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ABSTRACT

Arab Economic Integration: Missing links*

This paper surveys the recent literature on Arab economic integration, discusses the goals and progress that has been made to date and some of the key policy, regulatory and political factors that underpin the segmentation of Arab markets. It argues that there has been an excessive focus by both analysts and policymakers on trade in goods and that the prospects for – and returns to – efforts to deepen integration of other markets (services, labor and capital) are likely to be higher.

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1. Introduction

The idea of regional integration among Arab countries has been pursued for decades. Efforts to integrate regionally were started in the late 1950s, earlier than in any other developing region. All Arab states have concluded numerous agreements to reduce trade barriers on a preferential basis. Most of these have not had much of an economic impact. For a variety of reasons discussed in the literature, progress has been very slow, with frequent reversals (Sekkat, 1996; Fawzy, 2003).[2]

Most of the analysis on the reasons for intra-Arab integration failures focused on the level of intra-regional trade in goods. The finding that intra-Arab trade in goods is "too low" is supposed to imply that the expected benefits from regional integration would be low and, hence, the incentive to achieve such integration weak. This line of reasoning follows from the works by, among others, Al Atrash and Yousef (2000) and Testas (1998 and 2002) which consider mainly inter-industry trade. The former conclude that intra-Arab trade is lower than what would be predicted by the gravity equation. Testas (1998), comparing the importance intra-regional trade in the Association of South-East Asian Nations (ASEAN) and the Arab Maghreb Union (AMU), found that the former had a much more profound economic impact on its members than the latter. Testas (2002), using an economic growth model to estimate the static and dynamic output and welfare effects of the AMU on Algeria, found a very small effect.

However, Arab countries exhibit a wide range of GDP per capita (less than US$ 1,000 in Yemen and over US$ 25,000 in the UAE). These differences should generate incentives to engage in intra-industry trade driven by product differentiation in order to respond to differences in incomes and preferences. A precondition for such trade to expand is a reduction in standard trade barriers, such as non-tariff barriers (NTBs) and real trade costs, including the cost of services inputs (e.g., Hoekman and Messerlin, 2001; Hufbauer and Brunel, 2008). In this paper, we argue that the economic debate on intra-Arab integration is biased in two respects. First, it has mostly focused on the goods market to assess the desirability of intra-Arab integration, which might be misleading. On the one hand, such reasoning involves a vicious circle: intra-regional integration fails

[2] Until the late 1990s, the exception to the rule was the 1981 Gulf Cooperation Council. Even there, it took more than 2 decades for members to agree on a common external tariff, the minimum necessary condition for the realization of the customs union objective (Legrenzi, 2003).

because there is little intra-regional trade (IRT) and there is a little IRT because of the absence of effective regional integration. On the other hand and more importantly, integration of the goods market is not the only form of economic integration and is not a prerequisite for other forms of integration. The success of regional integration in Europe – the model or benchmark for most observers – started with an emphasis on the goods market, but there is no conceptual reason to adopt the same approach everywhere in the world. Integration of services, labor and/or capital markets might proceed independently of significant progress in goods market integration. The available evidence points to important potential welfare gains from integration of these other markets in the Arab region. In principle these should provide an incentive to policy makers to foster regional integration and may in practice be more important sources of potential economic gain than specialization and intra-regional trade in goods. Key questions then are to what extent integration of these different markets has already occurred and what constrains deeper integration of the non-goods markets.

Second, political considerations have played and continue to play an important role in both driving and constraining regional integration. The most prominent example of the predominance of political objectives is Europe, where prevention of another major armed conflict involving Germany and France was a key driver of integration. This political objective permitted European countries to put in place a set of *supranational* institutions that are responsible for the respect of the treaty and the implementation of integration provisions. In contrast, Arab countries have always resorted to an *intergovernmental* approach to integration reflecting, to a large extent, the reluctance of Arab leaders to transfer any sovereignty to supranational bodies (Fawzy, 2003). This reluctance coexists with the Pan-Arabism ideology that leaders defend in public. This political feature of the status quo is rarely addressed by economists, although it arguably lies at the heart of the problems that have confronted deep regional integration – not just of goods markets, but more importantly, of services and factor markets.

This paper focuses on these two dimensions. Section 2 briefly discusses the goals and progress that has been made to date in the PAFTA and GCC contexts.[3] Section 3

[3] These are the two major intra-Arab regional integration arrangements. Other agreements include Agadir, a FTA between Egypt, Jordan, Morocco and Tunisia and the Arab Maghreb Union between Algeria, Libya, Morocco, Mauritania and Tunisia. The latter was recently analyzed by Hufbauer and Brunel (2008). This

turns to the state of play in the integration of goods, services and factor markets. Section 4 discusses some of the key policy and regulatory factors hampering intra-Arab exchange. Section 5 presents some estimates of the potential gains from further integration of markets. Section 6 considers key political constraints that impede deeper integration of Arab markets and proposes some approaches that may help promote the realization of the integration objective. Section 7 concludes.

2. PAFTA and the GCC: Progress to Date

Members of PAFTA can be divided fairly naturally into three types of economies. One consists of relatively natural-resource-poor, labor-rich countries (less than one third of exports comprise natural resources). Another includes labor-scarce oil-rich countries (more than two thirds of exports consist of natural resources—mostly fuels). Finally, there is an intermediate group of labor-abundant countries where exports of fuels and ores constitute between one and two-thirds of total exports (World Bank, 2008a). One can also split the region into 3 geographic sub-regions: the Maghreb, the Mashreq and the Arabian Peninsula – the Gulf Cooperation Council (GCC) countries plus Yemen.

On 19 February 1997, the Arab Economic Union, which had been created in 1957 by the League of Arab States, decided to establish a Pan-Arab Free Trade Area over a ten year transition period starting on January 1, 1998. That decision was an effort to revive the 1981 Agreement for Facilitation and Promotion of Trade by establishing an Executive Programme. With the exception of Algeria, Djibouti, Comoros, and Mauritania, all the members of the Arab League agreed to dismantle their tariffs on manufactured goods by 2005 and to progressively free trade of agricultural products by 2008. The principal entity responsible for implementing the program is the Economic and Social Council of the League of Arab States, headquartered in Cairo.

In addition to tariffs, the Executive Programme calls for a schedule to be negotiated to suppress non-tariff barriers (Article 3). A committee on non-tariff barriers

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paper does not deal with these other agreements or the hub-and-spoke North-South FTAs that a number of MENA countries have concluded with the EU and the US. While the agreements with the EU have benefitted Tunisia and Morocco in particular, illustrating the potential gains that can accrue from implementation of deep FTAs with major economic powers, the focus of this paper is on the prospects for and potential benefits of the integration of the markets of Arab countries. See Noland and Pack (2007) for an extensive discussion of the role that deep North-South trade agreements could play in fostering growth in Arab countries, focusing specifically on the case of the United States.

has been set up to determine the scope of such negotiations but these have yet to be launched. The Agreement creating the PAFTA also mentions trade in services, and discussions have been held on liberalizing regional services markets. However, as in the case of NTBs, negotiations on trade in services have yet to be launched.

The agreement provides for the possibility of exceptions to the general reduction of tariffs. Member states were allowed to schedule a list of industrial products that may be exempted from tariff reductions during the first years of the program. This provision was aimed at providing space for local industries to restructure and adapt to competition from imports. Members may suspend tariff reductions on some agricultural products during harvest seasons, for a maximum period of seven months per year. Member countries are authorized to submit up to ten agricultural items for suspension. The maximum total exemption for all these items is forty-five months. All exemptions should have disappeared by the end of the transition period

Finally, Article 3 of the PAFTA agreement specifies that the principles agreed upon constitute “the minimum level of trade cooperation among the party-states”. Each party is therefore entitled to conclude either bilateral or multilateral agreements with any other Arab state or states. The Agadir Agreement is an example of such possibility. It was formally signed on 25 February 2003 by Egypt, Morocco, Tunisia and Jordan. The scope of the agreement includes customs procedures and rules on certificates of origin, government purchases, intellectual property protection, product standards and specifications and dumping, as well as mechanisms to resolve conflicts.

The Unified Economic Agreement between members of the Gulf Cooperation Council (UEA-GCC), signed in 1981 and adapted in December 2001, aims at the establishment of an economic and monetary union, that is, a common market for goods, services, investment and workers. The agreement includes chapters on trade facilitation and the movement of capital and persons. The GCC treaty deals with both investment and services activities as part of the Common Market chapter of the 2001 Economic Agreement, which requires that all GCC natural and legal persons be accorded the same treatment as nationals in any GCC country, without differentiation or discrimination. A common external tariff (CET) was agreed in 2003. In principle there are no exceptions to internal free trade, i.e., all products are covered. There is a two tier CET, a zero rate on

imports of 53 tariff lines at the HS 6-digit level (mostly essential goods) and a 5 percent tariff on other goods. It has been agreed in principle that tariff revenues are redistributed on the basis of final consumption within the GCC.

The GCC is not yet a full customs union, let alone a common market. Members continue to maintain some diverging external tariffs for specific products – e.g., cars. Bahrain, Qatar and Saudi Arabia maintain higher tariffs of up to 20 percent for certain sensitive products. There continue to be customs and border controls affecting intra-GCC flows of goods. In part this is because of the national divergences away from the common external tariff of 5 percent, and in part it reflects the fact that despite GCC efforts to adopt harmonized norms for goods, national conformity assessment procedures continue to apply. GCC members apply a 40 percent value added rule to determine origin of goods, and additionally impose a 51 percent GCC ownership criterion (i.e., firms producing goods must be majority GCC owned).

