

CASE Network Studies & Analyses

Institutional Harmonization and Its Costs and Benefits in the Context of EU Cooperation with Its Neighbors. An overview

Anna Kolesnichenko

No. 387/2009



Warsaw Bishkek Kyiv Tbilisi Chisinau Minsk

Materials published here have a working paper character. They can be subject to further publication. The views and opinions expressed here reflect the author(s) point of view and not necessarily those of CASE Network.

This paper has been prepared under the Workpackage 11 on 'The costs and benefits of institutional harmonization' within the framework of the ENEPO project (EU Eastern Neighbourhood: Economic Potential and Future Development), financed under the Sixth Framework Programme of the European Commission, Contract No 028736 (CIT5). The content of this publication is the sole responsibility of the authors and can in no way be taken to reflect the views of the European Union or any other institutions the authors may be affiliated to.



The project was carried out with the cooperation of CASE – Centre for Social and Economic Research CASE Ukraine



Keywords: Institutional harmonization, European integration, European Neighborhood Policy (ENP), market access, non-tariff barriers

JEL codes: **B41, F15, P33**

© CASE – Center for Social and Economic Research, Warsaw, 2009

Graphic Design: Agnieszka Natalia Bury

EAN 9788371784903

Publisher:

CASE-Center for Social and Economic Research on behalf of CASE Network

12 Sienkiewicza, 00-010 Warsaw, Poland

tel.: (48 22) 622 66 27, 828 61 33, fax: (48 22) 828 60 69

e-mail: case@case-research.eu

<http://www.case-research.eu>



The CASE Network is a group of economic and social research centers in Poland, Kyrgyzstan, Ukraine, Georgia, Moldova, and Belarus. Organizations in the network regularly conduct joint research and advisory projects. The research covers a wide spectrum of economic and social issues, including economic effects of the European integration process, economic relations between the EU and CIS, monetary policy and euro-accession, innovation and competitiveness, and labour markets and social policy. The network aims to increase the range and quality of economic research and information available to policy-makers and civil society, and takes an active role in on-going debates on how to meet the economic challenges facing the EU, post-transition countries and the global economy.

The CASE network consists of:

- CASE – Center for Social and Economic Research, Warsaw, est. 1991, www.case-research.eu
- CASE – Center for Social and Economic Research – Kyrgyzstan, est. 1998, www.case.elcat.kg
- Center for Social and Economic Research - CASE Ukraine, est. 1999, www.case-ukraine.kiev.ua
- CASE –Transcaucasus Center for Social and Economic Research, est. 2000, www.case-transcaucasus.org.ge
- Foundation for Social and Economic Research CASE Moldova, est. 2003, www.case.com.md
- CASE Belarus - Center for Social and Economic Research Belarus, est. 2007.



Contents

| | |
|---|-----------|
| Abstract..... | 5 |
| Introduction | 6 |
| 1. Concept of institutional harmonization and its applications to European integration..... | 6 |
| 2. What institutional harmonization with the EU may mean - lessons from existing arrangements..... | 13 |
| 2.1. Option 1 – accession to the EU (membership)..... | 14 |
| 2.2. Option 2 – European Economic Area | 14 |
| 2.3. Option 3 – EU-Switzerland cooperation | 15 |
| 2.4. Option 4 - EU-Turkey Customs Union | 16 |
| 2.5. Option 5 – Free trade area (FTA)..... | 19 |
| 2.6. Conclusions on other countries experiences..... | 20 |
| 3. Agenda for institutional harmonization of EU Eastern Neighbors | 21 |
| 4. Proposal of a harmonization package..... | 25 |
| 4.1. Industrial products | 26 |
| 4.2. Agriculture | 26 |
| 4.3. Services..... | 28 |
| 4.4. Custom procedures | 29 |
| 4.5. Competition, public procurement and state aid..... | 29 |
| 4.6. Environment | 29 |
| 5. Benefits of institutional harmonization..... | 30 |
| 5.1. Improved market access | 31 |
| 5.2. Increased investment..... | 31 |
| 5.3. Increased competition | 32 |
| 5.4. Reduction in corruption..... | 32 |
| 5.5. Increased credibility of reforms and certainty in the economy | 33 |
| 5.6. Improved domestic institutions and the system of economic governance..... | 34 |
| 6. Costs of institutional harmonization | 34 |
| 7. Note on quantifying the effects of institutional harmonization | 35 |
| 8. Overall conclusions | 37 |
| References | 40 |



Anna Kolesnichenko has been working with CASE Ukraine since 2001. She currently specializes in the political economy of European integration, EU-Ukraine relations and energy security and efficiency. She has also worked with the EU-Ukraine Business Council, the NATO Parliamentary Assembly, the Centre for Strategic and International Studies (CSIS) in the USA, the United Nations Development Program (UNDP) in Ukraine and the Harvard Institute for International Development (HIID) in Ukraine. Anna holds an MA in European Studies from SAIS, Johns Hopkins University; an MA in Economics from the EERC program at the Kyiv-Mohyla Academy; and a Specialist degree in Environmental Management from the Donetsk State Academy of Management.



Abstract

Institutional harmonization is an important part of European integration, and its effects are more far reaching than the effects of trade liberalization. In its policy towards neighbors (the European Neighborhood Policy, ENP), the EU puts a lot of stress on the desirability of institutional harmonization, at least in certain areas. In particular, the free trade agreements that the EU envisages concluding with its Eastern neighbors will involve substantial harmonization of product standards, competition policy and a range of other policies and processes. At the very least, the harmonization will have to focus on the areas that relate to improvement of market access, i.e. removing restrictions to trade, harmonizing product standards and the systems of quality control etc. But in order to implement the new standards and rules, the EU neighbors will have to reform many related areas, so that the harmonization will encompass the whole system of economic governance. Not only will such a revamp help attaining better access to the EU markets, but also (and probably more importantly) it will stimulate modernization of the neighbors' economies and bring much needed efficiency gains.

In measurement of benefits of harmonization we refer to two methods: one based on the computable general equilibrium (CGE) modeling of welfare effects of better market access, and the other employing a growth model to estimate the wider effects of European institutions on growth. The estimation of costs of harmonization bases on extrapolation of the analogous costs in other countries, in particular CEE. These costs include expenses by a public sector on introduction of harmonization measures, as well as private sector expenses and investments related to their implementation.



Introduction

This paper summarizes the results of the workpackage 11 on “The costs and benefits of institutional harmonization” of the Specific Targeted Research Project on “EU Eastern Neighborhood: Economic Potential and Future Development (ENEPO)” funded under the EU Sixth Framework Program, Priority 7, contract No 028736 (CIT5). Section 1 discusses the concept of institutional harmonization and its application to European integration process. Section 2 contains an overview of various forms of economic integration observed in both Europe and its neighborhood and the role played by an institutional harmonization in each variant. Section 3 analyzes institutional harmonization in the context of the European Neighborhood Policy. Section 4 makes attempt to define the institutional harmonization package for the EU Eastern neighbors. Section 5 discusses the potential benefits of institutional harmonization while Section 6 offers the similar analysis in respect to their costs. Section 7 addresses the issue of how to quantify both benefits and costs of institutional harmonization. Finally, Section 8 presents conclusion of both the paper and other analyzes conducted under WP11 of the ENEPO project.

1. Concept of institutional harmonization and its applications to European integration

It has become an established fact that institutions are an important factor of economic performance of economies. Numerous empirical studies showed a positive correlation between the level of development of institutions of countries and performance of their economies across space and over time (the earliest and most famous of them done by North (1990). According to him, institutions are formal rules, informal constraints, and enforcement mechanisms that provide the basic structure by which human beings create order and attempt to reduce uncertainty in exchange. By reducing uncertainty, institutions help reduce transaction costs and, hence, the profitability and feasibility of engaging in economic activity.

It is widely recognized that mere trade liberalization with the EU is not going to bring much benefit to the European neighbors and to the EU. Different studies on the potential impact of integration between the EU and its neighbors show that creation of “deep” Free Trade Areas is



going to have much stronger effect than removal of tariffs alone. This effect is expected due to the institutional harmonization between these countries and the European Union that is going to result in reduction of non-tariff barriers and general modernization of the economy, bringing about major efficiency and welfare gains. Despite its huge effects, the institutional harmonization in the context of economic integration and trade liberalization often remains quite vaguely or narrowly defined. This section aims to review some relevant concepts and suggest a definition that will be employed in this study.

The concept of institutional harmonization is very comprehensive, as it touches upon diverse political and economic issues. In the political domain, it means convergence of political institutions towards some single model. There is a big body of literature discussing the spread of the democratic institutions and the mechanisms of regime change. The economic dimension of the concept gets into discussions about globalization and the spread of the liberal market model of economic governance. In Europe, the process of institutional harmonization has acquired some special features and received a special name – Europeanization.

Broadly defined, Europeanization is a process of internalization of European values and policy paradigms. Europeanization involves not only formal institutions, but also values and informal institutions. It takes place within the EU itself, as well as beyond its borders. Enlargement, for example, stimulated Europeanization in the acceding states. The European Neighborhood Policy (ENP) attempts to bring the same forces into play beyond EU frontiers.

