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RSCAS 2016/29
Robert Schuman Centre for Advanced Studies
Global Governance Programme-219

Deep and Comprehensive Free Trade Agreements

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EUI Working Paper **RSCAS** 2016/29

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ISSN 1028-3625

© Bernard Hoekman, 2016

Printed in Italy, May 2016

European University Institute

Badia Fiesolana

I – 50014 San Domenico di Fiesole (FI)

Italy

www.eui.eu/RSCAS/Publications/

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Abstract

This paper reviews elements of the history of association agreements between the EU and countries that are covered by the European Neighbourhood Policy (ENP). It considers the rationale for negotiation of Deep and Comprehensive Free Trade Areas with neighbouring countries based on research that assesses the design, salience and incentive effects of such agreements. It makes a case that developments in the global economy and the experience with using trade agreements to pursue deeper integration of markets suggest that alternatives to DCFTAs may be more effective instruments for cooperation for both sides. The 2015 review of the ENP creates new opportunities to consider such alternatives. These could span sectoral agreements, more focused efforts targeting specific policy areas that have a significant impact on trade costs, and initiatives that centre on the adoption of international standards and internationally recognized good regulatory practices.

Keywords

European Neighbourhood Policy; DCFTAs; Association Agreements; Euro-Mediterranean Partnership

Introduction

Trade agreements have been a central feature of the EU's engagement with countries in the 'European neighbourhood', both those that were (are) eligible for EU membership and those that are not. Trade agreements have also been a core element of the EU's engagement with countries in the rest of the world. The EU, as did the European Economic Community in the pre-1993 period, has negotiated numerous trade agreements aimed at reducing or removing barriers to trade, reflecting a long history of using trade as an instrument of foreign policy. The Union currently has 53 preferential trade agreements (PTAs) in place, with another 80 or so in the pipeline – both agreements that have been negotiated and are waiting ratification and agreements that are in the process of negotiation (e.g., the Transatlantic Trade and Investment Partnership with the United States).¹ The latter number includes many African, Caribbean and Pacific (ACP) former colonies of European countries. Historically, these were granted nonreciprocal trade preferences that were more beneficial than those offered to other developing countries, a situation that required periodic waivers by the WTO membership. Increasing resistance to granting such waivers led to the launch of negotiations on so-called Economic Partnership Agreements in the last decade, which required reciprocity from partner countries. Many of these have yet to be concluded successfully.

Over time both the design and content of the EU's trade agreements has evolved substantially.² This paper focuses on the evolution of approaches taken by the EU towards reciprocal trade agreements – treaties under which access is granted to EU markets in return for specific liberalization commitments and other policy reforms by partner countries. More specifically the focus is on the shift from 'shallow' trade agreements that centre mostly on the liberalization of merchandise trade towards 'deeper' trade agreements that also liberalize trade in services, public procurement markets, and cross-border investment and include disciplines on the implementation of national regulatory regimes. This shift was part of the 2004 European Neighbourhood Policy (ENP), which was put in place with the aim of providing a framework for engagement with the EU's 'neighbours' to the east and the south. The ENP makes provision for interested governments to negotiate Association Agreements that include the establishment of a 'Deep and Comprehensive Free Trade Area' (DCFTA) between the EU and partner countries.³

DCFTAs have not had a very successful track record. Take up has been limited. As of early 2016, only four DCFTA negotiations have been concluded: with Armenia, Georgia, Moldova and Ukraine. Those with Georgia and Moldova began to be applied on a provisional basis in 2014; the one with Ukraine became operational in January 2016. DCFTAs with the Eastern Partnership (EaP) countries became a focal point of contention with Russia, which opposed them. It sought – unsuccessfully – to convince Ukraine to become a member of the Eurasian Economic Union (EEU). In the case of

¹ See http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf, accessed March 25, 2016. These numbers do not include initiatives through which the EU grants preferential access to its markets on a unilateral (non-reciprocal) basis to developing countries.