The GCC has a relatively flexible institutional structure – it is an inter-governmental arrangement, there are no supranational bodies. There are two levels of political oversight – the Supreme Council comprising the Heads of State (which provide policy direction and appoint the Secretary General of the Secretariat) and a Ministerial Council that meets quarterly. The latter spans a number of committees (e.g., on Financial and Economic Cooperation, Education, Health, Labor and Social Affairs) that prepare studies and submit recommendations to the Supreme Council. The GCC Secretariat is responsible for the supporting meetings of these intergovernmental bodies with reports, including monitoring the implementation of decisions. A number of specialized agencies have been created for technical policy areas, including a GCC Standardization Organization, a commercial arbitration body, and a registry for patents. GCC members are in the process of unifying the standards and conformity assessment/certification systems. Some 2,700 standards have been agreed by the GCC Standardization Organization, but enforcement is on a country-by-country basis, i.e. there is not yet system of mutual recognition and free circulation of goods. GCC bodies are headed by representatives of the member states, and often have their own permanent technical staff.[4]

[4] For a more in-depth discussion of the GCC see Alabdulrazzaq and Srinivasan (2007).

3. Deeper market integration: state of play

Goods markets

A potential obstacle to reaping significant benefits from intra-Arab integration is that the Arab region suffers from a small overall product market. Moreover, many Arab countries are relatively similar to each other and compete more with each other for the same export markets. Compared to countries with similar per capita income levels the region has a narrow industrial base. Since one motive for trade is to take advantage of differences in endowments (comparative advantage) between trading partners, this situation suggests limited prospects for large benefits from regional economic integration.

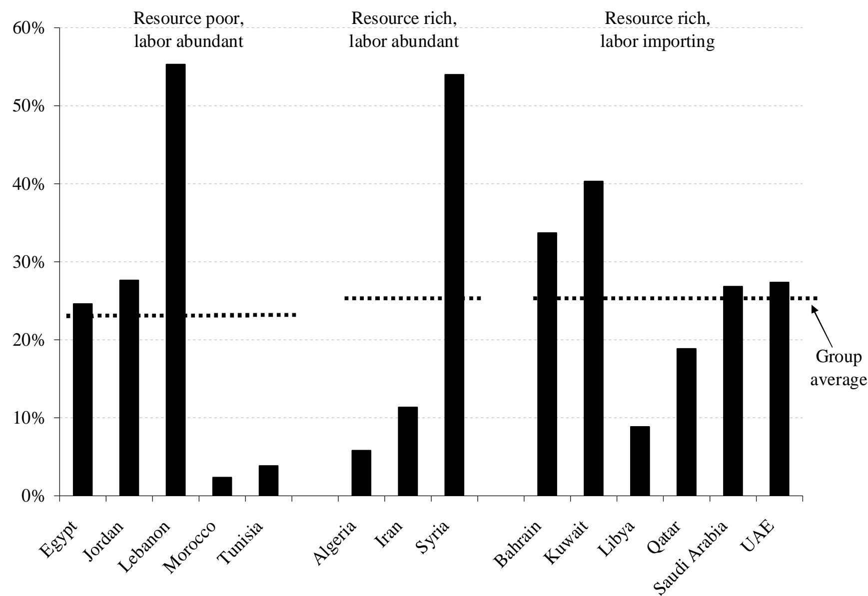
However, as mentioned in the Introduction, the fact that Arab countries exhibit a wide range of GDP per capita could generate incentives to trade. In a number of countries, especially Egypt, Morocco and Tunisia there has been a significant diversification of the export base in the last decade or so. This in turn has led to an increase in intra-industry trade (IIT).[5] Among Arab countries, Tunisia has the highest share of IIT, at some 40 percent, followed by Morocco and the UAE. The magnitude of IIT has been growing rapidly in a number of other countries, as well, including Egypt and Jordan.

Research on trade in the region has concluded that since the late 1980s there has been a trend of increasing trade intensity among Mashreq countries and a higher concentration in non-traditional exports such as processed agricultural products and basic manufactures in goods traded regionally than in exports directed to the EU and the rest of the world (Zarrouk, 2001). However, using IIT as an indicator, analysts have also pointed out that IIT remains far below the ratios registered by Asian comparators, which have IIT indices in the 60 percent (Havrylyshyn and Kunzel, 2000). A complement to IIT is the possibility of production sharing or processing-type trade, where labor, energy or water-intensive parts of the production process is undertaken in countries where such factors are in relative abundance. Such exchange is also limited, in part reflecting trade barriers and real trade costs, including the cost of services inputs. (These are discussed further below).

[5] The index is defined as $IIT = 1 - [\sum\sum\sum \left| X_{ijk} - M_{ijk} \right| / (X_{ijk} + M_{ijk})]$, where X_{ijk} represents the exports of products from industry i from country j to country k and M_{ijk} represents the imports of products from industry i by country j from country k.

More recent data indicate that the geographical pattern of exports of Arab countries continues to mirror the product structure in that the importance of oil results in most trade being with the rest of the world. In the late 1990s/early 2000s the set of countries that tended to trade substantially with other Arab countries (20 percent or more of total exports) was limited to Jordan, Lebanon and Syria. For most Arab countries, regional exports accounted for less than 10 percent of total exports. This continues to be the case today. However, if the focus is limited to non-oil-related trade the ratio rises substantially for many countries. About one-quarter of total non-oil exports go to other Arab countries (Figure 1). For Lebanon and Syria, regional markets account of more than half of non-oil exports, while the GCC countries are in the 25-40 percent range. Only the Maghreb countries trade little with the rest of the region—exports go predominantly to the EU.

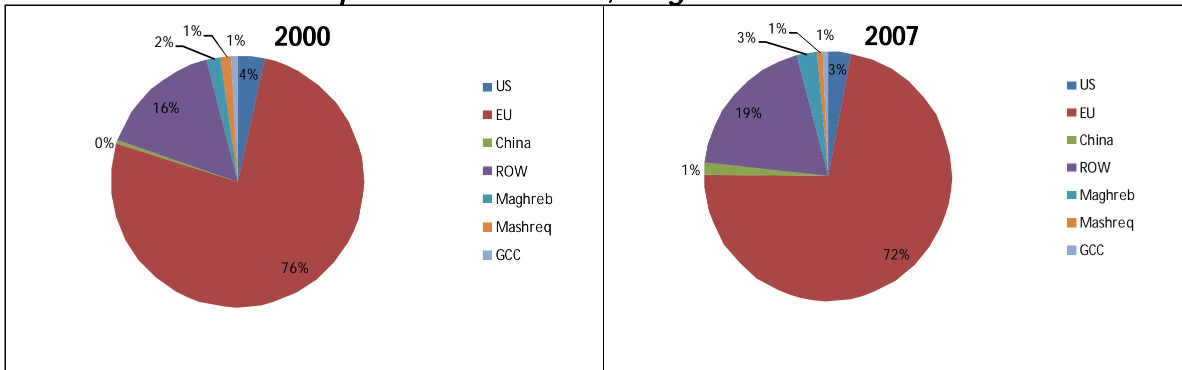
Figure 1. Intra-Arab share of total non-oil merchandise exports, 2006



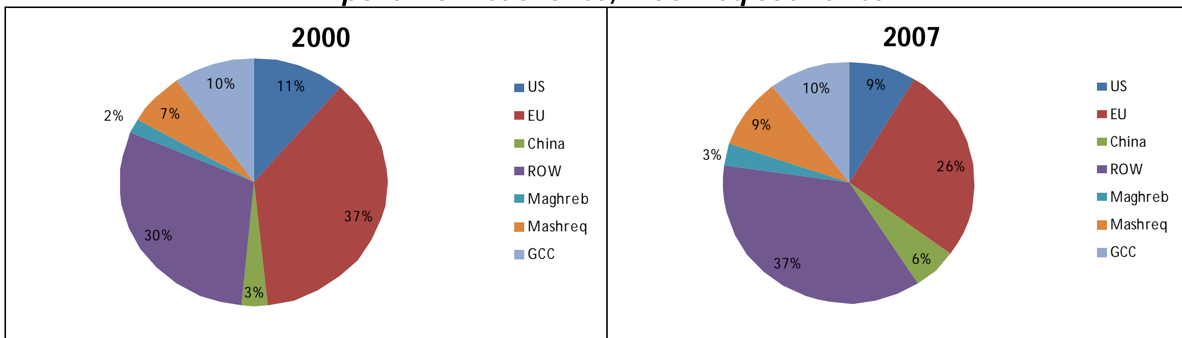
Source: World Bank (2008a).

Figure 2: Non-oil exports: by destination and growth rates, 2000 and 2007

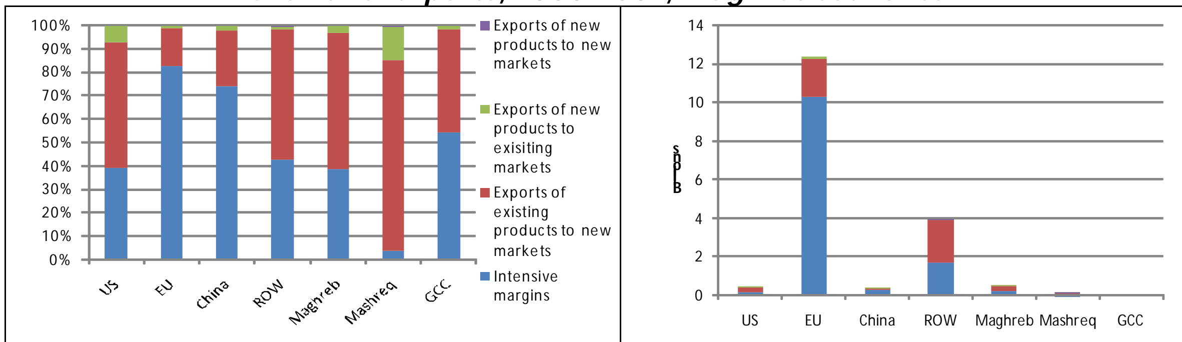
Export market shares, Maghreb countries



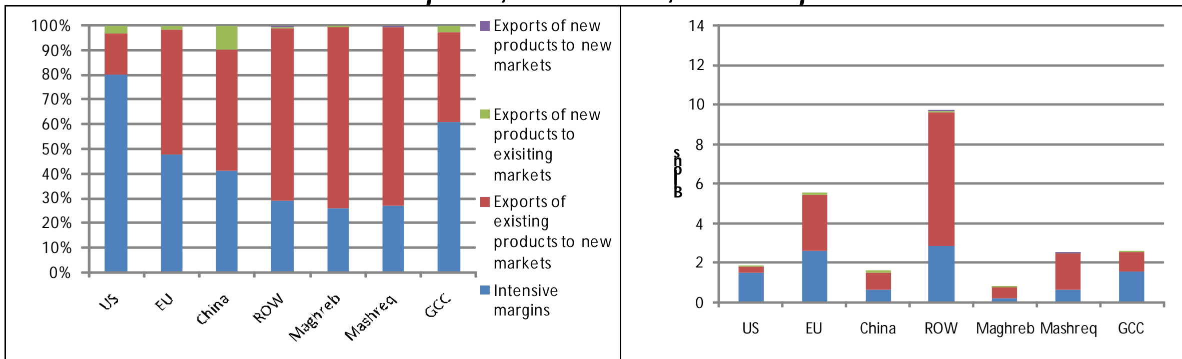
Export market shares, Mashreq countries



Growth of exports, 2000-2007, Maghreb countries



Growth of exports, 2000-2007, Mashreq countries



Source: Chauffour (2009), based on UN Comtrade data.

