1

Between Hope and Reality: An Overview of Arab Economic Integration

AHMED GALAL
BERNARD HOEKMAN

Arab economic integration (AEI) has been on the agenda of Arab politicians and intellectuals and of interest to the Arab public at large for some fifty years. The force behind AEI has been the widely held belief that the formation of a united Arab economic bloc would strengthen the bargaining power of the region in an increasingly polarized world and offer its people the opportunity to achieve a better standard of living. During this period, several attempts at economic integration have been made. The Arab League, for example, was created in 1945, providing a potential institutional means of carrying out such a project.

Fifty years later, however, AEI remains elusive, in contrast with the European economic integration experiment, which began around the same time. European Community members succeeded in converting their vision into reality, while supporters of AEI remain hopeful. The divergence in the outcomes of the two experiments raises a host of questions. Were the expected economic gains from AEI so small as to preclude taking concrete and systematic actions toward integration, or was it the absence of political incentives? Did the region lack the institutional mechanisms to carry out the project, or was it opposition from interest groups within individual countries that has prevented real progress to date? Looking ahead, what is the possible impact of AEI on the welfare of the Arab countries involved? Are there any lessons to be drawn from the European Union (EU) experience for the Arab region, or are the two experiments so different that AEI must follow a unique path? These are the broad questions addressed in this volume.

The search for answers to these questions is now more pressing for the Arab region than ever before. Global competition has become more intense. International markets are increasingly dominated by regional economic powers. Economic progress in the developing world is quite uneven, with openness to trade being a feature of successful countries. In contrast and despite significant policy reform in the 1990s, the Arab countries remain less integrated among themselves than hoped for and less open to trade with the rest of the world than rapidly growing economies, and they still lag behind in economic performance. It is noteworthy, for example, that Egypt's per capita income, which in the 1950s was similar to that of Korea, today is less than one-fifth of Korea's. Morocco's per capita GDP, which was close to that of Malaysia, today is only one-third of Malaysia's. And Saudi Arabia's per capita GDP, which was higher than Taiwan's, now is only half.[1] Absent profound policy changes, GDP growth is not expected to exceed 3 to 4 percent in the coming decade. Given average growth in the labor force of more than 3 percent a year, it would be difficult to significantly reduce current levels of unemployment, which run as high as 20 percent in some countries.[2] The most recent *Arab Human Development Report* reaches a similar conclusion.[3] Despite significant progress in the region, much remains to be done to close the gap with most of the world on various human development indicators.

In this volume there is no presumption that Arab economic integration would necessarily improve the welfare of member countries, collectively or individually. Furthermore, there are no prior views on how to implement it. Rather, the focus is on addressing a number of key questions objectively, with a view to recommending a course of action. The analysis presented here complements previous work on regional integration carried out by the

1. Hoekman and Messerlin (2001).
2. Nabli and De Kleine (2000).
3. United Nations Development Program and Arab Fund for Economic and Social Development (2002).

Egyptian Center for Economic Studies (ECES) involving free trade agreements between a number of Arab countries and the EU[4] and the prospects of a free trade agreement between Egypt and the United States.[5]

In the chapters that follow, the authors provide an explanation of the outcomes of past efforts at Arab regional economic integration; offer an estimation of the expected benefits, should such integration be carried out; and discuss the possible lessons of the EU experience for the Arab region. Their objective is to identify the necessary preconditions for successful integration in the future.

Why Past Attempts at Arab Economic Integration Failed

Arab governments have a long history of negotiating regional trade agreements of many types, from bilateral treaties to reduce tariffs on a limited number of goods to ambitious programs aimed at creating an Arab common market. Most of these agreements have not been effective, and many were never fully implemented, resulting in limited intraregional trade compared with that of other regions (see chapter 2, table 2-1). Examples include a 1953 treaty to organize the transit of goods trade among the states of the Arab League; a 1964 agreement between Egypt, Iraq, Jordan, and Syria to establish an Arab common market; a 1981 agreement to facilitate and promote intra-Arab trade signed by eighteen member states of the Arab League; the short-lived Arab Cooperation Council, made up of Egypt, Iraq, Jordan, and Yemen; and the Maghreb Arab Union, composed of Algeria, Libya, Mauritania, Morocco, and Tunisia.[6]

To economists, nondiscriminatory liberalization of trade is preferable to regional economic integration agreements, as the latter can be costly in economic terms because of trade diversion. But regional agreements are not merely about economics. They typically have political objectives, and political gains may offset or outweigh economic costs. While it is difficult to attach the appropriate weight to each side of the equation, the challenge is to ensure that regional integration results in the attainment of overall net gains. Furthermore, it is important to realize that political gains tend to

4. Galal and Hoekman (1997).
5. Galal and Lawrence (1998).
6. Zarrouk (2000).

diminish over time as primary objectives are realized. Thus, even if the economic costs and benefits remain constant, continuous initiatives are needed to make up for the declining value of political gains.[7] The inability of regional integration arrangements to attain and maintain a positive overall cost-benefit balance may be why many agreements were stillborn or later died.