² Non-reciprocal market access programs have come to focus more on the poorest countries, with the 2001 'Everything But Arms' initiative offering duty- and quota-free access for all goods originating in economies designated as a least developed country (LDC) by the United Nations. Other developing countries with per capita income below US\$4,125 (the threshold above which a country is classified as an upper middle-income economy by the World Bank) benefit from less generous trade preferences that cover around two-thirds of all product categories, with the possibility of full removal of tariffs if governments take action to ratify and implement specific international conventions pertaining to human and labor rights, protection of the environment and good governance.

³ The meaning of the letter A in the DCFTA acronym is somewhat ambiguous, as both the European Commission and analysts interchangeably use either 'areas' or 'agreements'. In principle Association Agreements provide the overall framework for relations between the EU and ENP countries; DCFTAs are a specific type of free trade area that are established by the relevant (bilateral) agreements.

Armenia, however, Russian pressure led the government to decide to join the EEU, so that the DCFTA that was negotiated in 2013 never entered into force. Following the Arab spring uprisings in 2011, the European Council agreed to a negotiating mandate for DCFTA talks with Egypt, Jordan, Morocco and Tunisia. To date only two of these countries, Morocco and Tunisia, entered into negotiations. Negotiations with Morocco were halted in July 2014 at the initiative of the Moroccan government in order to assess the potential impacts on its industry, reflecting concerns about the net benefits of a DCFTA and worries that an agreement would not have enough domestic support.⁴

There has been a global trend for trade agreements to address ‘behind-the-border’ policies that impact on bilateral trade and investment flows. In this regard the shift to DCFTAs in the context of the ENP therefore is not unique. The EU has also been negotiating deeper trade agreements with non-ENP countries – recent examples include a ‘new generation free trade agreement’ with the Republic of Korea (described as such on the DG Trade website); a Comprehensive Economic and Trade Agreement (CETA) with Canada; and ongoing talks with Japan on a EU-Japan ‘economic partnership’ and with the US to create a ‘transatlantic trade and investment partnership’. These initiatives are not called DCFTAs, although they address behind the border policies, procurement, services and investment issues. They differ from DCTFAs because the latter are explicitly linked to various elements of the *acquis communautaire*. This reflects the fact that DCFTAs are intended to be instruments to support convergence in the partner country with specific areas of EU legislation and regulation that pertain to the operation of the Single Market.

The pursuit of deeper trade agreements with OECD member countries implies that alternative approaches can be pursued to foster greater integration of markets, and that convergence to the *acquis* is not necessarily needed in order for partner countries to sell goods and services on the EU market and for firms to be able to invest and establish commercial operations in EU countries. DCFTAs differ from other types of PTAs in that they involve significant convergence towards EU norms and legislation, but do not offer the partner countries much of a say, if any, on what the rules of the game are. The presumption is that what is embedded in the *acquis* is appropriate for partner countries even if they are not accession candidates. Whether DCFTAs help to address prevailing constraints to growth in a partner country – which will generally differ across countries – or do so in a manner that minimizes the ratio of costs to benefits are important questions for countries that have no prospect of acceding to the EU (Hoekman, 2011; Messerlin et al. 2011). Thus a policy question for both the EU and the ENP countries is whether DCFTAs are the best instrument to use.

The discussion that follows starts in Section 1 with a brief review of some of the salient history of trade agreements between the EU and ENP countries and the rationale for negotiation of DCFTAs with interested ENP governments. Section 2 discusses elements of the relevant research literature on the economic effects of DCFTAs, including ex-ante impact assessment studies commissioned by the European Commission (DG Trade) to inform the negotiations. Section 3 considers a number of broader trends in the global economy and developments in the coverage and design of international trade agreements. This illustrates that alternative approaches to deepen integration of product markets might be considered by ENP countries and the EU. Section 4 concludes.