Recent export growth in the Maghreb region has been at the intensive margin, with limited dynamism in terms of exports of new products or diversification of existing exports towards new markets in the post-2000 period: most growth reflects exports of existing products to new markets and growth of existing products to existing markets (the bottom 2 segments of each bar in the lower part of Figure 2). For the region as a whole, the share of manufactures in total exports has actually decreased since the early 1990s. The EU is by far the most important export destination for the Maghreb countries. For the Mashreq, the EU share declined to only a quarter, with most of the growth of exports directed towards the "rest of the world" – mostly Asia. However, intra-regional trade has also been a growth area, as opposed to the Maghreb, where this has been stagnant. In both groups of countries diversification has mostly taken the form of selling existing products into new markets.

Services markets

More than 15 years ago Fischer (1993) noted that the region was already more integrated in terms of trade in services than trade in manufactures. Services are not just important in terms of foreign exchange generation – e.g., tourism, transport, and other commercial services. Hoekman and Messerlin (2001, 2003) point out that services are a critical determinant of the competitiveness of firms, and that policies that result in high cost, low quality services can impose a high implicit tax on industries that are buyers of services inputs. Pro-competitive service sector reforms could lower trade-related costs by reducing prices of transport, logistics and other services as well as increase the variety and quality of key inputs used by firms – such as finance, telecommunications and professional services. This in turn could have positive knock-on effects on investment and trade in manufactured goods and services by boosting productivity performance and profitability (Francois and Hoekman, 2009).

An expanding service sector will also generate employment opportunities for skilled and unskilled workers who are either unemployed or who are employed by government or by import-competing private manufacturing. Indeed, a (political) precondition for public sector downsizing is that such alternative employment opportunities emerge. Fears of employment loss need to be addressed ex ante through the

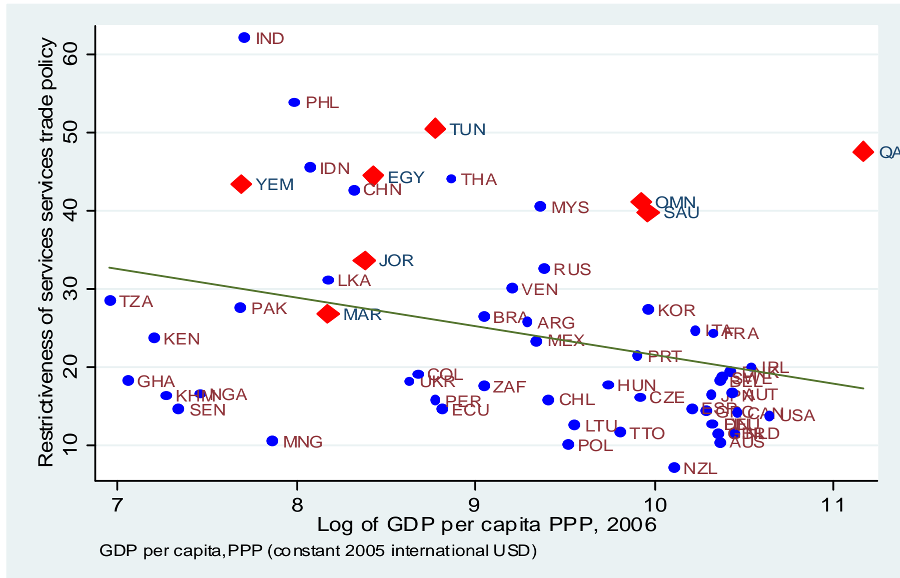
establishment of safety nets and transitional adjustment assistance, but what matters most is that employment opportunities are created elsewhere in the (regional) economy following reform. A major benefit of a concerted strategy towards service sector reform is that this will in itself generate greater demand for labor by the private sector; whether it is in services or goods-producing industries (Jensen, Rutherford and Tarr, 2008).[6] Most employment in modern economies is generated in small and medium-sized enterprises (SMEs), many of which tend to operate in services sectors. Whatever their industry, investment in and the viability and growth prospects of SMEs depend importantly on access to competitively priced services that are tailored to their requirements – ranging from public goods (services) such as energy and infrastructure, to producer services such as finance, distribution and professional services. Absent such services inputs, overall employment growth prospects will be limited.

The limited tradability of services implies that FDI is an important avenue through which access to best practices and new services can be acquired. Given that many service activities are subject to investment restrictions (e.g., nationality requirements, restrictions on movement of personnel, limits on foreign equity shareholdings), service sector reform is closely tied to privatization and removal of licensing and related entry and operating restrictions. A noteworthy feature of services trade and investment policies in the region is that they are on average more restrictive than in other parts of world in countries with similar levels of per capita income (Figures 3 and 4). Bringing down these barriers would facilitate the exploitation of the large differences that exist between Arab countries in terms of current account balances, with oil surplus countries being able to invest a greater share of their wealth in other parts of MENA where prospective rates of return are higher than at home, and potential "cultural distance" costs are lower than in the rest of the world. Rather than seek to industrialize and diversify their national economies, it would be more efficient to invest in other Arab countries that are well endowed with labor and generate greater economic activity and employment in those other locations (El Gamal, 2009). Of course, a precondition for this

[6] Rossotto et al. (2005) illustrate the potential impact of opening up telecommunications to competition in Arab countries. Controlling for the influence of other structural factors, they find that better performance of telecommunications strengthens export performance in manufacturing exports (including of intermediate products) and increases foreign direct investment (FDI).

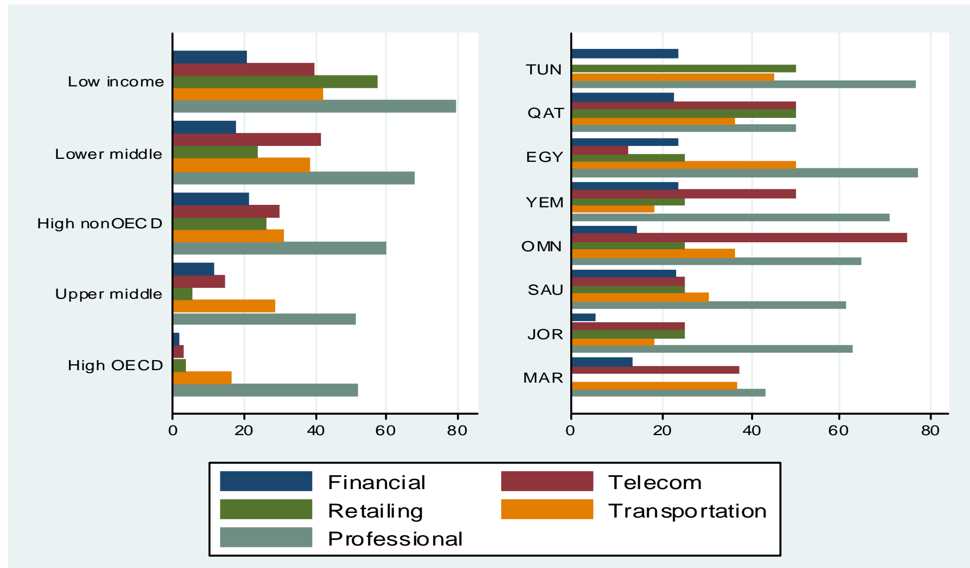
to be technically and economically feasible (i.e., profitable), the focus of policy needs to be on the constraints and operating barriers that confront such investment – which include access to services.

Figure 3: Restrictiveness of services trade policies, 2008



Source: Gootiz and Mattoo (2009).

Figure 4. Restrictiveness of Services Policies in Selected Arab countries



Source: Gootiiz and Mattoo (2009).

While much of what is needed in terms of reforms to reduce such restrictiveness could be pursued through unilateral action, an Arab integration-based effort to liberalize services may help to overcome constraints to reform. Economists often stress the potential role of PTAs as a mechanism to "lock-in" a reform path through pre-commitment to specific targets or outcomes. An important policy question then is how an Arab cooperation strategy may help to address the major political economy constraints that impede national (unilateral) reform.

One of these constraints is related to the large role the State continues to play in many Arab economies. Greater participation by the private sector will require privatization and abolition of entry and exit restrictions for (new) firms. Government policies and procedures are also the cause of high transactions costs at the border (red tape) and high operating costs – e.g., finance and intermediation services. Thus, a major factor determining the relevance of any integration strategy will be to what extent it is used by governments to pre-commit to actions aimed at reducing the role of the State. An implication is that the focus of analysis must be on *government services* as well as other, privately supplied services (Hoekman and Messerlin, 2001). Two interest groups play a major role in this connection—government employees in general, and more specifically, those responsible for enforcement of regulatory policies and procedures at the border (Customs) and for specific service industries (sectoral regulators).