Was the lack of such balance responsible for the limited progress on AEI? In chapter 2, Fawzy suggests that political and economic incentives have been lacking. On the political front, concerns over the distribution of gains from integration across and within countries; national sovereignty; and the cost of adjusting to increased competition all constrained AEI. Shortage of "commitment" institutions, especially of mechanisms to compensate those who lose as a result of trade reform, and lack of consensus on choosing one or more states to act as regional leader were other limiting factors. On the economic front, Arab countries have not had sufficient incentives to integrate because they have had similar production structures, sheltered by high levels of protection. One consequence of this has been limited intra-Arab trade.[8] Further, because they have had less hospitable investment environments, higher transaction costs, and more restrictive barriers to entry than comparable countries, intraregional investment also has been limited.

Have the significant reforms of the last two decades changed the economic incentives sufficiently to favor AEI? Only partially. Both the incentives offered to firms and nontariff barriers continue to deter Arab intraregional trade and investment. Galal and Fawzy show in chapter 3 that in Egypt the prevailing incentive structure continues to favor production for the domestic market. Their conclusion is based on a simple simulation of the profitability of two Egyptian firms that are identical in all respects, except that one of them faces the incentive structure of an export company and the other the incentive structure of a company that produces for domestic consumption. It is based also on a simulation of the profitability of an Egyptian exporter compared with that of a similar exporter in other developing countries. This anti-export bias, which originates from an over-

7. Messerlin (2001).

8. This point is explored in depth in chapter 6 in this volume and elsewhere by Al-Atrash and Yousef (2000), Devlin and Page (2001), Havrylyshyn and Kunzel (2000), and Yeats and Ng (2000).

valued exchange rate, high tariff levels, and high interest and corporate tax rates, persists even when the partial compensation of exporters through duty and tax exemptions is taken into account. This means that trade liberalization has not gone far enough to reverse decades of inward-looking industrialization strategies, and most Egyptian firms still do not find it attractive to export to other Arab countries or to the rest of the world. Considering that a similar bias might exist in other Arab nations, it is not surprising that regional integration has been limited.

In chapter 4, Zarrouk estimates the magnitude and incidence of nontariff barriers for eight Arab countries on the basis of a survey of the private sector. The results indicate that the cost of compliance with all non–tariff-related measures averages 10 percent of the value of goods shipped. Next to bureaucratic red tape, customs clearance procedures are the most important source of nontariff trading costs. The average company spends ninety-five workdays a year resolving problems with customs and other government authorities. On average, unofficial payments associated with customs clearance account for only 1 percent of the value of shipments, but one-fifth of survey respondents reported paying between 2 and 17 percent.[9] Excessive delays result from the lengthy inspection and clearance process, the number of documents and signatures needed to process a trade transaction, and frequent problems with customs and other government authorities.

The 1998 Greater Arab Free Trade Area (GAFTA) agreement will not entirely reduce or eliminate these nontariff barriers. It is true that, unlike previous attempts, GAFTA embodies specific commitments requiring across-the-board elimination of tariffs, tariff-like charges, and nontariff measures.[10] Import duties and other barriers to trade in goods of Arab origin are to be eliminated by 2008. However, GAFTA is a traditional (shallow) preferential trade agreement, limited to trade in merchandise. Services and investment are excluded, greatly reducing the agreement's ability to exert a significant positive economic impact. As a result, nontariff measures are likely to remain important barriers to regional integration, unless further reforms are undertaken.

9. The survey indicates that a number of Arab countries, such as Egypt and Jordan, have improved the performance of customs in recent years. In other countries, such as Lebanon, Saudi Arabia, and Syria, matters either have not improved or have deteriorated.

10. Zarrouk (2000).

Whatever the obstacles to AEI in the past, whether the project is likely to be beneficial is the key question determining political incentives to integrate. This question is taken up in chapter 5.