⁴ Matters were further complicated in early 2016 following the decision by the Moroccan government to suspend all contact and cooperation with EU institutions following a ruling by the General Court of the European Union (the EU’s first instance court) in a case brought by Frente Polisario (the National Liberation Movement for Western Sahara) against the Council. The Court annulled a 2010 agreement liberalizing trade in agricultural products with Morocco insofar as these pertained to products originating in Western Sahara, finding that Morocco violated fundamental rights of inhabitants of that territory. The ruling was appealed by the Council to the ECJ; a related case against a fisheries protocol is ongoing. See, e.g., Van der Loo (2016).

1. From shallow to deeper integration with neighbouring countries

The ENP was intended to provide a framework for deepening economic as well as non-economic relations with neighbouring countries that were not EU accession candidates. The primary motivation for the ENP was the 2004 enlargement of the EU to encompass eight former centrally-planned Central and Eastern European countries.⁵ The goal was to offer neighbours of the newly acceded member states opportunities to deepen cooperation with the enlarged EU and to replicate and build on approaches and mechanisms that had been used by the EU to improve economic policy, institutions and democratic governance in the recently acceded countries. The ENP became the ‘umbrella’ for subsequent initiatives targeting cooperation with countries located to the south of the EU – the 2008 Union for the Mediterranean (UfM) – and those to the east of the EU – the 2009 Eastern Partnership (EaP).⁶

The ENP seeks to deepen relations through more extensive political dialogue, economic integration and improved access to EU Community programs. Basic principles underpinning cooperation under the ENP are commitment to common values, including democracy, the rule of law, good governance and respect for human rights, and complementing binding treaty-based cooperation with financial and technical assistance from the EU. A key feature is to offer partner countries the opportunity to converge to EU norms and standards in specific areas of regulation on a *à la carte* basis without however giving countries a seat at the table in the elaboration of norms. The approach has often been characterized succinctly by the phrase: ‘everything but institutions’.

Specifically, the ENP has three objectives: (1) to support the national development strategy of partner countries; (2) integrating partners into parts of the EU economic and social structures, especially those relating to the Internal Market; and (3) implementation of negotiated Association Agreements (European Commission, 2004). The aim is opening up markets to trade and investment and convergence with EU norms and legislation—i.e., the *acquis* (competition policy, social norms, provisions to support free trade in services, etc.). The presumption is that harmonization with (some) EU laws and regulations will both deepen integration with the EU and promote economic development. At the same time it is recognized that administrative and implementation capacity and priorities differ across countries. This is reflected in the *à la carte* nature of the ENP framework, as well as the provision of aid via a European Neighbourhood and Partnership Instrument (ENPI).⁷

Before discussing DCFTAs it is helpful to discuss the experience of the Euro-Mediterranean Partnership (EMP), which eventually was incorporated into the ENP. Launched in 1995 in Barcelona, the objectives of the EMP were to achieve reciprocal free trade between the EU and Mediterranean countries for most manufactured goods; enhance market access for agricultural products; establish conditions for gradual liberalization of trade in services and investment; and encourage economic integration between Mediterranean partner countries. The EMP did not create any prospect for eventual accession of any of the partner countries to the EU, as is also the case for the EaP countries.

Bilateral trade agreements were a core feature of the EMP. As noted in the European Commission's request for EMP negotiating authority in 1994: “in order to be able to enter progressively into free trade with the Union and to take on board a wide range of trade-related Community regulations

⁵ In 2004, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia joined the EU. In 2007, two more Eastern European states acceded: Bulgaria and Romania.

⁶ The ENP encompasses ten Mediterranean economies—Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia—and six countries located to the east of the EU: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. In addition to the Mediterranean states covered by the ENP, the UfM also includes Mauritania, Turkey and Western Balkan countries. See Cardwell (2011) for a discussion of the genesis and development of these initiatives; Del Sarto (2015) for an assessment of the EU's underlying goals and references to the literature.

⁷ See European Commission (2004), Emerson and Noutcheva (2005), and Dodini and Fatini (2006) for early discussions of economic dimensions of the ENP.