Cross country experience suggests the latter group can be a serious constraint to the adoption of more pro-competitive policies. Sectoral ministries or regulators that oversee service industries often may be concerned with supporting domestic incumbents and maintaining the status quo, having little incentive to actively encourage new entry and greater competition—be it from domestic or foreign suppliers. The PAFTA and the GCC have not yet taken serious, concrete steps to harness the PTAs to pursue service sector reforms aimed at increasing the contestability of markets. As discussed below, this is an area where there is significant potential to enhance the welfare gains from Arab integration. A precondition for harnessing these gains will often be liberalization of intra-regional labor mobility.

3.3 Labor movement

In theory, free labor mobility leads to efficiency gains and increases in world income. According to Walmsley and Winters (2003) and Rodrik (2002), liberalizing cross-border labor movements can yield substantial benefits to the world economy—with full free trade generating gains that may be some 20 times larger than those that would accrue from free goods and capital flows, given the huge differential in the wage rates for similar skills in developing and developed countries. Although the potential benefits from migration are huge at the world level, the impact of migration will differ across origin and host countries. A host country can benefit from immigration in a variety of ways (e.g. immigration removes labor scarcity and leads to fuller utilization of abundant capital, provide the skilled human capital necessary to enhance provide social welfare, filling jobs that cannot be filled by locals). There are also potential negative impacts on the labor markets of the host countries (e.g. lowering wages among unskilled workers or increasing their unemployment rates).[7] For the origin country, some economists have argued that emigration, especially of the most talented workers (brain drain), may reduce the average level of human capital of the labor force and impact on growth prospects. Others downplay the negative externalities imposed on those left behind and stress the positive role of remittances, return migration and diaspora externalities. Some of the literature focusing on brain drain even finds a positive effect on human capital formation in the origin country (e.g., Beine et al., 2001; Özden and Schiff, 2005). Recently, Beine et al. (2008) find a positive effect of skilled migration prospects on human capital growth in a cross-section of 127 developing countries, with an elasticity of about 5 percent.

Some limited evidence documents the potential from emigration gains for Arab countries. For instance, workers' remittances were over US$15 billion in 2006, much larger than net FDI flows and net official flows (World Bank, 2008b). Remittances exceed 15 percent of GDP in Jordan and Lebanon (Maimbo and Ratha, 2005). McCormick and Wahba (2001) studied the linkages between overseas employment, savings and entrepreneurial activity on return to Egypt and conclude that both overseas savings and the duration of stay overseas increase the probability of becoming an

[7] However, there is no strong empirical evidence to support these claims (see, for example, International Organization for Migration 2005).

entrepreneur amongst literate returnees to Egypt. Amongst illiterate returnees, overseas savings alone increase the probability of becoming an entrepreneur. The results for literates suggest that skill acquisition overseas may matter more substantially than overcoming a savings constraint in explaining how overseas opportunities influence entrepreneurship on return. In a study of return migration in Tunisia, Mesnard (2004) concludes that temporary migration contributed to economic development through transfers (remittances) sent by migrants to Tunisia and savings repatriated upon return of the migrants, which allow poor workers to overcome credit constraints for investment into small projects.

Migration has historically played an important role in absorbing a part of Arab labor forces. Workers from Egypt, Jordan and Yemen were actively recruited for employment within oil exporting Gulf countries in the 1970s and 1980s. In 1990 some 700,000 Egyptians were working in Iraq and over 800,000 Yemenis were employed in Saudi Arabia and the Gulf. In turn, Syrian workers moved into Lebanon and Egyptian workers to Jordan. As of the early 1980s, over four million expatriate workers were employed in the oil exporting Gulf countries. Non-nationals made up nearly 70 percent of the workforce and a quarter of total population within the Gulf. By some estimates, roughly 10 percent of Egypt's and 15 percent of Yemen's labor force was employed in other Arab countries. As a result of the oil windfall, real wages and standards of living rose throughout the region, and poverty rates fell substantially.

Table 1: Migrants to Arab countries as a share of total migrants, 2000 (%)

Origin Countries	Share 1	Share 2
Yemen	98.94	82.03
Egypt	94.25	71.39
Jordan	92.08	83.72
Syrian Arab Republic	74.65	49.13
Iraq	52.93	54.24
Lebanon	45.36	20.03
Tunisia	15.90	10.16
Algeria	2.61	7.06
Morocco	2.27	8.73

Source: Parsons et al. 2007.
Notes: Share 1 = less complete/more reliable; Share 2 = more complete/less reliable matrices.

Arab workers also migrate to non-Arab countries. Accurate and complete data on the destination of workers, which can help assessing the degree of intra-Arab labor markets integration, are still lacking. One exception is the recent data base constructed by Parsons et al. (2007) at the University of Sussex which provides 4 matrices of migration around the world by origin and destination. Table 1 reports estimates of the share of total outward migration to Arab countries based on the less complete/more reliable and on the more complete/less reliable matrices.[8] The focus is on the most important sender countries. Irrespective of the matrix used, the figures suggest that the labor market in Mashreq countries is highly integrated (most migrants from these countries go to other Arab economies) while the Maghreb is not – reflecting in part the attraction of the EU, which is the major destination for migrants (Hoekman and Özden, 2010).

Although the level of migration in the Arab region is high, migration is constrained and distorted by market failures (most visibly information asymmetry and imperfect contracts) and government failures (inefficient or non-existent national migration and labor policies) (World Bank, 2008a). Moreover, migration to other Arab countries has been greatly impacted by oil price movements. Arab labor markets have witnessed two profound transformations in recent decades: (i) integration driven and financed by the oil boom in the 1970s; and (ii) in the 1990s, fragmentation following the decline in oil income and the Gulf conflicts.[9] In the 1980s and early 1990s net outflows of Arab workers to the oil-exporting countries fell sharply, driven by lower oil prices and the effects the 1991 Gulf War. As a result of the former, worker remittances to non-oil exports in the region dropped and an economic slowdown was transmitted throughout the region. The latter gave rise to a shift in sourcing away from traditional Arab suppliers of workers towards South Asia. The effect of regional conflicts has been that labor markets have become increasingly nationalized.

There is great scope for more intra-regional trade in labor between the capital rich, labor poor GCC countries and the Mashreq. An alternative (complementary) response to

[8] The matrices differ in their degree of reliability and completeness with the most reliable being based on the officially reported stocks of migrants by host countries. This matrix is, however, highly incomplete. To construct the 3 other matrices various assumptions are used to make them more complete.

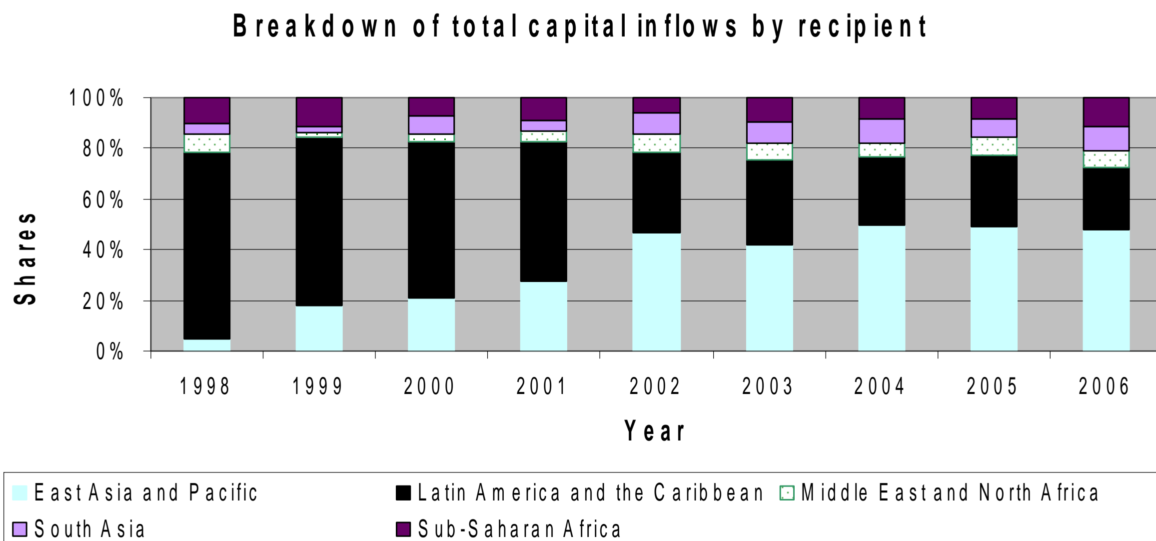
[9] Conflict has been another element driving labor flows. The neighbors within the region have accommodated large flows of refugees from Sudan, Iraq, and Palestine. The Middle East accounts for a large share of global refugee flows.

the supply-demand imbalances that characterize regional labor markets and demographics is for capital to move the parts of the region that more well-endowed with labor.

