N}egotiations between African, Caribbean and Pacific countries (ACP) and the European Union (EU) are in progress with the aim of concluding new Economic Partnership Agreements (EPAs) to replace the previous trade and cooperation arrangement of the Cotonou Agreement. Time is running out, however, and the initial schedule for finalising a new treaty by the end of 2007 at the latest is probably already at risk. EPAs are still the subject of fierce international discussion. While certain non-governmental organisations (NGOs) insist on seriously and urgently assessing alternative(s) (to) Economic Partnership Agreements,1 ACP countries and the EU are still continuing their negotiations after having postponed the agreed review of alternative options for ACP countries not willing to enter into and sign an EPA with the EU from 2004 to the end of 2006.

Numerous studies assessing the EPA impacts on trade, growth and budgets have contributed to the ongoing discussions and negotiations, but could not capture all the relevant effects or failed to estimate their size with sufficient accuracy and probability. This is due in part to the weak statistical basis of the (mostly least developed) ACP countries; this often prohibits more advanced modelling. Moreover, previous analyses are based on standard assumptions which may not be fulfilled in reality. This leaves discussants, negotiators and decision-makers in an extremely uncomfortable situation of considerable uncertainty.

**Institutions, Trade and Growth**

In order to reduce this ambiguity and to assess the probability of anticipated or desired EPA effects, we reconsider one of the most crucial assumptions made in previous analytical work on EPA impacts, i.e. the functioning of the adjustment mechanism due to trade liberalisation in less developed environments.

It is commonly assumed in EPA-related impact studies that production factors such as labour and capital can move at no cost between industries within a country. Obviously, this is a naive view of the interaction of the participants in an economy. The reallocation of factors, i.e. a shift of capital and labour from the (declining) import-competing sector to the (expanding) export sector due to trade liberalisation, is associated with adjustment costs. For this shift of resources, the regulatory quality, as one important area of institutional quality, matters for the interaction of trade and economic growth in particular. For welfare gains from trade to materialise, the necessary institutions2 must be in place to assure effective competition and a smooth structural adjustment process.

This hypothesis has been tested in an extensive empirical analysis of the linkages between trade, institutions and growth with special focus on the Economic Community of West African States (ECOWAS) as one of the six EPA groupings.3 The results support our hypothesis. First of all, countries with excessive regulations cannot take advantage of trade. For example, in these countries trade-induced adjustment costs may exceed the welfare gains from increased trade

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1 Sanoussi Bilal and Francesco Rampa: Alternative (to) EPAs. Possible scenarios for the future ACP trade relations with the EU, ECPDM Policy Management Report 11, Maastricht 2006.


3 Matthias Busse, Axel Borrmann, Silke Neuhaus: Trade, Institutions and Growth: An Empirical Analysis of the Proposed ACP/EU Economic Partnership Agreements for ECOWAS Countries, Preliminary Study on behalf of the Friedrich-Ebert-Foundation, Hamburg 2006; available on request via busse@hwwa.de.
through specialisation and the exchange of goods and services. Excessive regulations are either part of the institutional setting or they can be the outcome of a particular setting.

Second, among a set of 17 different indicators for institutional and regulatory quality, there are three indicators that matter most for the successful dismantling of trade barriers. Above all, the most significant results can be obtained for market entry regulations (starting a business), labour market regulations, and paying taxes. Starting a business describes the costs and time required to set up a new company, whereas labour market regulations measure the flexibility of hiring and firing and employment conditions. Paying taxes measures the amount of taxes a company has to pay and the quality of the tax authorities.

In particular the first two regulation indicators are very important for the reallocation of factor resources within a country, which is a prerequisite for harnessing the gains from trade. For example, high market entry barriers lead to less entry, which impede local entrepreneurs from taking full advantage of export opportunities abroad. Excessive labour market regulations impede the efficient reallocation of labour, i.e. a shift of workers between industries and/or the allocation of workers to the most productive firms.

However, the results do not imply that the other 14 institutional and regulatory indicators, such as government effectiveness, control of corruption, democratic accountability, political stability and other forms of regulation, do not matter for economic growth rates. Rather, it simply means that the indicators emphasised are more important for the relationship between trade and income/growth. Moreover, the results obtained reinforce the general belief that countries have to reform their regulatory framework to be able to benefit from increasing regional, inter-regional and/or global integration.

Institutional Quality and Performance in ECOWAS

A benchmarking for the ECOWAS, as the third major result, reveals that the large majority of the 16 West African countries are most unlikely to benefit from an increasing integration into the world economy with their present institutional setting. Countries from this regional EPA grouping show scores for the most important indicators that fall precisely into the category of countries that are not able to benefit from trade.

As can be seen from Table 1, the overall regulation intensity in developed countries is far lower (average regulation index of 4.65) than in developing countries (-1.30). What is striking, however, is the very low scores for sub-Saharan African countries, with an average of -3.32 for the aggregated index and consistently negative figures for all ten disaggregated indicators. What is more worrying is the fact that the scores for the average regulation indicator and the majority of disaggregated indicators are even lower for ECOWAS countries than for the other sub-Saharan African countries. Among the ten disaggregated indicators, ECOWAS countries have, on average, particularly low scores for registering property, dealing with licences, labour market regulation, getting credit, and starting a business.

A few examples demonstrate that the institutional quality is even worse if we go beyond averages and look at individual ECOWAS countries and specific business regulations:

- entrepreneurs in Sierra Leone have to pay 835 per cent of (national) income per capita to start a business;
- the cost of firing an employee in Mali is equivalent to some 81 weeks’ wages;
- firms in Sierra Leone which intend to pay their taxes in full would have to part with 164 per cent of their gross profits, that is, everything they earn and more;
- to import a product into Niger, it takes 19 documents, requires 52 signatures and takes 89 days to deal with the required paperwork and customs inspections;
- the judicial procedures for the enforcement of a contract in Burkina Faso take 446 days and cost some 95 per cent of the debt, i.e. almost the entire disputed amount;
- to register a property in Nigeria, the owner has to part with 27 per cent of the property value.

Though these are admittedly extreme examples, business regulations in West Africa often fail even on their own terms: higher tax rates do not always bring in more revenue, and the most tightly regulated labour markets do not always offer the best protection to workers. Rather, extremely inflexible business regulations drive firms and workers into the informal economy, beyond the reach of inspectors, trade unions and tax authorities. Needless to say, working conditions

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