The Likely Impact of Arab Economic Integration

Ideally, a general equilibrium model for each country affected is needed to answer the question of whether AEI would be beneficial. The changes that AEI would bring could then be introduced to determine the likely impact for each country and for the region as a whole. Given that economic integration could take the form of shallow integration (involving only reforms of policies applied at national borders) or deep integration (involving additional "behind the border" reforms), different simulations would have to be carried out under various assumptions.

Although an assessment of the likely impact of AEI on all Arab countries is not available, in chapter 5 Konan provides such an estimate for Egypt and Tunisia, using an economywide model for each country. Simulations were carried out for both shallow and deep forms of integration, focusing in particular on the impact of improving the efficiency of service industries (for example, finance, transportation, marketing) in light of their importance to the competitiveness of Arab firms.[11] Although the exact numbers differ for Egypt and Tunisia, the qualitative results are remarkably similar. The most significant result is that comprehensive service sector reforms would generate gains far superior to those that could be attained through tariff removal alone. Overall, gains estimated at 13 percent of GDP for Tunisia and 10 percent for Egypt could be attained through competition and reform of regulations governing the service sector. In the case of Tunisia, the estimated gains are more than three times those that would be generated by the liberalization of trade in merchandise alone; for Egypt, the gains are double. The reasons why deeper reforms that improve the efficiency of the service sector would improve welfare significantly are not difficult to grasp. Reforming

11. Recent ECES studies illustrate the importance of efficient services to the economy. Mansour (2001) identifies the services most needed to support the competitiveness of small and medium enterprises (SMEs) in a sample of Arab countries. Tohamy (2001) discusses the importance of services generally and documents the extent of service sector liberalization in Egypt. Galal (1999) estimates the potential gains from greater competition and deregulation in the Egyptian telecommunications sector.

the service sector affects the economy as a whole, not just the external sector; it entails removing high barriers to entry for both domestic and foreign firms; and it eliminates policies that create needless transaction costs. This differs from merchandize trade liberalization, which gives rise to efficiency gains only.

This does not mean that liberalizing trade in merchandise should be stopped or postponed. Gains are highest if both reform agendas are pursued. Trade liberalization aligns domestic and world prices, and price alignment is a critical factor in ensuring that investments are allocated efficiently, materials are obtained from the least costly suppliers, and firms have access to the latest technologies. Trade liberalization also is key to reducing the cost of adjustment to reform. Scenarios in which governments eliminate domestic distortions first and then turn to border distortions (trade barriers) produce unfavorable results. That approach not only reduces real income gains, it also exacerbates adjustment costs. Labor has to undergo "churning" from one sector to another. During the initial stage, domestic resources would flow to the most protected industrial and service sectors. Subsequent service sector reforms would generate shifts in the opposite direction.

In sum, the likely economic impact of AEI is positive, at least for Egypt and Tunisia. Gains are expected to be much greater if AEI involves actions to increase the efficiency of the service sector as well as the removal of tariff and nontariff barriers to trade. Whether similar gains can be expected for other Arab countries, especially oil-producing nations, remains an open question. Assuming that the net gains are positive for the majority of participating countries, the question arises as to the nature and optimal path for making progress on AEI. Chapters 6 and 7 look for clues from the EU experience.

Lessons from the EU

In many respects, understanding the experience of the EU is highly relevant to understanding past Arab regional integration efforts and to informing future attempts. Both the EU and earlier AEI experiments were politically motivated. Both sought to use economic cooperation as a mechanism for integration. Proximity was another common factor. For those reasons, it is instructive to look at the EU experience for insights, keeping in mind the historical context of the two regions, the initial condition of their economies, and the structure of economic incentives. Another major reason for looking at the EU experience is that it is the preeminent example of successful integration.