3.4 Investment flows

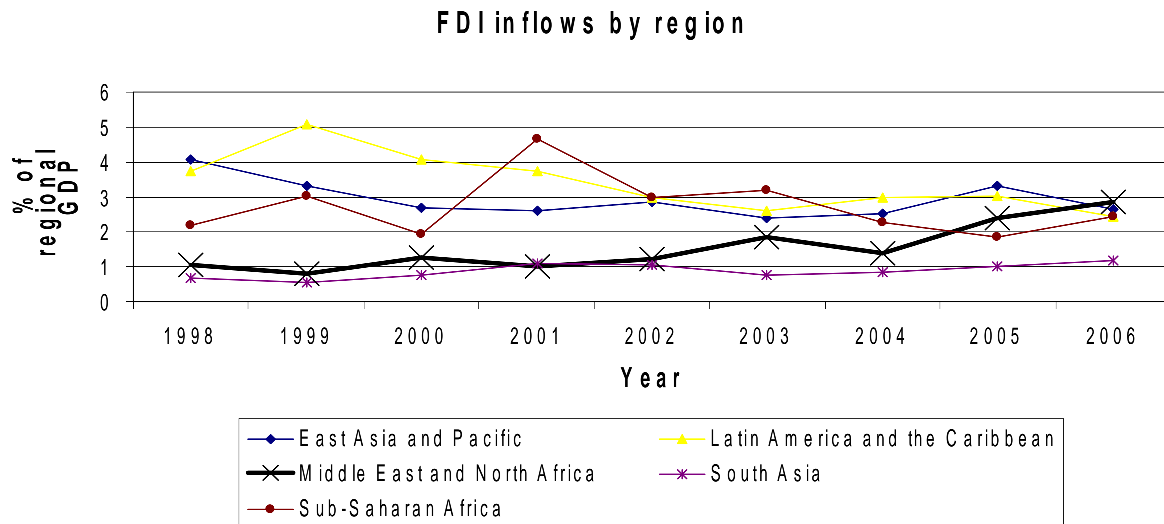
The Arab region has long been the world's smallest recipient of foreign capital. During the early 2000s, the ratio of foreign capital inflows to GDP averaged around 1% for the Arab region during the 2000s, as compared to some 3% in Sub-Saharan Africa and 4% in Latin America – with most of the growth occurring in Asia (Figure 5). Private capital flows comprise three components: FDI, portfolio equity flows and debt flows. FDI constitutes the largest component (between 50% and 80% over the period 1998-2006) followed by debt flows. Portfolio equity flows are rather marginal. FDI is of particular importance not only because it is large but because it is a source of knowledge and positive spillovers and are usually seen as longer-term and hence result from long-term decisions about the productive capabilities of the country whereas other flows can be more speculative in nature (see Gibson et al. 2006 for a recent survey). Although the ratio of FDI to GDP increased to 3% in 2006, it is still below that of other regions (Figure 6).

Figure 5



Unfortunately, data on bilateral FDI inflows are almost nonexistent for the region. Hence, instead of focusing on actual flows, what follows focuses on the potential for intra-Arab FDI flows using UNCTAD's Outward and Inward FDI Performance Indices. The former is calculated as the ratio of the share of a country's outward FDI in world FDI to its share in world GDP. Hence, a value greater than 1 indicates that the country sends more FDI than its relative economic size, a value below one means that it sends less. The Inward FDI Potential Index captures several factors expected to affect an economy's attractiveness to foreign investors (e.g. GDP per capita, GDP growth, the share of exports in GDP, an indicator of infrastructure, the share of tertiary students in the population, and country risk). It is increasing in the degree of attractiveness.[10]

Figure 6

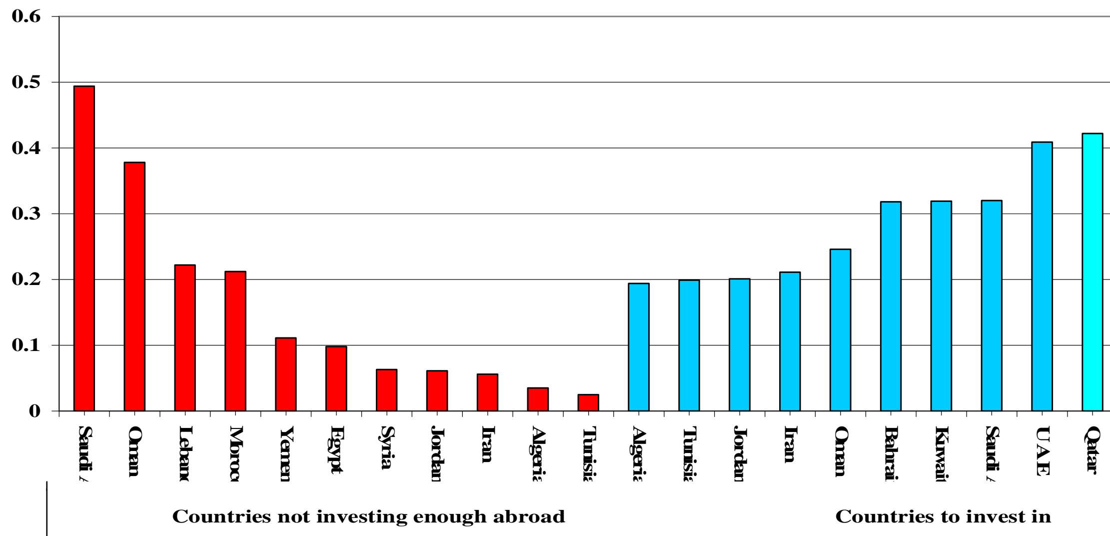


Excluding OECD countries, the world average of the potential index is 0.18. Hence, a country with a score above 0.18 is more attractive than the world average.

[10] These indices are based on the literature that shows FDI inflows to countries are determined in part by the size of domestic and accessible foreign markets (Lucas, 1993), sound economic policies (Blomstrom and Kokko, 1997), infrastructure (Wheeler and Mody, 1992) and political/institutional security (Wei, 2000 and Henisz, 2000). Studies on Arab countries confirm the relevance of these factors for the region. Sekkat and Veganzones (2007) confirm the importance of openness, infrastructure availability and sound economic and political conditions in increasing countries attractiveness with respect to FDI, especially in the manufacturing sector. Méon and Sekkat (2004) conclude that political risk and specific aspects of governance (corruption, government effectiveness and the rule of law) do much to explain the limited FDI performance of the region.

Figure 7 summarizes the main information in the indexes in two panels. The left hand panel gives the Outward FDI Performance Index for countries investing too little abroad (i.e. with an index below 1) in both regions. The right hand panel gives the Inward FDI Potential Index for countries that are more attractive than the world average (i.e. with an index above 0.18). Interestingly, there are countries with potential index above the world average (i.e. a good candidate for FDI inflows) and countries investing too little abroad. This suggests that there is room for greater intra-regional FDI flows. Given the large differences in current account balances across countries in the region, there is substantial scope for greater investment in the non-oil countries by the capital surplus economies. Such investments can help the both the region to integrate more, and at the same time allow the oil exporters to diversify.

Figure 7. Outward FDI Performance and Inward FDI Potential Indexes



4. Sources of Market Segmentation

Reducing market segmentation for goods, services and factor markets can help improve productivity performance and expand overall employment by encouraging new entry and investment, especially by small and medium-sized enterprises. Many countries in the region are small or relatively small; and, as noted, there are very large imbalances in terms of demand-supply of labor and capital. Regional integration of markets can help

narrow these imbalances and allow better exploitation of the opportunities offered by world markets. The challenge then is to identify and address the major sources of market segmentation through cooperative mechanisms. This need not involve moving towards a formal common market. What it does (must) involve is a concerted effort to deal with policies that keep trade and operating costs high and that impede entry by foreign investors and producers. What follows discusses a number of the key areas for policy initiatives.

Rules of origin

Although tariffs have been (mostly) removed on intra-regional trade in merchandise, rules of origin (ROO) apply that are aimed at preventing trade deflection. There is a large literature now estimating the effects of rules of origin (e.g. Cadot et al., 2006). This shows that the rules have a statistically significant impact in restricting trade, having the effect of a tariff in the 3 to 4 percent range. The basic rule that applies under the PAFTA is a value added criterion of 40 percent, although in practice individual PAFTA members apply varying rules for the same product. Under PAFTA the origin requirement is reduced to 20 percent if a good is produced in two Arab countries. Agreement on a more detailed set of rules of origin of the type found in EU and US PTAs has not proved possible. This not necessarily a bad thing: a value content rule is at least transparent, and allows PAFTA members to use the level of value added as a focal point for future efforts to reduce the trade restrictive effects of the ROO.

ROO are also important for trade and investment in services. Fink and Molinuevo (2007) and Fink and Jansen (2009) argue that the rules of origin that are contained in most recent PTAs in the rest of the world that cover services are mostly liberal, in that PTA benefits extend to non-member firms that are established (have a commercial presence) and substantial business operations in a PTA member. Fink and his co-authors argue that such liberal rules of origin necessarily mean PTAs on services are multilateralizing in nature (i.e., do not give rise to potential trade diversion incentives). However, if there are significant policy-based barriers to entry in a market and thus significant rents, there are obvious incentives for firms in the PTA partners to seek to limit entry by non-PTA firms. Thus, as in the case of trade in goods it is not (only) the

rule of origin that matters, but the level of prevailing market access barriers against ROW suppliers. Not much is known about the status quo in this area in PAFTA countries.

A way to cope with the problems related to the ROO is to move to a Customs Union and adopt a Common External Tariff (CET). The PAFTA has stated it aims to establish a customs union. Experience suggests this will be difficult as it requires not just agreement on the level of tariffs but on the design of revenue allocation rules and implementation mechanisms. This has been achieved in the GCC, but it took many years to agree on and implement a CET. Nor is moving from PTA to customs union necessarily welfare improving. The literature on regionalism suggests a number of reasons why there may be a bias for the external trade policy of a customs union to be more restrictive than under a PTA. As discussed at greater length in Hoekman and Kostecki (2009), because there is no common external trade policy, member countries compete in their external trade policies. Industries cannot lobby for area-wide protection. While import-competing firms in member countries may have an incentive to obtain such protection, each industry will have to approach its own government. The required coordination and cooperation may be more difficult to sustain than in a customs union where the centralization of trade policy requires firms to present a common front. In any particular instance, some member country governments will award protection, whereas others will not. If industries in member countries are all competing against third suppliers, protection by one member may benefit industries in other member states. Such free riding can result in less protection than in the absence of the PTA.