Europeanization is a multifaceted concept and includes historical, cultural and political dimensions. The complexity of this phenomenon gave a rise to a debate on what Europeanization is. A discussion of different definitions of the concept could be found, for example, in Sittermann (2006). From the historical point of view, the term Europeanization refers to the “export” of European political institutions, political practice and “way of life”. In the cultural domain, it refers to the transnational diffusion of everyday habits, ideas and traditions. Finally, the political side of Europeanization includes adaptation of the West European state model by other states, penetration of European rules, directives and norms into the different domestic spheres and the emergence and development of distinct structures of governance at the European level (EU institutions). The following definition, given by Radaelli (2004), is the most comprehensive one:



Europeanization consists of processes of (a) construction (b) diffusion and (c) institutionalization of formal and informal rules, procedures, policy paradigms, styles, 'ways of doing things' and shared beliefs and norms which are first defined and consolidated in the EU policy process and then incorporated in the logic of domestic (national and subnational) discourse, identities, political structures and public policies.

There are studies that explore how Europeanization works, in particular, the European influence on domestic politics and policies. One can distinguish two major schools of Europeanization: rational institutionalism and sociological institutionalism. The former presupposes that agents know their preferences and act accordingly; the latter school claims that actors are not necessarily driven by self-calculated interest and pre-defined preferences, but rather by accepted norms and ideas about what constitutes a proper behavior.

The rational institutionalism school studies how EU policies influence domestic settings (top-down approach) and the reverse – the domestic reaction to EU policies (bottom-up approach). The work of Knill and Lehmkuhl (2002) is an example of the first approach. The authors distinguish three channels of Europeanization:

- *Institutional compliance*: the EU precisely prescribes the institutional setting to which the EU member states have to adapt. This mechanism is characteristic for such policy fields as environmental protection, safety regulation at the work place, consumer protection.
- *Changing domestic opportunity structures*: the EU changes the distribution of power and resources between domestic actors granting in its regulations more favorable conditions to some stakeholders and less favorable to others.
- *Framing domestic beliefs*: the EU may frame domestic beliefs prior to introducing certain new policy ideas. This can be done by introducing small changes (through regulations) that are in line with current domestic policies but that lead to indirect changes supporting the broader political intention of the EU.

The second (bottom-up) approach posits that the outcome of Europeanization depends on how much EU influence can empower the agents of change in the country. According to Börzel (2003), the capacity of the EU policies to make such an influence depends on the number of veto points and the existence of formal institutions that help the agents of change to win over the supporters of the status quo. Veto points are the opportunities that diverse domestic stakeholders can use to block the implementation of institutional changes. "The more actors



have a say in political decision-making and the more power is dispersed across the political system, the more difficult it is to foster the domestic ‘winning coalition’ necessary to introduce changes in response to Europeanization pressures” (Börzel, 2003). On the other hand, the existence of the formal institutions that help empower the agents of change facilitates the transformation. Börzel (2003) refers to an example of promotion of women rights in different EU countries: in the UK, different public institutions helped women rights organization to make sure EU equal pay and equal treatment directives were implemented; by contrast, in France there was no such assistance, and the directives were poorly implemented.

Another stream of the institutionalist school, the sociological institutionalism, claims that actors are not necessarily driven by self-calculated interest and pre-defined preferences, but rather by accepted norms and ideas about what constitutes a proper behavior. In their view, Europeanization happens through adoption of European norms and rules of appropriateness by domestic actors through processes of persuasion and social learning, so that the domestic actors redefine their interests and identities accordingly. In this setting, the leading role belongs to the agents of change (also called *norm entrepreneurs*) who persuade and mobilize others to redefine their interests and identities by engaging them in processes of social learning in light of the new norms and rules (Börzel, 2003). The role of norm entrepreneurs can be played by actors with an authoritative claim to knowledge, for example, research institutes.

The attempts to measure the effects of Europeanization in the Western European countries have not given any conclusive results yet. In her overview of different studies on the outcomes of Europeanization, Börzel concluded that they found little evidence for homogenization or convergence of domestic institutions, policies, and processes toward common models and approaches in the Western Europe (Börzel, 2003). At the same time, it is undeniable that there is an EU influence, but its impact is far from revolutionary and is rather an “adaptation with national colors”.

In view of the recent EU enlargements, a series of studies emerged devoted to the issue of Europeanization in the context of EU accession. The major difference of Europeanization in the Central and Eastern European accession countries is that in many cases it means institution-building rather than institutional change. Also, unlike in the old EU members, Europeanization in these countries went hand in hand with the accession process, which through conditionality and negotiations made the EU influence stronger. Furthermore, the scope and the depth of the EU



influence on the development of governance in Central and Eastern Europe went well beyond its official competences in the current member-states due to the “market economy” and “democracy” Copenhagen criteria (Grabbe, 2001). For example, in the old member states, the EU has no say over issues such as the quality or organization of their political institutions or civil service; but it can influence these areas in the accession countries, as they fall within the realm of the Copenhagen criteria. In the case of accession, there is also a major difference in the structure and agency nature of Europeanization: while EU members can influence the EU policies that affect them, acceding countries cannot. Finally, the accession countries do not have an opportunity to opt out of some EU policies, like some old EU members do. All these factors suggest that the Europeanization has stronger effects on the new entrants than on the old member states.

At the technical level, the EU has developed special mechanisms for promoting Europeanization in the accession states. Grabbe (2003) distinguishes the following mechanisms:

- Provision of legislative and institutional templates
- Aid and technical assistance
- Benchmarking and monitoring
- Advice and twinning
- Gate-keeping: access to negotiations and further stages of the accession process

While the first three mechanisms have been in use in the EU-15 itself, the last two have been used specifically for the CEE entrants. As Grabbe (2003) shows, even the application of the first three mechanisms often had greater scope and depth in CEE entrants than in the EU-15 states. For example, CEE countries often adopted non-obligatory parts of the EU legislation or practices in order to prove they are serious about membership. But conditionality (“gate – keeping”), specific to the accession process, has proven to be the strongest device: the EU used it not only with respect to the fulfillment of the minimal membership criteria, but also employed it to demand particular actions in selected areas (Grabbe, 2003).

The research on the effects of Europeanization in the new EU member states is at its early stage. In her overview of the effects of Europeanization on governance, Grabbe (2003) concludes that there was little evidence of convergence in general governance patterns in CEE. However, she argues, there are certain areas where the EU effect is rather strong. First of all, this is economic governance, which the EU affects through the regulatory agenda connected



with compliance with the Single Market norms. EU competition policy, sectoral policies and industrial standards are the main channels of this impact. Other areas where the EU impact is significant are the reform of the civil service, public procurement, budgetary procedures, and regional self-government.

An attempt to make a quantitative assessment of the effects of Europeanization on growth in CEE was done in Piazzolo (1999). The author uses EBRD Transition Indicators in a growth model to estimate a coefficient for the institutions variable. According to his results, a full harmonization with EU norms will boost GDP by 12% in CEE countries. This is a static effect not taking account on capital mobility. The author estimates that the capital mobility will lead to doubling of the harmonization bonus, which may reach 24%-36% of GDP.

A more recent and sophisticated assessment of growth benefits from harmonization with the EU has been provided by Cernat (2006). The author developed a growth model that included several variables which accounted for the external policy transfer as well as several variables commonly used in growth regressions. Europeanization was captured by three variables: an index of implementation of the EU acquis, annual PHARE transfer (EU financial assistance on institutional harmonization) and the number of annual twinning projects (which indicate the effect of cross-country institutional cooperation). The index of the implementation of the EU acquis was based on the assessment of the progress in the implementation of 31 chapters of the acquis as documented in the European Commission reports on the progress of enlargement. The author added other variables depicting the external policy transfer – the impact of the World Bank and IMF policies and the impact of transnational corporations (reflected in the model by the level of FDI), as well as a range of control variables characterizing domestic conditions, such as investment share in GDP, inflation and unemployment, index of economic freedom (depicting the overall quality of policies), and variables capturing the initial conditions. He applied ordinary list squares and weighted list squares models to the panel of 10 accession countries covering the period of 1990-2002.

