bad if any) reasons for adopting a new piece in the *acquis* — hence would substantially limit such risks.

Last but not least, the fact that mutual evaluation becomes the common procedure for assessing internal EC matters, as well as matters related to the relations between the EC and its neighbours, makes it much easier for EC neighbours to accept the changes that could be introduced in the EC current neighbourhood policy. EC neighbours could realize that such changes are not excuses hiding a different political agenda, but reflect a profound change of the EC approach to economic integration.

IX. CONCLUDING REMARKS

The paper suggests three key lessons. First, the EC itself is in a deep need of internal reforms. Its heterogeneity — much higher than in the past — implies that the EC “one size fits all” approach that has fuelled the continuous expansion of the *acquis* and regulatory convergence since the 1980s is becoming a source of economic costs, hence of political problems, as illustrated by the referenda on European Treaties. Second, despite the *acquis*, the ECMS remain engaged in a regulatory competition process. This process allows the use of EC heterogeneity as an asset (not to see it as a handicap) based on the fact that the EC is constituted by half-a-dozen larger ECMS surrounded by twenty or so smaller ECMS generating a competitive and innovative regulatory “fringe”. During the last decade, a number of smaller ECMS (Estonia, Ireland, Netherlands, Slovakia or Sweden) have launched successful regulatory initiatives — flatter taxes with a broader base, an environment more friendly to foreign direct investment, public evaluation of farm reforms, flexicurity, etc. — that first challenged the regulatory approach of the other ECMS, before being an inspiration to the others. Last but not least, regulatory competition can be enhanced by a process of mutual evaluation of the existing and envisaged regulations among the ECMS — a process aiming to promote growth of countries having very different

levels of incomes, hence different concerns and priorities in terms of social relations, environment, etc.

These lessons can be extended to the relations between the EC and its neighbours. It is beyond this paper to suggest actions based on these lessons. What follows provides some indications on what could be envisaged (Messerlin, forthcoming 2008).

The first two decades of the EC have shown that market access is a powerful engine of growth, a success suggesting two types of actions on the market access for goods. First, the current trade agreements between the EC and its neighbours should be thoroughly evaluated. They are much more favorable to the EC than to its neighbours for a wide set of reasons, with some having been imposed by the EC (such as the absence of substantial market access in farm and food products) and others imposed by the neighbours (the high barriers imposed by the EC neighbours on imports from non-EC countries give to the EC producers high preferences in the EC neighbours' markets).¹¹ Second, the current trade agreements between EC neighbours which tend to be empty shells or trade distortive should be evaluated under the same criteria as the agreements between the EC and its neighbours. In short, serious efforts could be devoted to create a true "common market" in goods covering the EC and its neighbours willing to participate to this endeavor — leaving the door open to the other EC neighbours feeling yet unprepared for such a move.

¹¹ Ten out of the 33 countries affected by the neighbourhood policy are not yet WTO Members (and constitute the bulk of the countries not yet members of the WTO). Twenty EC neighbours which are WTO Members apply tariffs lower than their bound tariffs, meaning that their trade relations are plagued with systemic uncertainty. The average "tariff water" (the difference between the bound and applied tariffs) of these 20 EC neighbours is 13.5 percent, with a maximum of 95.3 percent (Kuwait). The only exception to the high uncertainty in the trade relations with the EC neighbours is Turkey. The customs union between the EC and Turkey has so far prevented Turkey from increasing its tariffs, even when it faced economic difficulties. That said, Turkey is handicapped by the impossibility to duplicate (as it should) the EC policy of preferential trade agreements.

This broad and systematic approach in goods does not seem within reach in services, if only because opening markets in services is intrinsically very difficult, as illustrated by the slow progress of the EC Internal Market in these sectors. However, two very useful exercises — both relying heavily on mutual evaluation of the existing and envisaged regulations — could be done. The first one would start from the EC side and the existing and envisaged *acquis*. It would evaluate the capacity of the *acquis* to foster growth and the corresponding role of the domestic regulations of the various ECMS — recognition that such regulations have played (and still play) a key role in ECMS growth performances, as underlined above. The second exercise would start from the EC neighbours side. It would consist of determining the regulatory reforms which would boost the expected comparative advantages of the EC neighbours in services — including temporary labor mobility (Mode 4 in WTO jargon).

Both exercises in services would have two main spillovers. First, regulatory convergence becomes particularly costly when it imposes goals that make sense to the rich ECMS, but that may be detrimental to growth in the poor ECMS or EC neighbours. For instance, only one (development of the maritime and land highways) out of the six goals proposed by the Union for the Mediterranean addresses immediate concerns of the EC neighbours (the other goals are depolluting the Mediterranean sea and developing solar energy, civil protection, mobility for students and aid to small and medium businesses) (Bertho, forthcoming). Regulations with little growth content should be made conditional on the appropriate level of economic prosperity, a minimum level of countries' GDP per capita, for instance. Such an approach could imply that rich countries would be asked to contribute to environmental programs in the poor countries during a transitory period if a fast enforcement is desirable. Second, a more intensive use of mutual recognition would probably recognize the country of origin principle as

the most promising approach for improving market access in services.¹² However, such a principle requires that each country trusts the governance quality of its partners. As a result, agreements including all the ECMS and EC neighbours may not be doable in the short run, but an immediate impact of the mutual evaluation process could precisely contribute to building the necessary trust.

¹² The current financial crisis is (so far) the best illustration to date of the benefits from such a principle—and of the fact that governments understand the trade-off between reputation and the “race to the bottom”.

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