Some evidence is beginning to emerge that supports these theoretical considerations on the likely dynamics of PTAs vs. customs unions. Estevadeordal et al. (2008) conclude that the preferential tariff reduction following PTA formation in Latin America promoted subsequent external tariff reduction for those PTAs that do not involve the formation of a customs union. Bohara et al. (2004), focusing on the impact of preferential trade flows from Brazil to Argentina, find that greater imports from Brazil led to lower MFN tariffs in Argentina, especially in sectors where trade diversion occurred as a result of Mercosur. As the potential for trade diversion is especially great for South-South PTAs (because developing countries tend to have relatively high external trade barriers) the associated costs provide a powerful force for multilateralization:

lowering external barriers to trade will reduce such costs. Dealing with the costs of rules of origin directly – by adopting more liberal origin criteria – would address this source of transaction and trade diversion cost, while at the same time allowing countries to benefit from the positive political economy dynamics that have been observed in Latin America. A first step in this direction would be to reduce the trade impeding effect of ROO by adopting more liberal cumulation rules that allow sourcing from any country that has a PTA with an Arab country – as has been done in the EU context with the Pan European Cumulation System (PECS) (Gasiorek et al., 2009).

National regulatory policies and related trade and operating costs

A variety of other non-tariff measures segment markets and increase costs for traders and investors by constraining entry and limiting competition. Starting in the late 1990s analysis began to point to the negative effects of public monopolies in ports and poor infrastructure for loading and storing goods on the costs for handling and shipping containers in many Arab countries. Similar findings pertained to air transportation, professional services, fixed line telecommunications and utilities.[11] Policies restricting trade in land transport services, such as prohibitions on drivers originating in certain countries, arbitrary changes in documentary requirements, surcharges and discriminatory taxes, and prohibitions on obtaining cargo in the country of destination to take back to the country of origin, impose severe costs on intra-Arab trade (Zarrouk, 2000).

Based on a survey of firms in eight Arab countries, Zarrouk (2003) estimated that the cost of getting goods across borders in 2000 averaged 10 percent of the value of goods shipped. Next to bureaucratic red tape, customs clearance procedures were the most important source of non-tariff trading costs, with the average company spending 95 man-days per year resolving problems with customs and other government authorities. Excessive delays resulted from lengthy processes of clearance and inspection, the number of documents and signatures needed to process a trade transaction, and the frequency of problems with customs and other government authorities. Hoekman and Zarrouk (2009), discussed below, note that significant progress has been made since 2000 to remove

[11] See e.g., the contributions in Hoekman and Zarrouk 2000; Hoekman and Kheir el Din, 2000; Achy, Boughzala, Kheir-El-Din and Togan, 2005; and Rosotto, Sekkat and Varoudakis, 2005.

tariff-related barriers to intra-PAFTA trade in goods, including Customs-clearance related procedural burdens, so that the relative importance of transport and logistics related costs has risen. New sources of such as the World Bank's *Doing Business* and *Logistics Performance Indicators*, and investment climate surveys have allowed better assessments of sources of such costs.

Dennis (2006) attempts to assess the relative importance of real trade costs using a CGE model (GTAP), using the Zarrouk (2003) survey data. He finds that removing these costs generates more than double the welfare gains that would arise from the removal of tariffs. Méon and Sekkat (2004) show that measures of the quality of institutions (corruption, government effectiveness and the rule of law) limit Arab countries integration into the global economy. Longo and Sekkat (2004) examine the impact of infrastructure availability, economic policy, and internal political tensions on intra-African (including African-Arab countries) trade. They find that poor infrastructure, economic policy mismanagement, and internal political tensions have a negative impact on such trade. Harb (2008) assesses the impact of port infrastructure, Internet access, and administrative efficiency of government administration on intra-Arab trade. He finds that actions to improve these variables would reduce any welfare-reducing trade diversion effects induced by PAFTA. Port inefficiencies are found to be the main cost raising factor constraining trade.

Macroeconomic policies can also constitute a serious obstacle to intra-Arab trade. The significant macro-economic reforms in the 1980s and 1990s only partly changed the economic incentives confronting firms. Research in the early 2000s suggested that the tax incentive structure facing firms continued to be a deterrent to both global and intra-regional trade and investment. For instance, in Egypt, firms continued facing an overvalued exchange rate, high tariff levels, high interest and high corporate tax rates. This means that trade liberalization did not go far enough to reverse decades of inward-looking strategies, and most Arab firms still did not find it attractive to export to other Arab countries or to the rest of the world (Galal and Fawzy, 2002).

Product standards are another source of real trade costs/restrictiveness. As with rules of origin, there is only limited knowledge on the prevailing Arab national regimes and the scope (need) for regional cooperation to reduce the extent of market segmentation

caused by differences in product regulation through mutual recognition or harmonization. As noted previously, GCC members are in the process of unifying the standards and conformity assessment/certification systems, with some 2,700 standards already adopted by the GCC Standardization Organization. Much less is known about PAFTA and other PTAs, including those with the EU and US regarding standards and their effects.

Other policy areas that can affect intra-PAFTA competition (contestability) include industrial policy, subsidies (state aids), public procurement regimes, export and special economic zones, and the incentive regimes that have been put in place by different countries in terms of preferential treatment for investors and market access. Competition law and policy disciplines are very relevant in this connection. To date competition-related provisions in PTAs are limited to those with the EU and are confined to practices that have or may have an effect on trade, reflecting the EU's focus on market integration and the view that removal of private barriers to entry and anti-competitive behavior is a necessary complement to the removal of border barriers and restrictions on state aids. There is in principle significant scope to design PTAs so as to strike a bargain that involves joint enforcement and "outsourcing" of competition disciplines to the jurisdiction with the greatest capacity in this area (Hoekman and Saggi, 2007). How to structure such deals in practice and strengthen competition enforcement in the Arab region is an interesting area for research.

5. Possible gains from deeper integration

To assess potential gains from deeper economic integration, two approaches have been traditionally used. One is based on CGE modeling, the other is based on econometric estimation of gravity models. The gravity studies allow assessing the impact of implementing intra-regional liberalization on exchanges of goods, services, labor or capital. However, as the length of time that has passed since PAFTA has been implemented is short, there have been few ex post studies. An exception is Abedini and Peridy (2008), who incorporate both traditional determinants of international trade (GDP, distance, border effects) and variables that have not been used in the literature, such as expectations and sunk costs in a gravity analysis of PAFTA. They find that the agreement resulted in a gross increase in trade creation of approximately 20% in the 1988-2005

period. A problem with this conclusion is that PAFTA was only implemented gradually after 1998 (in initial steps of 10 percent, later accelerated to 20 percent a year to achieve full implementation in 2005). Thus, there is an attribution/identification problem – other events also need to be controlled for such as expansion of the EU, the exclusion of some agricultural products from PAFTA during much of the period (e.g. agriculture is the most dynamic import for Syria), and the gradual abolition of textile quotas under the WTO during the period.

The literature dealing with the ex-ante evaluation of the impact of PAFTA is not much richer. However, useful insights can nonetheless be drawn from CGE studies focusing on specific countries in the region. For example, Konan (2003) focuses on Tunisia and Egypt, and analyses both shallow integration scenarios (reduction in tariffs only) and deeper integration through reduction in NTBs and liberalization of trade and investment in services. She considers five scenarios: (i) shallow integration involving only reduction in tariffs on goods; (ii) preferential liberalization, either through the Euro-Med initiative or PAFTA; (iii) multilateral liberalization; (iv) deep integration, in which NTBs on goods are eliminated; and (v) services liberalization consisting of reduction of barriers on cross-border trade as well as barriers to FDI in the service sector. Table 2 summarizes the impact on GDP of the various combinations of these scenarios.

The gain from trade liberalization that involves only an elimination of tariffs for Tunisia is significantly greater in percentage terms than that for Egypt; except in one case. While PAFTA alone has almost no effect in Tunisia, trade liberalization involving also the EU would raise Tunisian GDP by 3 percent. This is due to trade diversion of PAFTA alone on Tunisia. In contrast, gain from PAFTA alone in Egypt is 2 percent of GDP while a shallow Egypt-EU trade agreement would have a negligible impact. The explanation of such differences seems to be that Tunisia's economy relies much more on trade than Egypt's does.[12]

Turning to the deeper integration scenarios, the results show that a liberalization involving elimination of tariffs and non-tariff barriers to trade in goods entails gains significantly higher than those of shallow integration. In the case of Tunisia, the GDP

[12] The surprising result in terms of ranking of the various scenarios (e.g. PAFTA plus Euro-Med induces less gain than of the scenarios alone) seems to be due to the interaction between domestic taxes and trade taxes (see Konan 2003 for further discussion).

gains are more than twice as higher. In Egypt the gains are, in general, also twice as higher although their levels are still modest compared to Tunisia's. Interestingly, the gains of deep integration are rather similar regardless of whether barriers are reduced through unilateral reform or through a regional agreement.

Table 2. Change in GDP (%) following scenarios of integration

Scenarios	Tunisia	Egypt
Shallow: tariffs only		
Euro-Med Agreement	3.03	0.90
PAFTA	-0.07	2.05
PAFTA plus Euro-Med	3.02	0.85
MFN	2.12	0.45
Euro-Med PAFTA plus MFN	2.20	0.45
Deep: tariffs plus goods NTBs		
PAFTA plus Euro-Med	8.26	1.87
Unilateral MFN Euro-Med	8.82	1.33
PAFTA plus MFN	8.85	1.49
Services liberalization		
Services Border Liberalization	0.74	2.49
Services Investment Liberalization	7.79	8.39
Full Services Liberalization	8.78	8.71
Combination		
PAFTA (tariffs only)	-0.07	2.05
PAFTA, Euro-Med, MFN (tariffs only)	4.31	0.45
PAFTA plus Euro-Med (tariffs plus goods NTBs)	8.26	1.87
PAFTA, Euro-Med, MFN (tariffs plus goods NTBs)	8.85	1.49
Services Liberalization (no change in goods barriers)	8.78	8.71
PAFTA plus Shallow Goods and Services Liberalization	4.85	0.81
PAFTA plus Deep Goods and Services Liberalization	16.49	8.2

Source: Konan (2003). MFN = unilateral tariff reduction with the rest of the world.