The results of the model showed a significant impact of the Europeanization variables: a 1-point increase in the Europeanization index corresponded to 0.19 percentage point increase in the growth rate in the same year, and 0.12-0.36 percentage point increase with one year lag. Interestingly, the variable for twinning exhibited a negative effect on growth (minus 0.14 percentage points); the author argued that this came from the fact that this variable reflects the



short-term costs needed for the *acquis* implementation. Other statistically significant variables were: the lagged impact of IMF policies, FDI, inflation, capital formation, unemployment and initial conditions (Cernat, 2006: 121-126). The conclusion that can be drawn from these results is that Europeanization, on balance, does have a positive growth effect: while in the short run the effect is mixed - positive impact of financial assistance coupled with a negative effect coming from costs of harmonization, - in the long run, the implementation of the *acquis* brings a definitely positive effect.¹

The major question of the current debate on the ENP, and the subject of our study, is whether and how can Europeanization work beyond EU borders. Emerson and Noutcheva (2004) claim that Europeanization can work similarly to the gravity model in economics and explain democratization in Europe by the degree of the proximity and possibility of anchorage and integration with the EU. There are however, some major differences between Europeanization within and beyond EU borders, and also between accession and non-accession options. Like in the accession countries, but unlike in the member states, outsider countries can not effectively influence EU policies that affect them. In this regard, Europeanization takes on the aspect of an EU foreign policy instrument (Emerson and Noutcheva, 2004). At the same time, the fact that EU neighbors do not have a prospect of membership posits the major challenge for Europeanization in these countries and, as Emerson and Noutcheva (2004) note, this may prove to be the litmus test of how far the Europeanization model has chance to be extended. Absence of membership perspective substantially weakens the conditionality mechanisms (which proved to be the most effective instrument of Europeanization in CEE, as was discussed above). Yet, there is still some room for conditionality, especially with regard to the countries that want to modernize and develop along the Western model. European standards are increasingly setting the world's standards², so that converging on the European economic rules can serve for the neighbor countries as a means of integration into the global economic system. Moreover, given the inadequacy of many institutions that these countries inherited from the Soviet planned system, convergence to the European model can help them to modernize. Therefore, even in the absence of the membership prospects, there are other potential benefits of Europeanization.

¹ This discussion of studies on growth effects from Europeanization is intended to give examples of possible effects and is by no means exhaustive. A more detailed discussion of the impact of Europeanization/ European integration on growth is a subject of Radziwill and Smietanka (2009) paper prepared under the same workpackage (WP11) of the ENEPO project.

² See for example "How the European Union is becoming the world's chief regulator", *The Economist*, 20 September 2007.



The question is how they can be materialized, where and how conditionality can be applied and which other mechanisms can be used.

To summarize this theoretical overview, institutional harmonization in the context of the European integration can be best defined by the term Europeanization. Yet, this concept is quite complex and multifaceted. In order to make it operational, we are going to limit the focus of our study to the institutions in the economic domain, which is also justifiable on the ground that these institutions have a direct effect on growth and welfare.

2. What institutional harmonization with the EU may mean - lessons from existing arrangements

In the economic domain, institutional harmonization with the EU means adopting the rules and policies that govern the EU economy. The highest degree of harmonization can be achieved by joining the EU; yet, other arrangements that involve a certain degree of harmonization are also possible. The existing arrangements vary in their degrees of integration and coverage. After membership in the EU, the strongest degree of integration is achieved within the European Economic Area (EEA), followed by the EU-Swiss bilateral cooperation, the EU-Turkey Customs Union and different free trade arrangements (such as the Euro-Mediterranean FTA or FTA with Chile). In addition, there are examples of sectoral arrangements, such as Mutual Recognition agreements in particular sectors. We will briefly discuss each arrangement and try to draw lessons for neighbor countries.

The major economic difference among the forms of integration is the scope and degree of market access. In order to get a wider and deeper market access, the more harmonization the countries have to do. In our review we proceed from the highest degree of integration to the weakest one.



2.1. Option 1 – accession to the EU (membership)

Although this option is not realistic in the timeframe of our analysis, it is worth discussing as a benchmark case as it represents the maximum of what can potentially be attained. During accession negotiations for the 10 countries that joined the EU in 2004, the parties negotiated 31 chapters as a part of the accession. They included free movement of goods, services, persons and capital, as well as company law, competition policy, agriculture, fisheries, transport policy, taxation, economic and monetary union, statistics, employment and social policy, energy policy and others.

In the economic sphere, institutional harmonization with the EU means, first of all, adoption of the EU's rules in the four domains of its internal market – goods, services, capital and labor. Harmonization and mutual recognition are the main instruments here. Harmonization means adopting EU *acquis*; while mutual recognition means that states give each others' laws and standards the same validity as their own. In addition to harmonization in the areas of the “four freedoms”, the acceding states need to take on rules in other areas of the European common market. For example, they must comply with EU competition *acquis*, and before accession, the European Commission tests whether enterprises operating in the candidate countries are accustomed to operating in an environment such as that of the Community.

It is clear that the scope and the depth of institutional harmonization between the EU and its Eastern neighbors will be smaller than in the case of accession states. In some sectors, harmonization can be deep, and in these cases it will be interesting to look at accession countries' experiences. Yet, in a number of sectors, no harmonization is likely to occur without the prospect of membership. It makes sense then to return to a discussion of accession experiences once it is decided which sectors will see deep harmonization.

2.2. Option 2 – European Economic Area

The European Economic Area (EEA) is an example of full markets integration with the EU without membership. Currently, the EEA includes Iceland, Lichtenstein and Norway. The EEA works on the basis of a multilateral agreement between EEA members and the EU. According to the agreement, EEA members adopt all EU *acquis* related to the functioning of the EU common market (with the exception of Fishery Policy and Common Agricultural Policy). With regard to



third countries, EEA states are free to set their own tariffs and conduct their own trade policy (including anti-dumping measures, or concluding mutual recognition agreements).

The major disadvantage of this arrangement is a quite weak influence on EU decision making (EEA countries can only participate in “decision shaping” through consultations in working groups). Plus, adoption of the full body of the EU Common market related *acquis* may be disadvantageous for some sectors.³ Finally, adoption of all EU *acquis* requires an advanced administrative and institutional capacity. On the positive side, one can mention, of course, unimpeded access to the EU internal market. EEA states also participate in a range of EU programs and institutions, for example, standardization bodies.

Experience of EEA countries shows that one can fully participate in the EU internal market without EU membership. Yet, it would be difficult for the EU Eastern neighbors to fully adopt EEA model in the near future mainly due to the lack of administrative capacity and also because their economies substantially differ from the EU economy (both by level of development and structure) much more than the economies of EEA countries. In their case, establishment of deep FTAs will have to be combined with achievement of developmental objectives, and probably different methods of harmonization will have to be used. Still, some mechanisms could be borrowed from the EEA arrangement, for example, neighbor countries could participate in standardization bodies in the areas in which they aim for substantial harmonization with the EU.

2.3. Option 3 – EU-Switzerland cooperation

EU-Swiss bilateral cooperation is based on a free trade agreement and a range of sectoral agreements on the free movement of persons, elimination of technical barriers to trade, public procurement, civil aviation, transport, agriculture, research and others. Switzerland adopts EU’s *acquis* only in the sectors covered by agreements plus related policies (public procurement, for example).

Such a harmonization “a la carte” has its obvious advantages, as partners may choose sectors in which it is beneficial for them to have harmonized policies. At the same time, it can pose

³ The issue of sectoral coverage will be discussed later, yet at this point it is worth noting that it could be difficult to avoid some losses in some sectors in any deal on integration/harmonisation with the EU. Thus far, the “package approach” has been a major feature of European integration that involved not only exchange of one-sector concessions, but also cross-sectoral deals. The basic initial deal between France and Germany that formed the European Coal and Steel Community (ECSC) is the most evident example to this end.



problems, as it limits the scope for package deals that involve concessions in different sectors and, thus, limits the scope for harmonization. In order to limit the “cherry-picking” by Switzerland, the EU introduced a so-called ‘guillotine clause’ so that Switzerland cannot opt out of one agreement without having all others suspended. Moreover, the limited scope of harmonization does not ensure genuinely free market access; for example, if competition policy is not fully harmonized (which is the case in Switzerland), it leaves room for launching antidumping cases and prohibiting market access.

Despite all these limitations, however, Swiss authorities recently confirmed their preference for continuing the cooperation based on bilateral sectoral agreements, because they think at the moment this option is the most efficient in promoting Swiss interests (Swiss Integration Office, 2006). This approach, based on the search for best options of promotion of state interests, as opposed to a search for the optimal shape of integration, could be very useful in the case of ENP countries, as it helps to focus on the substance and purpose, rather than form of integration and harmonization.

To summarize, the Swiss model of cooperation could be attractive to neighbors because of its selective nature. At the same time, their interests in relations with the EU may be different from those of Switzerland. For example, for ENP countries institutional harmonization with the EU may serve as a road to modernization; in such a case, it could be in their interest to have more comprehensive harmonization. In particular, adopting EU horizontal policies in areas such as competition can stimulate important market reforms in these countries. Therefore, in defining the scope and the depth of their institutional harmonization with the EU, one of the major parameters should be the extent to which each particular measure helps in the reform and modernization of their economies.

2.4. Option 4 - EU-Turkey Customs Union

Another option that Eastern neighbors could contemplate is a customs union (CU) with the EU. A CU means full trade liberalization accompanied by an application of a single external tariff. To date, the EU has only one such agreement with a non-member country – Turkey⁴. According to the agreement, the two parties eliminated tariff and non-tariff barriers to each other’s industrial goods, and Turkey adopted the Community’s Common Customs Tariff for imports from third

⁴ To be exact, the EU has other two CU agreements – with Andorra and San Marino, European microstates



countries. However, the customs union does not cover agriculture (except processed agricultural products), services and public procurement. Turkey harmonized its legislation in the areas of the protection of intellectual, industrial and commercial property rights, competition, state aid, public procurement and taxation, as well as settlement rights and services with that of the EU. The decision on implementing the customs union contains quite detailed prescriptions on what parts of the *acquis* should be adopted (or with which the Turkish legislation should comply) and when.