Although the two regions have similarities, their differences seem to be much larger. In chapter 6, Hoekman and Messerlin show that the conditions that prevailed in the 1950s and 1960s in Europe are quite different from those prevailing in the Arab region today. Differences in size, level of development, market structure, and level of protection all suggest that regional liberalization of trade in goods is not likely to be the best way to integrate Arab countries. Instead, simultaneous action involving nondiscriminatory trade liberalization and concerted reform of service markets may be more successful.[12]

Why would such a strategy have a better chance of success in the Arab region? The answer lies in the political constraints on trade policy reforms, especially when trade barriers are high and costly, as they are in the Arab economies. Trade policy is about a set of domestic bargains between conflicting domestic interests. Some gain, some lose. For liberalization and integration to succeed, there must be a sufficiently large domestic coalition that favors it over all alternatives, including the status quo.[13] Given the high level of trade protection in the Arab region, building such a coalition is critical, but it is difficult. In contrast, because services are a major input into the production process as well as activities such as distribution and sales, liberalization of services could generate significant gains from lower costs of production for the manufacturing and agricultural sectors—each a large and powerful constituency. Reductions in those costs should facilitate trade liberalization by enhancing the competitiveness of industry and agriculture. In addition, service sector reforms would increase investment in the liberal-

12. Hoekman and Messerlin further note, without elaboration, that integration of factor markets could complement a services-based integration strategy. Trade in labor traditionally has been relatively large in the Arab region—probably more so than in the EU. In fact, factor mobility and trade in services may have been a substitute for trade in goods in the Arab region, where there was significant labor mobility from labor-abundant countries (for example, Egypt, Jordan, and Lebanon) to labor-scarce countries (for example, Saudi Arabia and Kuwait). However, lack of cooperative arrangements may have constrained labor mobility so that it was less than it might have been. An agreement on a more stable and well-anchored regime of labor movement within the region could have significant payoffs.

13. Galal (2000).

ized industries, which would generate employment opportunities for skilled and unskilled workers employed by government or import-competing industries or for those who are unemployed. While the deregulation of entry will inevitably result in the restructuring of domestic industry, service sector reform has less far-reaching implications for sectoral turnover and aggregate employment than the abolition of trade barriers because services often need to be consumed where they are produced.[14]

In chapter 7, Winters identifies the key institutional features that made the EU integration effort a success. From the outset, the project was seen as a whole and as a process, rather than as a series of separate steps. There was strong political backing for integration and a central executive body to manage the process and push it forward. The grand vision of integration provided the basis for what followed, while the European Commission acted as guardian of the integration ideal during times of recession. Mechanisms for redistribution were devised to sustain cooperation, as was an agreement to pursue integration gradually.

The Way Forward

Perhaps the most important step on the road to AEI is to acknowledge the glaring fact that fifty years later, it remains more of a hope than a reality. No matter how well-intentioned past efforts have been, they have not been effective. Accordingly, a choice has to be made among three broad options: abandoning the AEI project altogether, continuing business as usual on the basis of preferential trade liberalization, or taking a leap forward by capitalizing on the experience to date. The choice must be informed by political, not just economic, factors. Abandoning the AEI project altogether means forgoing potentially significant gains to the region. The second option is highly imperfect, since preferential trade liberalization was met with strong resistance in the past and is in any event unlikely to be very beneficial. The most viable option is to capitalize on the lessons of experience to devise an alternative, more ambitious path to integration in the future, one that has clear economic payoffs.

If a more ambitious approach to AEI is chosen, the next step is to develop a common vision about the ultimate form of integration, at least initially

14. Konan, chapter 5 of this volume.

among a small core group of countries. To the founders of the EU, it was clear that the objective of the union was to create a common market with a common external commercial policy and eventually to allow the free movement of goods, services, investment, and labor among member states. For the Arab region, it is important to clearly articulate an ultimate objective. Two options that stand out are to create either an Arab common market or a deeper free trade agreement that extends to cooperation on regulatory policies and common institutions. The choice between these options is fundamentally a political decision.

Once a vision is agreed upon, the next step is to select an appropriate path to achieve it. In the EU case, regional trade liberalization provided the basis for further integration. Mobility of labor, liberalization of foreign direct investment, and efforts to reduce the regulatory barriers that segmented national service markets were to follow. Indeed, serious efforts to liberalize trade and investment in services did not occur before the 1990s, through the European "single market" or "1992" initiative. The path followed in the Arab region also started with the liberalization of intra-Arab trade in goods, although subsequent steps have not been articulated. Given that labor is somewhat mobile in the Arab region and that service markets are relatively inefficient, an alternative path could emphasize parallel agreements on trade liberalization (as in GAFTA), labor mobility, and liberalization of services, which would have a noticeable impact on firm competitiveness. That is not to say that all actions on those three fronts have to be undertaken up front, but that simultaneous progress on all is desirable to enhance their impact. The merits of such an approach are twofold: it should generate significant economic gains and help mobilize support for further trade reform among workers, industrialists, and agriculturists.