The findings pertaining to the service liberalization scenarios show that while the benefits of only border liberalization are positive, adding reforms that facilitate FDI induces substantial additional gains in both countries. The gains are comparable in both countries. While in Tunisia, these gains are comparable to those estimated to be achievable through deep liberalization of trade in goods, Egypt seems to benefit more from liberalization that focuses on services than trade in goods.

Bchir et al. (2006) shed light on the potential gains from moving from a simple PTA to a Custom Union among Maghreb countries. They examine three scenarios: (i) a free trade area among the Maghreb countries (similar to shallow integration in Konan 2003); (ii) a Customs Union between Maghreb countries; and (iii) a Maghreban Common Market (similar to deep integration in Konan (2003)). Table 3 summarizes the main results. The gains for Tunisia in terms of increases in GDP are almost the same as Konan's. Moreover, like in Konan, Tunisia seems to benefit more from any scenario of liberalization than the rest of the Maghreb. The explanation for this is likely the higher degree of openness of the Tunisian economy. The additional gains of moving from a simple PTA to a Customs Union are sizeable for both Morocco and Tunisia: around 4 percent increase GDP.

Table 3. Change in GDP (%) following scenarios of integration

	Tunisia	Morocco	Rest of North Africa
PTA	1.87	0.40	0.19
Customs Union	5.94	4.54	-0.48
Common Market	8.46	6.40	1.32

Source: Bchir et al. (2006).

These types of results highlight the sizeable increase in GDP that could be generated from deeper integration that spans removal of market segmenting NTBs, services policies, and FDI limitations. However, the extant studies cover only a small number of PAFTA members and tend to ignore movement of labor and capital. As argued above, both are likely to be very important. Apart form partial studies focusing on remittances or return migration major there has been little investigation of the markets to which migration is best directed to and the type of migration that should be supported by PAFTA governments (temporary or longer-term; skilled vs. unskilled, etc). The recent non-PAFTA literature increasingly includes household survey data (e.g., work on Russia embeds information from some 50,000 households) into the models and disaggregates by region within the country; incorporates heterogeneity of firms and product variety, and allows for FDI and trade in services.

The focus of much of the recent PAFTA literature has been on outward migration to non-Arab countries, but history suggests that the creation of a common Arab labor

market would generate large movements and potentially large gains. Hoekman and Özden (2010) discuss options to facilitate movement of workers within the framework of trade agreements, focusing on the EU's partnership agreements with Arab countries. Existing frameworks for cooperation offer the possibility of expanding temporary rather than longer-term or permanent movement of workers since trade agreements provide scope for negotiating specific market access commitments for services, including those delivered through the cross-border movement of natural persons. Even though the potential for such "embodied" trade in services will not be anywhere near what would be associated with substantial liberalization of migration regimes, furthering the services trade dimension of trade agreements offers significant potential Pareto gains over and above the gains from greater trade in services. The gains from temporary movement of service workers are both direct – through greater employment/revenue – and indirect, by helping to increase and sustain higher growth.

A major constraint in doing research in this area is the absence of reliable and comparable data on flows and stocks. Statistics are scarce and of generally low quality – see Parsons et al. (2007). More generally, data constraints are among the most important determinants of the gap between "best practice" research on regional integration and research in the region in terms of methodology and rigor. Production, trade, investment and employment data is often patchy if not non-existent for a number of countries in the region, including large economies such as Saudi Arabia. The same is true of data on policies, including the extent and manner in which PTAs have actually been implemented. The knowledge gap is by far the greatest on basic data needed to undertake empirical analysis. Dealing with this issue requires both a multi-year focus and a cross-country, network, approach to the design of research projects.

6. Towards deeper integration of markets

Even if governments have no intention to use regulation or domestic policies for protectionist objectives, government measures will often have market segmenting effects simply because they differ from those implemented in partner countries, thereby imposing additional compliance costs on foreign products and producers. PTAs offer a potential mechanism to negotiate and agree on specific (common) norms that result in

lowering such costs. There are different possibilities (Hoekman and Winters, 2009). One model is "hegemonic convergence": a large country is essentially able to impose its own model on its partners, not necessarily coercively but by the force of its market size. This appears to be the path that Morocco and Tunisia are on – convergence with the EU in many areas (as a result of deepening of PTAs with the EU; the European Neighborhood Policy and (gradual) convergence with different parts of the EU's Acquis Communautaire).

An alternative model is "competition between rules" i.e. acceptance by governments of policies as being equivalent. This has been an important feature of the EU model of integration of product markets, constituting a major vehicle to reduce the market segmentation that is created by differences in norms. The European Commission and European Court of Justice have pursued vigorous action against limitations on the freedom of movement of goods, applying the principle of mutual recognition in the area of product standards. In the EU, the political sensitivity of the convergence route is much higher in services than it has been for goods, as is evident in the constrained liberalization of cross-border services espoused by the recent Services Directive in the EU and the difficulties that have affected efforts by the EU and the US to make progress in moving towards accepting each other's regulatory norms for specific services as being effectively 'equivalent'. In the PAFTA context there has been little concrete discussion or proposals put forward to address differences in regulation and the other policies mentioned above. It is important to note that cooperation on these policy areas – agreeing to specific disciplines – does not necessarily require a decision to move towards a customs union or common market, although depending on the type of cooperation that is agreed there may be a need for joint enforcement institutions.

Arab countries have generally failed to seriously implement most of the PTAs that have been agreed since the 1960s. Fawzy (2003) argues that concerns over the distribution of gains from integration across and within countries, issues of national sovereignty, and the cost of adjustment resulting from increased competition – i.e., a lack of mechanisms to compensate losers – explain the lack of follow through. This suggests a need to focus on the institutional mechanisms that can address these political economy factors that impede closer integration.

Whatever the type of PTA that is used by governments to promote integration of markets, institutional mechanisms are needed to guide and assist governments in living up to agreements and building on them. Given the economic success of the European integration process, many analysts have sought to draw lessons from the EU experience (see, e.g., Winters 2003 and Kheir-el-Din and Ghoneim, 2005). As is well known, the European institutional framework is based on a supranational approach, with four key bodies: the European Council, the Commission, the Parliament and the Court of Justice. The *Council* includes the heads or ministers of member states depending on the matters to be discussed. Members of the Council represent their respective countries. The *Commission* is composed of Commissioners from member states whose appointments are approved by the Parliament. The Commissioners are not representatives of their country, but are supposed to defend the interests of the Union. The Commission is responsible for the implementation and enforcement of the various Treaties and initiates legislation (directives and regulations). Over time, the Commission has been a strong driving force behind deeper integration in Europe. At many occasions, it has taken positions that are substantially different from those of the member states, Council, and Parliament. The *European Parliament* is directly elected. Its members act on the behalf of their electorates and are not representatives of their countries. The Parliament has the power to accept or reject the composition of the Commission, "censor" (dismiss) the Commission, and reject directives, The *European Court of Justice* comprises judges and 'advocates-general' appointed by member states. The court settles disputes among member states, between the EU and member states, between EU institutions, and between the EU and individuals. It has supranational power in being the ultimate arbiter of EU law.

Both the PAFTA and the GCC differ from the EU by following an intergovernmental approach. Like many previous Arab integration schemes, PAFTA was launched under Arab League auspices, an intergovernmental organization established in 1945. It is the "hub" organization that governs Arab regional integration, with several more specialized organizations falling under its umbrella (such as the Arab Monetary Fund). The main responsible body within the Arab League for implementing PAFTA is the Economic and Social Council (ESC). Established in the late 1970s, the Council plays a role in suggesting legislation related to economic integration and coordinates among the

members of the Arab League. Compared to the EU, the ESC represents a mixture of the European Council and the European Commission but has no executive power. The Arab League's charter explicitly assures the precedence of the sovereign autonomy of member states (Fawzy, 2003). Moreover, the League lacks formal mechanisms for conflict resolution. There is no equivalent body to the European Court of Justice. Although there is a framework that embodies all the necessary requirements for acting as a dispute settlement body, this is not binding (Hoekman and Messerlin, 2003). This implies that judgments made under the system may not be implemented, as the PAFTA does not allow economic sanctions to be imposed. Hence, the dispute settlement system lacks the necessary credibility to ensure effective implementation of the PAFTA.

The contrast between the EU (supranational) and the Arab (intergovernmental) approaches to integration reflects to a large extent the reluctance of Arab leaders to transfer a part of their sovereignty to supranational bodies. This feature of the status quo is rarely tackled by economists, although it is arguably at the heart of the problems that have confronted attainment of the regional integration objective. An important question is why European countries (much more culturally diverse than Arab countries) accepted such transfer of sovereignty while Arab states did not. The answer lies in the political framework of the Arab world (Hinnebusch and Ehteshami, 2002).

Arab governments are typically personalized and authoritarian. In such regimes the choices and style of the leader are decisive, particularly in a crisis or a critical bargaining situation. Although in personalized authoritarian regimes broad public opinion will have some impact in specific circumstances, given divisions within countries along class or ethnic lines leaders generally enjoy significant autonomy. Transfers of sovereignty might then be blocked because this is seen as detrimental to the interests of leaders, rather than because of an assessment that on balance the costs outweigh the benefits for the nation as a whole. Even if an authoritarian leader is willing to transfer some sovereignty, this may be precluded because of opposition by powerful elites that form his power base.

In addition to this general feature of authoritarian regimes, since their independence many Arab leaders have sought legitimacy through the Pan-Arabism strategy (e.g. Nasser in Egypt, Saddam Hussein in Iraq, Khadafi in Libya, etc.).

Hinnebusch and Ehteshami (2002) suggest that Pan-Arabism continues to have an effect on foreign policymaking in the region because state identities remain inferior substitutes for Arab identity in many Arab countries. The result is that legitimacy of regimes is in part contingent on being seen to act in Arab interests. For Arab leaders, this generates an incentive to promote Arab causes and seek to win over public opinion and "outbid" rivals in the promotion of such causes. The Pan-Arabism strategy has at times involved "politics" that aimed at pressuring, threatening and even discrediting other Arab states' leaders. Thus, perversely, Pan-Arabism also contributes to constrain Arab integration as a result of leaders playing a zero sum game at the regional level.