The record of implementation of the CU agreement shows mixed results. On the one hand, as Ulgen and Zahariadis (2004) argue, it helped to transform Turkish industry by introducing stronger competition, which led to improvements in productivity, and changed the structure of Turkish industry through its integration in international production and distribution networks. Furthermore, it helped to modernize Turkey's economic legislation, which also facilitated creation of a favorable business climate.

On the other hand, a customs union has important downsides. First is the possibility of trade diversion. In the case of Turkey, this does not seem to have been the case, as Ulgen and Zahariadis (2004) argue. Yet, other countries should carefully consider the possibility of such an effect of the CU. Second, Turkey has no influence on setting its external tariffs and has to follow the trade policy of the EU. For example, it had to conclude free trade agreements with all third states with which the EU had FTAs. In the case of a CU with a partner as large as the EU, the situation is exacerbated by the very unequal character of the relationship, as the EU does not adjust its trade policy to Turkey's interests.

All these limitations make it difficult to recommend a CU as a suitable arrangement for ENP countries. The most important argument in their case is that the majority of them carry out a significant amount of trade with non-EU countries (very often between themselves, and particularly with Russia), so that trade diversion could bring substantial losses. ENP countries should also be careful not to bring about trade diversion even without establishing a Customs Union. For example, if they establish a free trade area with the EU but keep high tariffs with respect to third parties, trade diversion is also possible.

At the same time, it is instructive to look at the Turkish case because of the similarity of its level of institutional development with that of the ENP countries. Unlike EEA countries, which are able to adopt all economic *acquis* and get full market access, Turkey represents the case of a partner



with less developed institutions that not only faces the challenge of adopting EU economic requirements, but also diverse challenges of development and economic modernization.

The first lesson from the Turkish experience is that harmonization of standards is not enough to gain market access; what is also important is conformity assessment. Ulgen and Zahariadis (2004), for example, show that Turkish products often face difficulties entering the EU market due to a lack of conformity assessment, which arises due to weaknesses in the Turkish certification and accreditation system and, consequently, lack of trust on the part of the EU.

Second, despite adoption of EU product standards and different trade-related *acquis*, Turkey is not saved from EU antidumping investigations and other trade defense measures. According to the CU agreement, application of these instruments can be suspended if the EU-Turkey Association Council finds that Turkey has implemented competition, state aid control and other relevant parts of the *acquis* related to the internal market and ensured their effective enforcement (European Commission, 1995). As with the conformity assessment, Turkey is not there yet.

Third, it is important to ensure that the depth and coverage of market access is beneficial for both parties. For example, the EU-Turkey customs union does not cover agriculture and services, which substantially limits the benefit of the CU for Turkey.

Finally, the Turkish case also shows that it is better not to build economic cooperation on political assumptions: i.e. Turkey considered the CU as a stepping stone to EU membership. Yet, the road to EU membership appears to be rather long (and still not secure), and at the same time Turkey has had to bear different economic and political costs of the CU.

To summarize, it is difficult to advise creation of a customs union with the EU for ENP countries due to serious drawbacks of this arrangement, first of all, the possibility of trade diversion. At the same time, useful lessons could be drawn from the Turkish experience. On the one hand, it shows that the CU did stimulate harmonization and reform of the Turkish economy in line with EU requirements. At the same time, weak institutional capacity prevented Turkey from fully enjoying the benefits from such an arrangement (for example, due to a lack of conformity assessment). Other limitations of the arrangement - the possibility of imposition of antidumping duties, exclusion of important sectors (agriculture and services) from the arrangement - further



weakened its positive effect. These shortcomings are not necessarily features of the customs union per se, yet they could be instructive for the EU's Eastern neighbors for shaping their economic agreements with the EU.

2.5. Option 5 – Free trade area (FTA)

The EU has a multiplicity of FTAs: in addition to the EEA, it has been advancing FTAs with developing countries in the Middle East, North Africa, Latin America, the Caribbean and other regions. The most interesting, from the point of view of ENP countries, could be the Euro-Mediterranean Free Trade Area (EMFTA), as it applies to another group of EU neighbors. Creation of the EMFTA is a part of the Barcelona process – the process of cooperation and integration between the EU and the Mediterranean countries. The EMFTA does not exist yet – its creation should be completed by 2010. Currently, countries participating in the process have association agreements with the EU that define the mechanisms of completing the EMFTA.

Unlike the arrangement with the EEA, simple FTAs do not involve institutional harmonization, and are limited to conventional forms of trade liberalization (i.e. tariff reductions). The scope of these agreements is also limited: in the case of Mediterranean countries, Association agreements provide only for liberalization of trade in manufactured goods, but not in services or agriculture. Empirical estimates show that liberalization in agriculture in Euromed countries could bring between 0 and 0.5% of GDP (IARC, 2006). The small magnitude of the effect stems mainly from the expected shrinkage of the agricultural sector in Euromed countries, partly because of stronger competition from subsidized imports from the EU. As for the services sector, welfare gains from liberalization are estimated at approximately the same magnitude – at about 1% of GDP; yet, due to the effect on FDI and a stimulating effect on domestic reforms, services liberalization could bring benefits many times larger (up to 50% of GDP) (IARC, 2006). It was only recently that the EU and its Mediterranean partners started to advance the agenda of liberalization in agricultural products and services.⁵

The depth of harmonization envisaged by the Euromed Association agreements is insignificant: unlike in the EU-Turkey customs union agreement or in the EEA, Euromed agreements do not have any requirements for adopting EU *acquis*, except for rules of origin. Also, provisions on state aid, competition and other horizontal issues have a declarative character. An advance on

⁵ See, for example, Euromed (2005)



these issues is made in the Action Plans in the ENP framework, which, for example, set a clear agenda for harmonization of product standards (through implementation by Euromed partners of the Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA)), and also contain quite detailed and concrete provisions on customs, state aid and competition policy.

The conclusion that one may draw from the Mediterranean countries' experience is that gains from a simple FTA limited to liberalization of trade in goods are going to be limited, and EN partners should consider "enhanced" types of agreements. Also, the scope of liberalization should be broadened to include services and agriculture.

2.6. Conclusions on other countries experiences

- Based on the review of some lessons from the existing arrangements, one can conclude that ENP countries should opt for a wider integration agreement than just liberalization of trade in manufactured goods. They should opt for inclusion of agriculture and services.
- Harmonization should be based on the realistic assessment of integration options, and not assumptions. It should also focus on achieving the interest of ENP countries and not so much on the name and design of the integration model.
- Transposition of EU standards into national legislation does not give automatic market access; they also need to be effectively implemented.
- The sectoral approach could be attractive, as it offers flexibility; yet it also poses limits on integration.
- A customs union is stronger in promoting institutional harmonization than an FTA, yet its drawbacks make it an unattractive option for ENP countries.

The main conclusion that can be drawn from the above analysis is that none of the existing arrangements would suit to a large extent the circumstances and goals of the EU Eastern neighbors. That is why the EU has been in search of an optimal arrangement for the neighbors. EU's answer was the ENP and creation of "deep" free trade areas with neighbors.



3. Agenda for institutional harmonization of EU Eastern Neighbors

The debate on the prospects of integration and cooperation between the EU and its Eastern neighbors has been going within the framework of the ENP. The ENP was developed in 2004 with the general objective of avoiding the emergence of new dividing lines between the enlarged EU and its neighbors. The ENP covers all of the EU's Eastern neighbors, except Russia, and ten Mediterranean countries. Russia refused to join the ENP, but develops its relationship with the EU through a Strategic Partnership covering four "common spaces".

The analysis in this paper is going to focus on EU Eastern neighbors, by which we mean Ukraine, Armenia, Azerbaijan, Georgia and Russia. Although Russia is not formally a part of the ENP, it is still an Eastern neighbor; moreover, in many respects the agenda of the EU-Russia cooperation in the economic domain is similar to that of ENP provisions, and it can not be excluded that at some point EU and Russia can conclude an enhanced FTA that would involve substantial institutional harmonization. We do include Belarus in some parts of the analysis, as it is obviously an EU Eastern neighbor, but due to suspension of the ENP policy with respect to Belarus, our analysis of EU-Belarus relations is limited. We do not cover Central Asian states, as they are not EU immediate neighbors and are not a part of the ENP, consequently, the institutional harmonization with the EU is going to be quite limited there, at least in the near future.

The official economic objective of the ENP is to help the neighbors develop and modernize their economies by anchoring them to the European model of economic governance. The EU proposes doing so by creating enhanced FTAs and extending access to the EU internal market to its neighbors and undertaking deep integration in several sectors, first of all, energy and transport. The key promise of the ENP is that economic integration can go beyond free trade in goods and include "behind the border" issues: eliminating non-tariff barriers and progressively achieving comprehensive convergence in trade and regulatory areas such as technical norms and standards, sanitary and phytosanitary measures, rules of origin, customs procedures, and others (European Commission, 2006a, pp. 4-5).