(customs, standards, competition, intellectual property protection, liberalization of services, free capital movements, etc.) ... Mediterranean countries ... insist on ... the need for long transitional mechanisms and secure safeguards; the need to obtain improved access for their agricultural exports; the need for increased financial flows ... [and] the possibility to count on the Community's help to accelerate the modernization of their social and economic systems.”⁸ These various elements – reciprocal trade liberalization and gradual convergence towards EU norms and regulations complemented by technical and financial assistance – have been core features of the EU’s approach in both the Mediterranean and in the East since the mid-1990s.

The first EMP Association Agreement, negotiated with Tunisia, was signed in July 1995 and entered into force in 1998, following ratification by EU member states. An agreement with Morocco followed in October 1995 (entry into force in 2000). Subsequent agreements were negotiated with Jordan (November 1997, ratified in 2002), Israel (2000), Algeria (2001, ratified in 2005), Egypt (2001, ratified in 2004), and Lebanon (June 2002, ratified in 2004). Each agreement is unlimited in duration, with implementation spanning a 12 to 15 year transition period for full implementation. The agreements all have similar elements: (1) reciprocal liberalization of movement of goods; (2) provisions on the right of establishment (investment) and the supply of services; (3) competition policy and other economic provisions; (4) regional integration; (5) economic, social and cultural cooperation; and (6) financial assistance (development grants and concessional loans).

Many of the articles in the agreements call for cooperation across a broad array of economic, financial, social, and cultural areas. This reflected a recognition that much needed to be done to improve economic governance and the business environment so as to increase the competitiveness of local firms, address implementation costs and bolster domestic regulatory regimes and administrative capacities. Instruments of economic cooperation under the EMP included information exchange, provision of technical assistance, support for joint ventures and twinning arrangements, as well as funding for upgrading infrastructure and institutions.⁹

The market access dimension of the EMP agreements is shallow in nature. Trade liberalization is restricted to goods and does not include services. Transition periods were long – up to 15 years – and agricultural trade liberalization was confined to limited expansion of quotas that are allowed to enter EU and partner markets free of duties. While subsequent sectoral protocols were agreed that expanded agricultural access on a reciprocal basis, trade remained restricted for sensitive products on both sides of the Mediterranean. As noted at the time,¹⁰ the structure of liberalization commitments implied increasing effective rates of protection for many industries in partner countries, while the exclusion of services and investment meant that firms would not have access to the most efficient suppliers of key inputs. The right of establishment (i.e., freedom to engage in FDI) and liberalization of cross-border supply of services were objectives, not commitments. Liberalization of government procurement markets was also aspirational—no binding disciplines or timelines were specified. In all these important areas of trade policy the agreements called for the launch of negotiations at a future point in time.¹¹

⁸ "Strengthening the Mediterranean Policy of the European Union: Establishing a Euro-Mediterranean Partnership," Communication from the Commission to the Council and the Parliament, October 1994.

⁹ Financial assistance was an important dimension of the EMP. Between 1995 and 2006 some €8.7 billion was disbursed as grants, with about 10 percent of the total targeting regional (multi-country) projects. In addition to the grants, the European Investment Bank (EIB) provided loans. As of the end of 2004, these added up to around €12 billion (Hoekman, 2007).

¹⁰ See, e.g., Hoekman and Djankov (1996, 1997) and the contributions in Galal and Hoekman (1997).

¹¹ The agreements called for adoption of the basic competition rules of the EU as regards collusive behaviour, abuse of dominant position, and state aid measures affecting trade between the EU and each partner country, with implementing rules to be adopted by the Association Council within five years of the entry into force of the agreement.

A feature of the EMP was the promotion of greater integration between the Mediterranean countries. A set of bilateral agreements between the EU and individual Mediterranean countries may cause firms to locate in the EU and export to partner countries. The prospect of a hub-and-spoke pattern of investment and trade therefore creates incentives for Mediterranean partner countries to liberalize trade (and investment) flows between themselves and to adopt a system of regional rules of origin. Steps in this direction were taken: in the second half of the 1990s Arab League members agreed to remove all barriers to trade in goods under the umbrella of a Pan-Arab Free Trade Area (PAFTA) agreement which led to the removal of most tariffs on intra-PAFTA trade by the late 2000s (Hoekman and Zarrouk, 2009). In 2004, Jordan, Egypt, Morocco and Tunisia concluded the Agadir Agreement, which established a free trade zone among the four nations and included the adoption of a harmonized set of rules of origin that permits cumulation and that is accepted by the EU.¹²