Can alternative mechanisms to support regional integration be identified that do not imply supra-national institutions and transfer of sovereignty? A two-track approach may be most fruitful in this regard: (i) focusing (limiting) cooperation efforts to specific policy issues where there are clearly defined benefits for specific groups/stakeholders; and (ii) greatly improving the transparency of status quo policies, their impacts and the implementation of regional integration initiatives.

Targeting cooperation

Focusing on areas of cooperation for which the issue of sovereignty is less problematic *and* the economic payoffs to joint action (cooperation) are significant should help increase support for regional integration initiatives. For example, Hoekman and Messerlin (2003) suggest that trade facilitation, through reforms in key services (public and private) that lower trade transaction costs, is a possible focal point. Given that red tape costs largely represent a social waste, reducing such costs can benefit the economy substantially, reducing costs for all traders while only putting pressure on a small subset of the civil service. Given that any specific land border by definition involves 2 countries, moving forward on trade facilitation requires cooperation. The same is true for enhancing the contestability of specific transport markets – such as air transport. Focusing on liberalizing the air transport market through an open skies type of agreement would enhance choice for consumers and transporters and lower prices: an initiative that benefits all sectors of economic activity. In such initiatives to lower trade costs and enhance connectivity of markets there will always be losers – the less efficient

incumbents and those who are able to extract rents from the status quo. To make progress, adjustment costs need to be taken into account – through gradual implementation and possibly explicit adjustment assistance programs that are financed by those who gain from the reforms. What is critical is that the focus be on reforms in areas and activities that have clear "winners" – and thus constituencies that will mobilize in support of implementing and sustaining the reforms.

Regional cooperation on specific investment projects that center on exploiting the large differences among many Arab countries in terms of labor and capital endowments is another possible focal point. As argued above, a precondition to realize such potential gains from trade is that the focus of policy attention shift from liberalization of trade in goods to liberalization of the other markets. Given that restrictions on trade and investment in services and labor movement are significant in much of the region, and, as important, there is significant uncertainty regarding the applicable policy and regulatory regime over time in these areas – reflected in the absence of binding commitments that are embedded in the PAFTA of GCC frameworks – focusing attention on the barriers and reducing uncertainty could have large payoffs.

Another potential area for deeper cooperation could involve the establishment of regional regulatory agencies to oversee network services (telecommunications, electricity, railways, air transport). Similarly, recent evidence shows that weak competition has a significant and negative impact on productivity growth in the region (Sekkat, 2008, 2009). Many of the countries in the region have adopted competition laws, but there are large differences in the substance of competition regimes. Only Tunisia has an independent Competition Authority, which helps explain why there are many more cases there than in Egypt or Morocco (where no cases have been reported to date). Cooperation in this field, building on the experience of Tunisia, could generate significant benefits. However, a problem with these policy areas is that notwithstanding their importance from a regional integration perspective, cooperation inherently will give rise to "sovereignty concerns" and thus may difficult to realize.

Enhancing transparency and accountability

A major feature of PTAs in the region is that they are black boxes: very little is known by experts, let alone the citizens and economic actors who are affected about how these agreements are implemented, nor has there been much ex post empirical analysis of the economic impact of implementation. In part the dearth of analysis is explained by the fact that Arab agreements often simply have not been implemented. As far as the more recent PTAs are concerned the length of time that has passed since tariffs were removed has been short. Significant value added could be created through a regular (annual) monitoring exercise in which each PTA is assessed in terms of implementation and operation: what was done by the constituent governance bodies? What was on the agenda and what was decided? Were commitments implemented? Was there backsliding?

Based on the results of a survey of trading firms, Hoekman and Zarrouk (2009) conclude that tariffs have mostly been removed on intra-PAFTA trade and that customs procedures are now perceived to be much less of a problem than in the late 1990s. Non-tariff barriers, in particular standards and rules of origin were reported to be factors constraining intra-regional trade in specific sectors such as foodstuffs and textiles and clothing, but overall, the major barrier to trade perceived by exporters and importers operating in PAFTA today are transport costs and weaknesses in trade facilitation. In 2001, tariffs were ranked as one of the most important barriers to intra-regional trade; in 2008 they were ranked last. Instead, transport-related infrastructure and real trade costs (trade facilitation) were ranked as the most important constraints. Thus, the survey confirms recent analytical studies that conclude that the magnitude of Arab trade flows is significantly lower than it would otherwise be as a result of high real trade costs (e.g., Dennis, 2006; Harb, 2008; Péridy, 2007; Abedini and Péridy, 2008). It suggests that from a policy perspective efforts to facilitate trade and reduce the incidence of non-tariff measures deserve priority.

While such ad hoc surveys are informative, what is needed is a regular process through which comparable data is collected on the "state of integration" of Arab markets. Hoekman and Zarrouk (2009) argue that a regular process of monitoring of the type implied by the survey – bringing in the private sector not only as a source of information but as a partner – can help to build public support for the process of regional integration

and taking actions to reduce trade costs and enhance competitiveness. An annual report that that is widely disseminated to the press and discussed with stakeholders (firms, investors, consumer organizations) in the Region would help raise the profile of the PTA agenda and enhance the perceived relevance of the initiative to key 'constituencies'.

A related important dimension of the implementation of PTAs is dispute settlement. This is a big missing element in Arab PTAs. In PAFTA, dispute settlement is non-binding. There is no panel system along NAFTA or WTO lines, let alone a standing body as in the EU. No retaliation is allowed or foreseen. As a result, very little is known about disputes and how they are resolved. This may reduce the private sector's perceived value of and interest in the PTAs. The absence of information on disputes may reflect in some degree a lack of awareness by firms of the "rights and obligations" created by a PTA. Better information on implementation should help address this problem. But even with better information the question is what firms and consumers can do to hold governments accountable.

Bown and Hoekman (2005, 2008) argue that PTAs need to be complemented by mechanisms through which firms can more easily (i.e., at lower cost) obtain information on potential violations of agreements and channels through which the behavior of government agencies can be contested directly by the private sector. Identifying specific proposals to do this in the context of Arab PTAs is yet another subject for research that could have high payoffs in enhancing the relevance and thus the "ownership" of PTAs.

7. Concluding Remarks

Regional integration is an important element of the international policy strategy of Arab governments. After a long period in which integration efforts were characterized by a lack of implementation, PAFTA and the GCC have become the main focal points for intra-Arab cooperation to integrate markets. To date PAFTA has focused on removal of barriers to trade in goods, with the first major milestone comprising the removal of tariffs on intra-PAFTA trade in January 2005. The next steps announced by PAFTA members include extending the PAFTA to cover services trade and investment and to reduce remaining NTBs. The GCC has a more ambitious objective of establishing a common market and a monetary union. Progress has been made in establishing a common external

trade policy, reflected in the common external tariff, but less has been achieved in integrating product and factor markets.

The literature analyzing the potential benefits of further liberalization of intra-Arab trade in manufactures (or more broadly, merchandise) concludes that these are unlikely to be large. Available data on trade in labor, FDI flows, as well as new information on policies affecting trade and investment in services and the magnitude of real trade costs all suggest there are greater potential gains from integration of these other markets. Using PAFTA as an instrument of cooperation to agree to lower barriers to trade in services, labor and capital could generate economic benefits that are much larger than what can be realized with respect to trade in goods – in part because doing so would help to enhance competitiveness on international markets by reducing costs for firms.

A key question then is what to focus on and how to pursue further integration of these markets. Efforts to convert PAFTA into a customs union or a common market of the type described in the international economics textbooks may prove to be difficult given the need to agree on common external and domestic policies in a variety of areas. The experience to date – both outside the region and within it (i.e., the GCC) – has illustrated the difficulty of obtaining such agreement. Whether or not deeper forms of integration such as harmonization are pursued, institutional mechanisms are needed to guide and assist governments in mobilizing and maintaining support for integration efforts. The economic success of the European integration process owes a lot to the creation and operation of supranational institutions that have the mandate to monitor and implement the integration provisions. In contrast, the PAFTA and the GCC follow an intergovernmental approach to the implementation of integration. The contrast between the European (supranational) and the Arab (intergovernmental) approaches to integration reflects the reluctance of Arab leaders to transfer sovereignty to supranational bodies.

Credible paths to further Arab integration will likely imply no or very little in the way of supra-national institutions and transfer of sovereignty. This suggests focusing on areas of cooperation for which the issue of sovereignty is less problematic but the economic payoffs to joint action are significant. We have argued that at present there is relatively limited scope for using trade in goods as the driver of integration – reflecting the fact any significant increase in intra-regional trade in manufactures is conditional on

the development of a deeper industrial base and capacity in the countries that are better endowed with labor. Such development in turn is conditional upon greater investment in manufactures, including through inflows of FDI, which depends in part on removing the barriers and constraints that inhibit such investment. Areas in which potential economic payoffs of targeting cooperation to further integrate markets appear to be significant include producer services (including through FDI from any source, in or outside the region); certain social services (e.g., higher education) and factors of production (labor – temporary movement of people; investment capital). All of these are key "inputs" that determine the productivity and competitiveness of firms located in Arab economies.

Data availability and quality plays an important role in constraining assessments of the impact and magnitude of national regulatory policies affecting the movement of goods, services, labor and capital. Addressing this lacuna is important and urgent from both a policy and research perspective. A number of areas for research cannot be effectively pursued given the current state of available data on policies and outcomes (stocks, flows). The absence of timely and comprehensive data in turn greatly impedes accurate assessments of the potential gains from further integration in specific areas, and ex post assessments of what the impacts have been of implementation of the PTAs. A concerted effort to regularly collect and disseminate timely information on the implementation of the Arab PTAs is a precondition for identifying/designing policies and institutional mechanisms to harness regional integration efforts to promote greater economic prosperity for the region as a whole.

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