ENP Action Plans have been the main instruments guiding the implementation of the ENP. The EU concluded them with all Eastern neighbors except Belarus, with which cooperation is limited due to the undemocratic regime in this country. In one of its communications on the ENP, the European Commission states that “over time, the implementation of the ENP Action Plans, particularly on regulatory areas, will prepare the ground for the conclusion of a new generation of deep and comprehensive Free Trade Agreements (FTA) with all ENP partners”. These FTAs will cover a substantial part of trade in goods and services, including sectors important for ENP countries, and will include strong legally-binding provisions on trade and economic regulatory issues (European Commission, 2006a, p.4). The summary of the Action Plans provisions that involve institutional harmonization in the economic domain is provided in Table 1.1.

Table 1. Key provisions on institutional harmonization in the economic domain as defined in ENP Action Plans for EU Eastern Neighbors

| | |
|---|---|
| Trade general | Exploration of possibilities for establishment of a free trade agreement |
| Horizontal issues: | |
| Customs | Harmonization and simplification of customs legislation and procedures |
| Trade in EU harmonized areas | Adoption of European and international legislative and administrative practices for standards, technical regulations and conformity assessment in EU harmonized areas, especially in priority sectors of cooperation for both parties |
| Trade in EU non-harmonized areas | Elimination of discrimination in EU non-harmonized areas, increasing information exchange |
| SPS | Modernization of SPS through: adoption of WTO requirements on SPS, gradual convergence with EU practices |
| Company law and establishment | Convergence and effective implementation of key principles of company law, accounting and auditing with international and EU rules and standards |
| Services | Gradual liberalization of trade in selected service sectors |
| Movement of capital | Ensuring the free movement of capital related to direct investment |
| Movement of workers | Abolishing discrimination towards migrant workers as regards working conditions, remuneration or dismissal |
| Taxation | Developing the tax system in accordance with general EU and international principles |
| Competition policy | Convergence with EU principles on competition, in particular through establishing full transparency of state aid, increase in capacity and independence of competition authorities |
| Intellectual and industrial property rights (IPR) | Ensuring full conformity of IPR legislation with TRIPS and its effective enforcement; development of cooperation with EU law enforcement bodies in field of IPR |
| Public procurement | Ensuring compliance of the public procurement system with EU procurement legislation and principles, in particular transparency, information provision, access to legal recourse, and awareness, as well as limited use of exceptions |
| Statistics | Adoption of statistical methods fully compatible with European standards |
| Sectors: | |
| Transport | Approximation of legislative and regulatory frameworks with European and international standards, in particular for safety and security (all transport |



| | |
|-------------------------------|---|
| | modes); co-operation in satellite navigation; conclusion of agreements on air services with the EU; development of the Pan-European Corridors and Areas |
| Energy | Energy policy convergence towards EU energy policy objectives; gradual convergence towards the principles of the EU internal electricity and gas markets |
| Information Society and media | Adoption of audiovisual legislation in full compliance with European standards with a view to future participation in international instruments of the Council of Europe in the field of media; approximate digital television and audio broadcasting to European standards |
| Environment | No exact requirements on convergence, but demands to ensure that conditions for good environmental governance are set and implemented; enhance co-operation on environmental issues |
| Science and technology, R&D | Encourage integration into the European Research Area and into Community R&D Framework Programs |

As the above summary of provisions demonstrates, the harmonization agenda is quite wide in scope and encompasses all major horizontal policy areas. The depth of harmonization, however, differs, with the highest demands for technical regulations regarding industrial products, SPS and competition policy.

The second major route for neighbors' engagement as foreseen in the ENP is sectoral integration. The analysis of Action Plans suggests that transport and energy will see the deepest degree of integration and harmonization in the near future. EU neighbors can potentially go as far as full integration in the European energy and transport networks. Most importantly, there is a strong mutual interest in integration in these sectors: in particular, in the energy sector, integration would allow enhancing energy security for both the EU and its neighbors. The EU is also interested in integration in the aviation sector to gain better market access in the ENP countries,⁶ while the latter hope it will help upgrade the sector and attract investment. As in the case with market access of goods, the most important effect of integration in these sectors for the neighbor countries is going to be the stimulus for internal liberalization and reform of these sectors that the integration will demand.

The EU's partnership with Russia is developed within the framework of the "Common European Economic Space" that was agreed on at the Russian-European summit in May 2002. At the St. Petersburg Summit in May 2003, the EU and Russia decided to develop four common spaces: a common economic space; a common space for freedom, security and justice; a space for cooperation for external security; and a space for joint research and education. At the Moscow

⁶ The Action Plans, in particular, suggest possible joining by Ukraine, Moldova and Georgia of the European Joint Aviation Authorities. The EU has also concluded in March 2007 an aviation agreement with Russia that provides for elimination of Siberian overflight charges starting from 2013.



Summit in May 2005, a package of Road Maps was adopted that outline the actions necessary to implement the common spaces. The general provisions of the common economic space (CES) are similar to the provisions of the ENP Action Plans, but are put in different wording. The major difference is that it does not speak of Russia's adopting EU's *acquis*, but rather about "dialogue" and "approximation". So, the Road Map on the CES is concerned with the creation of an "integrated market". As with ENP countries, the CES includes proposals on creation of common networks in several sectors: telecommunications, transport, energy, space and environment. Cooperation in the energy sector is likely to be a priority.

To summarize, the current debate and the existing ENP documents suggest that the process of harmonization will be shaped by the establishment of deep FTAs, supplemented by integration in selected sectors. Deep FTA lies somewhere in between simple FTA and full market integration, as exemplified by the EEA.

The exact content of deep FTAs with neighbors has yet to be defined. The first comprehensive study that developed the idea of a "deep" free trade area for an EU neighbor (Ukraine) was CEPS (2006). The authors suggest that a deep FTA between Ukraine and the EU should include (p. 127):

- the reform of customs services;
- harmonization/ mutual recognition of product standards;
- the adoption of agro-food standards;
- convergence of regulatory policies;
- financial services: complete openness but a staged process for regulatory approximation with Basel I;
- civil aviation: full *acquis* compliance and inclusion in a common aviation area;
- road transport: liberalization and *acquis* compliance, plus investment in pan-European corridors;
- telecommunications: complete with openness and compliance with the 1998 *acquis*;
- the energy sector: extensive *acquis* compliance for regulatory norms;
- electricity: if grid linkage is sought, then full *acquis* compliance would be necessary;
- competition policy: convergence on EU practices;
- corporate governance: adoption of basic measures on best international practices;

- the environment: a long-term process of gradual acquis compliance and links to Kyoto measures.

This proposal is generally concordant with the provisions of the ENP Action Plan for Ukraine, but puts priorities and elaborates some details of the harmonization agenda. In particular, the authors stress the importance of harmonization in several backbone services sectors - those that provide crucial infrastructure for the rest of the economy (financial services, transport, energy and telecoms). Another important point advanced in the study is that the harmonization should be comprehensive, as there are important synergies to be achieved by simultaneous reform in various areas.

4. Proposal of a harmonization package

Based on the review of the existing integration arrangements, as well as the current policy debate and proposals within the ENP, we conclude that the institutional harmonization in the neighboring countries with the EU is going to be driven by the agenda of facilitating market access, especially in the goods sector, and integration in infrastructure sectors, notably energy and transport. Some integration is also likely in certain service sectors (first of all, financial and telecom services), and possibly, to much smaller extent, in agriculture. It should be stressed that harmonization will involve not only transposition of certain norms from the EU, but also their proper application, which will require drastic changes in the whole system of economic governance.

We suggest that in addition to liberalization within the framework of a simple FTA, institutional harmonization between the EU and its neighbors in the medium term (next 10-15 years) will likely involve the following:

- 1) Industrial products: adoption of regulations in EU harmonized areas and voluntary harmonization and mutual recognition in non-harmonized areas;
- 2) Partial harmonization in agriculture;
- 3) Partial liberalization of trade in services; high degree of liberalization and harmonization in financial services and telecoms; integration with EU energy and transport networks.



- 4) Harmonization of customs procedures
- 5) High degree of competition and public procurement policies convergence
- 6) Environment: limited convergence

This agenda follows, to a large extent, the ENP Action Plans provisions, as well as the proposals that CEPS puts forward in its study. Below we elaborate on the details of the proposed agenda.

4.1. Industrial products

In order to be able to export to the European markets, companies of ENP countries will have to comply with EU product regulations and standards. Regulations have been introduced in the higher-risk product sectors (such as vehicles, pharmaceuticals, medical devices, chemicals, and others) and established detailed parameters of products. ENP countries will have to adopt EU regulations fully in these areas to be able to export to the EU but also to improve the level of product safety at home.

In some areas the EU has introduced product standards, which are voluntary. CEPS (2006) suggests that such standards should be adopted by ENP countries but without becoming obligatory, so that the companies that are interested in exports to the EU adopt them and others are free to choose other local standards. We generally agree with this proposal, although it is not without a cost: if a company exports to different markets, as it will have to bear higher compliance costs due to differences in standards.

In the rest of areas, the EU uses a principle of mutual recognition, so that every EU Member State must accept on its territory goods legally marketed in another Member State. For non-EU members, getting mutual recognition requires compliance with EU standards that are developed by EU standardization bodies. To get EU recognition of compliance, EN will need to sign the Agreement on Conformity Assessment and Acceptance of Industrial products (ACAA) and will have to establish conformity assessment centers accredited by the EU.