Given the vision and the path, the next step is to rethink the institutions necessary to carry out an integration project. In the EU case, the structure included supranational institutions: an executive agency (the European Commission), a political oversight body (the European Council), a judiciary (the European Court of Justice), and a directly elected European Parliament. The design of the institutional arrangements for AEI has to take into account the nature of the agreed-upon project, existing institutions, and the gaps between both. Broadly speaking, if AEI remains a shallow form of integration focusing on regional liberalization of trade in goods, there is minimal need for adjustment of current institutional arrangements. On the other hand, if the project is redesigned to favor an Arab common market, implementation would require major institutional changes. The model in this case is analogous to that of the EU, and the lessons laid out by Winters in chapter 7 become highly relevant. If, in a third scenario midway between the two, a deeper form of regional economic integration is created that does not include a common external trade policy, a careful revision of existing institutions is necessary. While the results of such a revision cannot be judged beforehand, the likelihood is high that it would require strengthening an entity within the Arab League to oversee the design and enforcement of the broad issues of the agreement as well as creating new entities to address new areas of agreement—for example, labor mobility and liberalization of network services.

The project's timeframe and credibility both are crucial to its overall success. In particular, sufficient time should be allowed to enable countries to adjust at a pace that is socially acceptable to them. The more difficult task is to build credibility, especially in light of a history of fifty years of making agreements that do not stick. But here is where external commitments and political leadership make a real difference.

References

Al-Atrash, Hassan, and Tarik Yousef. 2000. "Intra-Arab Trade: Is It Too Little?" IMF Working Paper 00/10. Washington: International Monetary Fund (January).

Devlin, Julia, and John Page. 2001. "Testing the Waters: Arab Integration, Competitiveness, and the Euro-Med Agreements." In *Towards Arab and Euro-Med Regional Integration*, edited by Sebastien Dessus, Julia Devlin, and Raed Safadi. Paris: Organization for Economic Cooperation and Development.

Galal, Ahmed. 1999. "The Welfare Impact of Telecom Reform in Egypt: An Ex Ante Analysis." In *Partners for Development: New Roles for Government and the Private Sector in the Middle East and North Africa*, edited by Samiha Fawzy and Ahmed Galal. Washington: World Bank.

———. 2000. "Incentives for Economic Integration in the Middle East." In *Trade Policy Developments in the Middle East and North Africa*, edited by Bernard Hoekman and Hanaa Kheir-El-Din. Washington: World Bank.

Galal, Ahmed, and Bernard Hoekman, eds. 1997. *Regional Partners in Global Markets: Limits and Possibilities of the Euro-Med Agreements*. London: Center for Economic Policy Research.

Galal, Ahmed, and Robert Lawrence, eds. 1998. *Building Bridges: An Egypt-U.S. Free Trade Agreement*. Brookings.

Havrylyshyn, Oleh, and Peter Kunzel. 2000. "Intra-Industry Trade of Arab Countries: An Indicator of Potential Competitiveness." In *Catching Up with the Competition: Trade Opportunities and Challenges for Arab Countries*, edited by Bernard Hoekman and Jamel Zarrouk. University of Michigan Press.

Hoekman, Bernard, and Patrick Messerlin. 2001. *Harnessing Trade for Development in the Middle East and North Africa*. New York: Council on Foreign Relations.

Mansour, Antoine. 2001. "Support Services and the Competitiveness of SMEs in the Arab Region." ECES Working Paper No. 56. Cairo: Egyptian Center for Economic Studies (May).

Messerlin, Patrick. 2001. *Measuring the Costs of Protection in Europe*. Washington: Institute for International Economics.

Nabli, Mustapha, and Annette De Kleine. 2000. "Managing Global Integration in the Middle East and North Africa." In *Trade Policy Developments in the Middle East and North Africa*.

Tohamy, Sahar. 2001. "Case Study of Egypt's Service Liberalization, Service Barriers, and Implementation of the GATS." In *Services in the International Economy*, edited by R. Stern. University of Michigan Press.

United Nations Development Program and the Arab Fund for Economic and Social Development. 2002. *Arab Human Development Report*. New York.

Yeats, Alexander, and Francis Ng. 2000. "Beyond the Year 2000: Implications of the Middle East's Recent Trade Performance." In *Catching Up with the Competition*.

Zarrouk, Jamel. 2000. "The Greater Arab Free Trade Area: Limits and Possibilities." In *Catching Up with the Competition*.