The goal to create a Euro-Mediterranean Free Trade Area by 2010 was effectively abandoned with the launch of the 2008 Union of the Mediterranean initiative which was intended to ‘re-boot’ the EMP by focusing it more on concrete areas of joint interest to both sides of the Mediterranean (Kausch and Youngs, 2009). In part the failure to establish a Mediterranean PTA reflected continuing political disagreements between some country pairs – e.g., Morocco and Algeria.

Assessments suggest the impacts of the EMP were limited.¹³ Trade policy in partner countries became less restrictive, with the average tariff falling to the 10-12 percent range in the mid-to late 2000s. However, this reflected unilateral reforms, and intra-Arab liberalization as well as EMP-based reforms. Tariffs on intra-Arab trade were largely removed; progress was made to improve Customs administration and some indicators measuring the business environment improved (Hoekman and Sekkat, 2010). It is difficult to calculate how much of this should be attributed to the EMP, but clearly it played a role by generating greater incentives for liberalization, in part to reduce trade diversion. Less progress was made with respect to nontariff barriers (NTBs). Numerous NTBs continue to restrict trade (Augier et al. 2013)—administrative red tape, products standards that do not conform to international norms, restrictive rules of origin and weak trade facilitation performance. More generally the hoped for private sector dynamism and associated diversification and employment creation did not materialize. Continued dominance of the State, reflected in a pattern of ‘crony capitalism’ and reliance on the government as a provider of employment (see e.g., Rijkers et al. 2014 on Tunisia) limited the ability of firms to grow and reduced incentives to invest.¹⁴

Bilateral trade costs for Mediterranean countries are double those in EU countries, especially for trade between Arab countries (Shepherd, 2011). The cost differentials relate mainly to distance, trade logistics, and the effect of NTBs. Trade costs are consistently higher for agricultural products than for manufactured goods. This reflects the higher transportation costs (per unit value) and time sensitivity of perishables, but also the impact of NTBs such as tariff-rate quotas and food standards. Research has found that geographic advantages in terms of connectivity to the EU are more than offset by trade and transactions costs. These are high in part because markets for logistics services, including trucking, are fragmented by country, with many small providers and few incentives for consolidation and efficiency gains (Malik and Awadallah, 2013).

Although tariffs on EU manufactured goods in partner countries fell significantly, as did tariffs on trade between partner countries, as noted, full liberalization of agricultural trade was not on the agenda of the EMP. Liberalization was limited to expanded tariff rate quotas, complemented by technical assistance to attain EU standards, with particular focus on sanitary and phytosanitary (SPS) norms and

¹² Augier, Gasiorek and Lai-Tong (2005) analyze the impacts of rules of origin as a constraint to regional trade. Péridy (2007) provides an ex ante assessment of the potential economic impacts of the Agadir agreement.

¹³ See, for example, IMF (2006) and the contributions in De Wulf and Maliszewska (2009) and Ayadi et al. (2015).

¹⁴ On (lack of) progress in these areas, see, e.g., Péridy and Roux (2012), Hoekman and Sekkat (2010) and Augier et al. (2013).

rural development. Mediterranean countries were hesitant to discuss services policy reforms with the EU. Talks to do so were supposed to be launched 3 to 5 years after the entry into force of the respective Association Agreements, but were only initiated much later, if at all, and did not make much progress. Conversely, the EU has been reluctant to liberalize services trade occurring through the temporary movement of service suppliers. Services trade and investment liberalization is arguably the biggest area of omission from the EMP trade agreements (Hoekman and Konan, 2001; Konan and Maskus, 2006). Services are of great importance for growth and employment, given that firm-level productivity and thus competitiveness depends on the costs, quality and availability of a broad range of services. Excluding services and investment from liberalization implied large opportunity costs for EMP countries (Montalbano and Nenci, 2014) and may help explain why ex post assessments of the EMP conclude that trade effects were asymmetric, with imports from the EU growing much more than exports to the EU (e.g., Hagemeyer and Cieslik, 2009).