4.2. Agriculture

Market access in the agricultural sector is likely to be quite limited due to the sensitive nature of the sector for both sides: the EU so far largely excluded agriculture from the FTAs, and its ENP neighbors have also exhibited a high degree of protectionism in the sector. Moreover, the



agricultural sector in the ENP countries is undergoing modernization, which will take some time before the sector is ready to comply with EU standards. These obstacles, however, do not need to stop at least some harmonization efforts.

The agenda of harmonization in agriculture is going to be shaped around compliance with EU food safety requirements and WTO sanitary and phyto-sanitary (SPS) measures. First, the ENP countries have to comply with WTO SPS measures, as all of them are either members of the WTO or are in the process of accession. In order to be theoretically able to access the EU market, they will have then to comply with EU food safety regulations that are normally much more stringent than SPS.

The current agenda for harmonization in this domain, as set in the ENP documents (Action Plans and general framework documents), is not very ambitious and is directed primarily at studying the possibilities of harmonization. Yet, there are certain areas where the need for harmonization is more or less certain. In particular, these include compliance with EU regulations on monitoring the residues of substances and prohibition of substances, compliance with general EU food safety principles, and establishment of proper analysis and control system. The latter will require developing laboratory networks that would comply with ISO standards.

It is unlikely that in the medium term harmonization in the agricultural sector will go beyond the outlined measures, as implementation of these measures will be costly enough. Yet, deeper compliance is likely to happen at the firm level – by the enterprises wishing to export to the EU. The role of the state would be to provide the necessary legislature and infrastructure to support them.

4.3. Services

Integration and harmonization of the service sector potentially can bring large gains, as it is large in ENP countries – it constitutes between 32% and 60% of GDP (Table 2).

Table 2. Composition of GDP, %, 2004

| Country | Agriculture | Industry | Services |
|----------------|-------------|----------|----------|
| Armenia | 25,4 | 39,1 | 35,6 |
| Azerbaijan | 13,5 | 54,3 | 32,2 |
| Georgia (2003) | 20,5 | 25,5 | 54,1 |
| Moldova | 23,4 | 21,4 | 55,2 |
| Russia (2003) | 5,2 | 34,2 | 60,7 |
| Ukraine | 13,7 | 40,1 | 46,3 |

Source: <http://www.europa.eu.int/comm/trade/issues/bilateral/datapdf.htm>

We think that the proposal presented in CEPS (2006) for a comprehensive harmonization in the financial services, telecommunications, transport and energy transit can be extended to all Eastern ENP countries. In particular, in the financial services ENP countries should target to adopt relevant EU acquis and also allow substantial participation of foreign investors in their financial markets – this would facilitate better competition and the spread of best practices. The same applies to telecoms: adoption of EU acquis and attraction of FDI into the sector in order to improve the infrastructure. In the transport sector, the agenda should include a full integration into the EU single aviation market and pan-European transport corridors. Finally, ENP countries can be integrated into European energy networks for gas and electricity (for example, through participation in the Energy Treaty that the EU concluded with the South-Eastern European countries); they should also target to implement EU energy sector acquis, as this will not only help them integrate with European networks but will also facilitate internal market reforms. Yet, the major component and indeed a prerequisite of the institutional harmonization in services will be the reform of economic governance, as it is not that much the differences in formal rules, as the red tape, corruption, and poor regulatory quality that hamper sector development and integration into world and European markets.



4.4. Custom procedures

Facilitation of border crossing has to be put high on the harmonization agenda in Eastern Neighborhood. Currently, the cross border movement of goods and people is hampered by inefficient border procedures, but even more so by pervasive corruption. The ENP countries should aim for the highest possible degree of harmonization of their customs procedures with those of the EU. This will require substantial infrastructure investments, but more importantly capacity building and curbing corruption. Some countries do better than others in fighting corruption and improving customs procedures; for example Georgia has achieved substantial progress over last several years, according to the Doing Business survey of the World Bank, which testifies that the problems are not impossible to overcome.

4.5. Competition, public procurement and state aid

ENP countries should aim to fully harmonize their competition, state aid and public procurement policies with those of the EU by adopting the respective *acquis*. A high degree of harmonization will facilitate better market access for both trading sides, as equality of rules will help reduce discrimination. Also, by adopting European rules in these areas, the ENP countries will be able to improve the efficiency and competitiveness of their internal markets. Yet, as stressed earlier, the key to success will be the proper implementation of the new norms, something that will require substantial administrative costs and probably - technical assistance from the EU.

4.6. Environment

The ENP countries should aim to implement a comparable level of environmental protection to that of the EU. Yet, this is going to be a medium- to-long-term goal, as full harmonization is rather costly. In the context of enhanced FTAs what could and should be achieved is a stronger transborder cooperation and harmonization with selected European norms. In particular, ENP countries should target to adopt international and European standards in handling and storage of radioactive materials. Another priority should be improvement of energy efficiency, which is going to be aided by participation in Kyoto mechanisms (to which all studied ENP countries have subscribed).

We expect the content of an FTA with the EU for all ENP countries analyzed in this study to be similar to a large extent, because all of them have comparable problems and priorities. The



priorities of the EU with regard to these countries are also very similar. In particular, all these countries still use product standards devised in the USSR, so harmonization of product standards is going to be an important component of their economic relations with the EU. All Eastern neighbors are important for the energy security of the EU (either as energy suppliers or transit countries), so cooperation and integration in the energy sector will apply to all of them. Obviously, there are cross-country differences, which emerged during the transition period and exist objectively due to natural resources endowments, location and other givens. Yet, these factors will rather influence the speed and the costs and benefits of harmonization, but not the initially set goals.

5. Benefits of institutional harmonization

The experience of previous integration initiatives, both in the EU and in other parts of the world, could give insights into what to expect from institutional harmonization in the EU neighboring states. This section starts with an overview of the theoretical underpinnings on the impact of institutional harmonization on the performance of the economies, to which examples provided by empirical studies have been added. The focus of the analysis is on the effects for countries that import institutions, i.e. countries that integrate with the EU.

There are different channels through which institutional harmonization with the EU is going to benefit a country. The most important of them are:

- better market access
- increased investment,
- increased competition
- reduced corruption
- increased credibility of reforms and certainty in the economy
- improved domestic institutions and the system of economic governance

The ultimate result of all these effects is higher economic efficiency, economic growth and welfare.



5.1. Improved market access

Institutional harmonization, especially in the economic sphere, will improve the mutual market access between the EU and the partner country. This effect comes due to the reduction in non-tariff barriers as a result of harmonization in economic regulations and standards. In the case of European integration this means harmonization of the partner country's institutional settings, first of all legislation, with the requirements of the European internal market. These include product standards and regulations, competition and state aid policy, and other areas regulated by the EU's *acquis*. To its turn, better market access brings efficiency gains that promote growth. Moreover, compliance with EU standards will open for ENP countries not only EU markets, but also world markets, thus allowing them to participate in global value chains.

Lejour et al (2001) distinguishes two channels through which market access can have a positive effect on economic efficiency and growth. One channel is through better exploitation of comparative advantage. An improved market access (through the removal of NTBs) leads to a change in relative prices and, therefore, makes prices more informative of real comparative advantages of countries, thus encouraging a more efficient trade pattern. This in turn, leads to economic growth. The second effect works through the change in terms of trade for both partners due to removal of the loss that NTBs generated (unlike tariffs, NTBs do not generate income to any parties involved and are a pure efficiency loss). For example, in the case of CEE countries which can serve as a comparison for the CIS countries, Lejour et al (2001) found that an improvement of access of CEE countries to the EU market leads to a 5-9% GDP welfare improvement in CEE. Maliszewska (2004) obtained a similar result: 3-7% GDP. There exist a range of other estimates of effects from better market access through the removal of NTBs, which are discussed in detail in Maliszewska, Orlova and Taran (2009).

5.2. Increased investment

The estimated efficiency and growth gains from the institutional harmonization are going to be larger if one incorporates their dynamic effect, in particular, on investment. First, institutional harmonization makes the environment in the partner country more familiar to investors. Secondly, as the quality of imported institutions will be better than of old domestic ones (as we assumed for ENP countries), the business environment will become more hospitable to investors. For example, a successful adoption of EU norms on property rights or competition is likely to substantially increase the attractiveness of ENP economies for investment. Thirdly, the effect of "tying hands", as discussed above, increases credibility and stability of government



policies. All these effects result in the reduction of the risk premium and, thus, of interest rates. A lower risk premium will attract risk-averse investors and will also bring efficiency gains due to higher certainty. Furthermore, the reduction in interest rates will make investment more affordable. All these effects will stimulate capital accumulation and growth.

Baldwin et al (1997) estimated for the CEE that the effect from the reduced risk premium would increase the welfare gain from 1.5% (obtained due to the elimination of all trade barriers and adoption of a common external tariff) to 18.8% (this result is obtained under the assumption that the risk premium decreases by 15%). CEPS (2006, p. 72) estimates for Ukraine give about a 4-5% welfare improvement from the reduced cost of capital (CEPS's study assumes the fall in the risk premium of 17%).

5.3. Increased competition

Integration into the European market and the accompanying institutional harmonization can spur competition in the economy. These effects lay at the core of the original idea of the EU common market. The positive effect on competition comes through trade liberalization, as the common market demands the removal of protective trade barriers and exposes companies to strong competition from other companies in the united market. Also, adoption of EU competition and state aid rules is going to have pro-competitive effects. Finally, integration and harmonization with the EU can help the government overcome domestic protectionist pressures by referring to the need to comply with the demands of integration. Finally, competition promotes efficiency and growth (although there are still many unresolved questions in the empirical research on the effect of competition on growth⁷).

5.4. Reduction in corruption

Probably one of the most important benefits that institutional harmonization is going to bring is reduction in corruption. As discussed in detail in Kolesnichenko et al. (2007), the ENP countries inherited from the Soviet system a peculiar economic and societal structure called "limited access order", in which power is preserved through paternalism and limitations on entry into the power circles. This contrasts with "open access" societies, characteristic of the Western countries, where access to power is based on political and economic competition. Even though the ENP countries broke with the Soviet system of governance, many vestiges of the "limited access order" remain, manifesting themselves in pervasive corruption. Dubrovskiy (2006) demonstrates that corruption leads to distorted economic outcomes and may halt any reform

⁷ See Aghion and Griffith (2005) for a good overview of different studies and an attempt to reconcile them.



effort. Therefore, reducing corruption and facilitating the transformation from the “closed” to “open” access order in ENP countries should be a part of any reform.

There are different ways in which harmonization with EU norms is going to facilitate this process. One of the instruments is “tied hands”: the restrictions that harmonization imposes leave less room for discretionary interpretation of rules and, thus, decrease opportunities for corruption. Moreover, increased competition due to freer trade reduces monopoly rents and, therefore, removes incentives for companies to bribe politicians. Furthermore, closer cooperation will lead to diffusion of European norms and values and local companies will learn a different way of doing business.

5.5. Increased credibility of reforms and certainty in the economy

The credibility of reforms is a major condition necessary for their success. If economic agents do not believe the announced reform plans, they will not adjust their economic behavior accordingly, and thus, the reform will not have the desired effect. The credibility problem arises either when the government’s policies are inconsistent or when the government’s motives are unclear; when the anticipated political costs of the policies are high; and finally, when the macroeconomic environment is unstable (Rodrik, 1989, as cited in Piazzolo, 1999). The literature suggests several strategies to deal with the credibility problem: to signal commitment, to change governmental incentives and to reduce the scope of governmental maneuvering.

Integration with a more advanced partner, such as the European Union, can help enhance the credibility of reforms. In particular, Piazzolo (1999) argues that integration with an advanced partner such as the EU gives an opportunity to use all of the above mentioned strategies to improve credibility. First, commitment to integrate serves as a signal of a government that limits the scope of its maneuver, including deviation from reforms. Second, integration involves obligations that reduce the possibility of arbitrary changes of policies. Finally, integration may change the incentive structure of the government (i.e. when integration brings valuable benefits to the government), so that it becomes reluctant to deviate.

A similar argument is developed by Whalley (1996), namely that the objectives of the countries that seek regional integration are not limited to economic gains from trade, but also include a multiplicity of other goals, including securing irreversibility of reforms. For example, according to Whalley (1996), it was not so much market access, as the need to secure the irreversibility of reforms that was behind Mexico’s negotiations of NAFTA.



Previous enlargements of the EU can provide insights on how these effects operate. In the process of accession of CEE countries, the Europe Agreements served as guides for implementing domestic reforms and advancing the integration agenda. A failure to comply with them could have substantially delayed the integration process, which was regarded as very undesirable by the acceding countries. In such a way, the Europe Agreements served as a powerful reform catalyst and a disciplinarian device. The accession of Romania and Bulgaria confirms the very strong effect of accession to the EU on the credibility of domestic policies. In 2005, the EU began talking of postponement of accession of these countries, as they had not reformed sufficiently; the EU was especially concerned about the pervasive corruption. The fear of such a delay prompted the Bulgarian and Romanian governments to intensify their efforts.

5.6. Improved domestic institutions and the system of economic governance

It is not only trade-related areas that will see the gains from harmonization with EU norms, but the entire system of economic governance in ENP countries. As the above discussion of the effects of harmonization shows, on top of better access to external markets, there are going to be substantial domestic changes. Often, the requirements for getting better market access can serve as catalysts of the internal reform. For example, improvement in product standards and their effective implementation would require modernization of production processes in the private sector and enhancement of the quality of public regulatory bodies. Indeed, it is only in synergy of formal harmonization and internal reform that economic integration can proceed. This link between European integration and institutional reform will stimulate modernization of ENP countries' economies and help them achieve developmental objectives. The resulting growth and welfare gains can be substantial what has been analyzed by Radziwill and Smietanka (2009) and Maliszewska, Orlova and Taran (2009) under the same research task.

6. Costs of institutional harmonization

Institutional harmonization of neighbors with the EU may involve some costs. Harmonization in the economic domain - adaptation of standards, policies and regulations - will require companies to make additional investments and the government to conduct a lot of work on harmonization of legislation and its implementation.



The assessment of the costs of harmonization is a very difficult exercise, both conceptually and technically. The major methodological difficulty lies, as with the assessment of benefits, in separating the effect of integration from the effect of the general reform and modernization. Another difficulty is the definition of the cost. For example, whether expenses on improvement in product safety should be considered as a cost or as an investment or whether compliance with higher environmental standards should be treated as a cost or as investment? From a long-term perspective, many expenses on improvement of product safety, environmental quality, administrative procedures and the like are not costs, but rather investments, as they lead to improvement of the economic environment and quality of life. Therefore, a more appropriate name for the “costs” would be “investment in the short run”. These should be clearly separated from costs that emerge due to unproductive losses.

There were some attempts to estimate the costs of compliance in the CEE countries in the course of their accession to the EU. The cost of compliance in the agricultural sector was especially high. So, in Poland the cost of dairy sector adjustment were estimated at PLN 15.5 bn (EUR 3.7 bn) in 1999 (CEN, 2003, p. 126); the investment in the area of environment – at EUR 30.4 bn (Ibid p. 155).⁸ The total cost of compliance in the agricultural sector in Poland and Lithuania was estimated at 2-2.5% of GDP (CEPS, 2006, p. 89).

In order to help accession countries to make the adjustments, the EU provided a lot of institutional and financial help. In the case of neighbor countries, the amount of support is likely to be substantially lower. Therefore, in their harmonization effort with the EU they should carefully calculate costs and weigh them against the expected benefits in order to shape and schedule their harmonization effort accordingly.

Dimitrov (2009) discusses the costs of institutional harmonization and the ways to measure them in more detail.

7. Note on quantifying the effects of institutional harmonization

Measuring the effects of institutional harmonization is a challenging task. The major methodological difficulty lies in separating the effects of institutional harmonization from the

⁸ At the same time, it is expected that by 2020 the accumulated benefits from improvement of environmental standards will accrue to EUR 41- 208 bn (mainly due to improved health of the population).



effects of general reform effort and modernization that would have taken place anyway. To the best of our knowledge, there are no studies that suggest a methodology for disentangling these two effects. What the existing studies do is separating the impact of the quality of institutions on growth in general. The most frequently applied method for measuring the effects of integration, including harmonization of legislation, is the Computable-General Equilibrium (CGE) model. To assess the impact of institutional harmonization institutional variables are translated into tariff equivalents.

Another methodological difficulty lies in the very broad spectrum of effects of institutional harmonization, not all of which are easily measurable. Yet, as the overview of the effects in the previous section suggests, many of them do impact economic growth and welfare one way or another. Therefore, changes in country's economic welfare could be considered as a general indicator of the effect of institutional change.

The limited nature of neighbors' integration with the EU also poses some methodological challenges, as it means partial harmonization. This necessitates making some assumptions as to the degree and the coverage of harmonization. For the purposes of our analysis we assume that harmonization will be the most advanced in the economic domain, which is, in fact, what the EU itself has announced, i.e. that economic integration will be the priority area of the ENP. The second major assumption concerns the degree and form of the integration – namely, that it is going to be the movement towards full market access in the majority of economic sectors. This assumption is based on the provisions of Action Plans and other ENP documents.

In sum, for the purposes of measuring the effects of institutional harmonization of Eastern neighbors with the EU, we will concentrate on the welfare and growth effects stemming from improved market access. The estimation of costs of harmonization will be based on the same assumptions, i.e. that economic integration will be the focus of ENP integration plans, and that it will proceed along the lines of getting a better market access.



8. Overall conclusions

The purpose of WP11 of the ENEPO project was to identify and assess the costs and benefits of the institutional harmonization in the EU Eastern neighborhood. We consider that this goal has been attained. Given the complexity and ambiguity of the object of study we dedicated a substantial amount of effort to defining what the institutional harmonization between the EU and its neighbors means. Also, we had to define harmonization in such a way as to be able to measure its effects. The proposal we came up with was to consider institutional harmonization in the economic domain in the context of a creation of enhanced FTAs.