2. DCFTAs

The move in the late 2000s to negotiate DCFTAs and focus more specifically on integrating markets was a significant shift in approach by the EU. Much has been written by scholars and civil society groups about the associated reduction in attention and emphasis by the EU on ‘exporting’ its fundamental values – human rights, political freedoms, etc. and the implied turn to focus more on economic policies affecting market access and related regulation (see e.g., Kausch and Youngs, 2009; Bauer, 2015). Less attention has been given in the literature to the political economy of DCFTAs (Monastiriotis and Borrell 2012 is an exception).

The big change associated with DCFTAs was that they are far more prescriptive. DCFTAs are similar to the EMP trade agreements in terms of issue areas covered, but they differ substantially in the approach taken to address them. Instead of extensive ‘soft law’ language, they establish specific, binding (enforceable) disciplines and aim at the (gradual) convergence of policies in covered areas with those of the EU.

Examples of policy commitments in extant DCFTAs with EaP countries include the following:

- Abolition of import tariffs on both agricultural and industrial products. The extent of inclusion of agricultural products is a big difference compared to the EMP agreements, although coverage of agriculture in DCFTAs depends on the partner country. Thus, the agreement with Ukraine has 10-year transition periods for the EU to remove tariffs on many items, and tariff quotas will remain on ‘sensitive’ products.
- Provisions on Customs and trade facilitation, including the substance and administration of Customs laws and regulations, which reflect EU norms.
- National treatment for investors (right of establishment) (subject to exceptions) .
- Enforcement of competition policy, with alignment of rules and enforcement practices to that of the EU *acquis* in a number of areas, applying equally to private as well as state-controlled enterprises. Partners are also to adopt disciplines on state aid (subsidies) that are similar to those in the EU.
- Commitments to apply EU product standards and norms for food, animal products and industrial goods and to put in place effective enforcement mechanisms to assure compliance. Partners are to gradually align technical regulations, standards and related infrastructure with those of the EU, and may seek to negotiate agreements on conformity assessment and acceptance of industrial products in the future. Such agreements would allow trade in covered sectors to occur under the same conditions as those prevailing in the Internal Market, i.e., partner country products would be treated as EU products and vice versa.

- Requirements to protect intellectual property rights (IPRs) and apply the EU's internal rules in this area, including for geographical indications (GIs) – with transition periods for some products to allow producers to establish trademarks or their own GIs;
- Agreement to open government procurement markets to EU competition (excluding defence-related purchases) through gradual adoption of all EU laws and procedures.
- Measures to open access to services markets. In the case of Ukraine, a process of legislative approximation in financial services, telecommunications services, postal and courier services, and international maritime services involves adoption of both the existing and future EU *acquis* in these sectors.

Space constraints prohibit a detailed discussion of the content of a DCFTA.¹⁵ Suffice it say that the focus is on areas where there are common EU policies, going beyond opening up partner markets to include disciplines aimed at ensuring markets are contestable and aligning policies that are the same or equivalent to those in EU in different areas of product market regulation (standards, competition policy and protection of IPRs, as well as certain service sectors). DCFTAs build on WTO rules and practices – the WTO is the baseline – but go beyond the WTO in many of the covered areas.¹⁶

There is much discussion in the literature what the EU's specific objectives are in negotiating DCFTAs, with some arguing they are an exercise in the projection of EU norms and others arguing that they should mainly be seen through a neo-realist lens – as efforts to ensure the security of the EU member states by reducing migration incentives, ensuring access to natural resources (energy), etc. Whatever view is taken, a necessary condition for realizing any of these objectives is that the DCFTAs result in higher growth and rising incomes in partner countries. Ex ante analyses of DCFTAs conclude that this will be the case, although specific industries and workers and communities that rely on these industries will be negatively affected as a result of greater competition from the EU.¹⁷