For the estimation of the trade-related harmonization effects we employed a computable general equilibrium model (Maliszewska, Orlova and Taran, 2009). The model encompassed the following three pillars of trade facilitation: legislative and regulatory approximation (reduction of standard costs), reform of customs rules and procedures and liberalization of the access of foreign providers of services. In our assumptions on reduction of barriers in these areas we relied upon the results of a survey of the non-tariff barriers made for Ukraine, and then made extrapolation to other countries based on the review of the respective barriers in these countries. According to our estimates, over 10-15 years, Ukraine is going to get the highest welfare gain - up to 5.8%, the welfare gains for the remaining countries are also sizeable i.e. Armenia (3.1%), Russia (2.8%), Azerbaijan (1.8%) and Georgia (1.7%). The economies of these countries are expected to experience significant structural changes with some sectors contracting and others expanding.

In our second approach to the estimation of the benefits of the institutional harmonization we used a growth model (Radziwill and Smietanka, 2009). In this methodology we use a system of simultaneous equations to test the links between reforms, European integration and growth. Our estimates show a strong impact of accession on reforms and vice versa. In turn, growth is strongly linked to structural reforms, but not to European integration directly. These results confirm our virtuous circle hypothesis, i.e. that growth, integration and reforms can become mutually reinforcing processes. Further we assume that deepened integration with the ENP countries can lead to the halving of the institutional gap between a given neighborhood country and the average of the Central European countries. This in turn leads to a faster growth. The resulting estimates show that the biggest beneficiary of the "growth bonus" of institutional harmonization is going to be Belarus with an average growth bonus of 4.71 percentage points



per year in per capita terms. The growth bonuses for other countries are also substantial: Armenia - 1.14, Azerbaijan - 2.34, Georgia - 1.19, Moldova -1.5, Russia - 1.62, and Ukraine - 1.62. Importantly, the growth bonus represents permanent increase in the growth rate, which means that the total gain overtime may be very large.

In sum, our analysis indicates that the economy-wide benefits of improvement in institutions are large, they go beyond those stemming directly from trade-related harmonization and are permanent. It is not difficult to see why this is so: the reform of economic governance not only gives better access to external markets, but it also improves the efficiency of the domestic economy. This makes a strong case for enhanced FTAs with a strong emphasis on the reform of domestic governance in addition to trade facilitation measures.

Obviously, in order to reap the benefits of harmonization, the neighboring countries have to spend effort and money on the needed adjustments. These are the costs of administrative and regulatory harmonization born by the public sector and costs and investments on the part of the private sector. Dimitrov (2009) made an attempt at estimating these costs. For this purpose he used the data on costs related to harmonization in CEE countries and extrapolated them to the neighbor countries. In doing so he took into account the limited degree and scope of harmonization in the neighboring countries compared to the full membership option. According to our calculations, the costs of harmonization in Armenia will amount to USD 2,3bn, Azerbaijan – USD 6,4bn, Belarus – USD 11,8bn, Georgia – USD 2,7bn, Moldova – USD 1,1bn, Russia – USD 296bn, and Ukraine – 32,3bn. This corresponds to about 30-36 % of 2006 GDP of those countries.

It is difficult to compare directly these costs to benefits that we estimated, as costs are incurred once, while benefits come over time. But even without making a direct comparison, it is clear that the improvement of institutions is going to benefit growth and the quality of life in these countries. Moreover, the costs of harmonization, as we stressed before, are not deadweight loss, but investments that would have been probably needed anyway. Therefore, a relevant question to ask is not whether harmonization benefits outweigh the costs, but rather what should be the scale and the timing of harmonization.

Finally, as the discussion in (Kolesnichenko et al., 2007) demonstrates, the success of harmonization will depend on whether it is accompanied by the transformation of the post-communist systems into the open access societies typical of western democracies. Indeed, the two processes are mutually reinforcing: the approximation with EU norms supports the development of the effective institutions, and in return, the better institutions will be conducive to



further harmonization. But for this link to work it is important to recognize that harmonization will happen in the framework of existing, and often flawed, institutions. Therefore, an additional effort should be made to make sure the transfer of the European model is adapted to local conditions. The design of such a framework lies beyond the scope of our report.



References

- Aghion, P. and Griffith, R. (2005): Competition and Growth: Reconciling Theory and Evidence, MIT Press.
- Baldwin, R., Francois, J. and Portes, R. (1997): *Costs and Benefits of Eastern Enlargement: the Impact of the EU and Central Europe*. Economic Policy, No. 24
- Börzel, T.A. (2003): *How the European Union Interacts with its Member States*, Institut für Höhere Studien Political Science Series, No.93, www.ihs.ac.at/publications/pol/pw_93.pdf
- CEN (2003): *Costs and Benefits of Poland's Membership in the European Union*, Centrum Europejskie Natolin (European Center Natolin), Warsaw.
- Cernat, L. (2006): Europeanization, Varieties of Capitalism and Economic Performance in Central and Eastern Europe, Studies in Economic Transition series, Palgrave Macmillan.
- CEPS (2006), The Prospect of Deep Free Trade between the European Union and Ukraine, Emerson, M. (ed.), Centre for European Policy Studies (CEPS), Brussels.
- Dubrovskiy, V. (2006): *Towards Effective Anti-Corruption Strategies in Ukraine: Removing the Cornerstone without Toppling the Building*, CASE Network Studies and Analysis, No. 322
- Emerson, M. and Noutcheva, G. (2004): *Europeanisation as a Gravity Model of Democratisation*, CEPS Working Document, No. 214/November.
- Euromed (2005): *Five Year Work Programme*, Euromed Barcelona Summit, 27-28 November, http://ec.europa.eu/comm/external_relations/euromed/summit1105/
- European Commission (1995): *Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union (96/142/EC)*
- European Commission (2006): *Communication from the Commission to the Council and the European Parliament on Strengthening the European Neighbourhood Policy*, Brussels, COM(2006)726, 4 December. http://ec.europa.eu/world/enp/pdf/com06_726_en.pdf
- Grabbe, H. (2001): *How does Europeanization affect CEE governance? Conditionality, diffusion and diversity*, Journal of European Public Policy, vol. 8(6): 1013-1031.

Grabbe, H. (2003): *Europeanisation goes east: power and uncertainty in the EU accession process*, in: Featherstone, K. and Radaelli (eds.): The Politics of Europeanisation, C., Oxford: Oxford University Press.

IARC (2006): *Sustainability Impacts of the Euro-Mediterranean Free Trade Area*, Final Report on Phase 2 of the SIAEMFTA Project, Impact Assessment Research Centre. Available at www.sia-trade.org/emfta

Knill, C. and Lehmkuhl, D. (2002): *The National Impact of European Union Regulatory Policy: Three Europeanization Mechanisms*, European Journal of Political Research, vol. 41 (2): pp. 255-280.

Kolesnichenko, A. (ed.), Dimitrov, V., Dubrovskiy, V, Orlova, I. & Taran, S. (2007): *Institutional Harmonization in the Context of Relations between the EU and Its Eastern Neighbours: Costs and Benefits and Methodology of Their Measurement*, CASE Network Reports, No. 75.

Lejour, A., de Mooij, R.A. and Nahuis, R (2001): *EU Enlargement: Economic Implications for Countries and Industries*, CPB Netherlands Bureau for Economic Policy Analysis, Document, No.11

Maliszewska, M. (2004): *EU Enlargement: Benefits of the Single Market Expansion for Current and New Member States*, CASE Network Studies & Analyses, No. 273.

Maliszewska, M., Orlova I. and Taran, S. (2009), *Measuring the benefits of improved market access*, CASE Network Studies and Analyses, forthcoming.

North, D.C. (1990): Institutions, Institutional Change, and Economic Performance, New York: Cambridge University Press

Piazolo, D. (1999): *The Credibility and Growth Effects of EU Institutions on Eastern Europe*, European Investment Bank Economic and Financial Report, No. 99/P2

Radaelli, C.M. (2004): *Europeanisation: Solution or Problem?*, European Integration online Papers (EIoP), Vol. 8, No. 16 Available at SSRN: <http://ssrn.com/abstract=601163>

Radziwill, A. and Smietanka P. (2009): *EU's Eastern Neighbors: institutional harmonization and potential growth bonus*, CASE Network Studies and Analyzes, forthcoming.

Rodrik, D. (1989): *Credibility of Trade Reform – A Policy Maker's Guide*, The World Economy, No. 12, pp. 1-16.



Sittermann, B. (2006): *Europeanisation- A Step Forward in Understanding Europe?*, Research Group European Civil Society and Multilevel Governance, Muenster
<http://nez.uni-muenster.de/en/index.php>

Swiss Integration Office (2006): *Information file on the Europe 2006 Report*,
<http://www.europa.admin.ch/index.html?lang=en>

Ulgen, S. and Zahariadis, Y. (2004): *The Future of Turkish-EU Trade Relations*, CEPS EU-Turkey Working Document, No. 5, CEPS, Brussels, August.

Whalley, J. (1996): *Why do Countries Seek Regional Trade Agreements?* NBER Working Papers, No. 5552.