Most of what is called for in a DCFTA revolves around national policy reforms by partner countries. Thus, much of what could be achieved through a DCFTA could in principle also be obtained through unilateral, autonomously implemented policy changes. This point is illustrated by Georgia, which was already more open to trade and investment than the EU was when it negotiated its DCFTA; it also had already implemented significant economic governance reforms (Messerlin et al., 2011). This raises the question what the value is of a DCFTA to a partner nation. While better access to the EU is certainly beneficial, EU markets are already relatively open. Insofar as a partner country has relatively high barriers to trade, preferential liberalization that extends only to the EU may generate trade diversion and create rents that accrue to EU firms instead of lower prices for consumers.

For the EaP countries it is clear that a central factor for pursuing a DCFTA (or, instead, refusing to engage with the EU) was whether on balance a country sought to become less susceptible to Russian hegemony. For countries where this was (is) the case, the balance of economic costs and benefits of a DCFTA may matter less than whether a DCFTA provides a robust framework that helps deliver greater economic independence. This is not obvious, as making the *acquis* the focal point of sector-

¹⁵ See Van der Loo, Elsuwege and Petrov (2014) for a comprehensive discussion and assessment of the DCFTA with Ukraine.

¹⁶ A precondition for the EU to negotiate a DCFTA is that the partner country is a WTO member. Extant DCFTAs with EaP countries do not include investor protection or investor-State dispute settlement provisions – because this was still a member state competence at the time they were negotiated.

¹⁷ Thus, Jensen and Tarr (2011), Movchan and Giucci (2011), and Shepotylo (2013) concur with the SIA undertaken for the EU in estimating substantial net welfare gains from a DCFTA for Ukraine, due mainly to better market access on EU markets for exports, and productivity gains from the deep aspects of the agreement, one of the consequences of which is a significant reduction in policy uncertainty facing investors.

specific provisions of the DCFTAs may have impeded progress on the ‘independence’ objective. Indeed, adoption of the *acquis* created a prospect that partner country firms would have to deal with two incompatible regulatory regimes (EU vs. Russia), and associated worries by Russian enterprises that they would be negatively affected by the adoption of EU norms and standards by ENP countries.

More generally, for countries that do not neighbour Russia the question is whether a DCFTA provides a useful guidepost and anchor for policy. This has several dimensions. First, does the *acquis* add value relative to a strategy that instead focuses on satisfying international standards for products, internationally agreed norms for good regulatory practices, internationally developed guidelines for public procurement policies, etc.? That is, does it have value in and of itself by representing international best practice? If not, it may still make economic sense to adopt the *acquis* if by far the largest share of the country’s trade is with the EU. But for countries that have a more diversified set of trading partners the question should be what the (opportunity) cost is of not converging (completely) with EU norms. This is also a relevant consideration for countries that do trade a lot with the EU. Many non-neighbour countries that trade intensively with the EU have not adopted the *acquis*, illustrating that convergence to EU norms is not a necessary condition for deeper trade relations with the EU.

Abstracting from the economic net benefits of adopting the *acquis*, DCFTAs may enhance policy credibility. Adoption of international good practice standards and norms will only be associated with domestic enforcement mechanisms, except insofar as commitments can be made in the WTO.¹⁸ Credibility ultimately requires that there are actors that have an incentive to take a matter to court. Part and parcel of a DCFTA is regular monitoring, dialogue and potentially enforcement action by the EU to address instances when a partner country does not implement relevant provisions that are legally binding. If a country attaches value to this enforcement dimension it should take that into consideration when deciding whether to adopt elements of EU law as part of a DCFTA. This depends of course on the extent to which the EU provides the desired monitoring and enforcement services.

A third consideration is that the EU will provide technical and financial assistance to bolster implementation capacity. But such assistance is also available from other sources, including the multilateral development banks and specialized agencies (e.g., EBRD, IMF, UN, World Bank, African Development Bank, Islamic Development Bank as well as bilateral donors). And the EU is likely to provide assistance independent of signing a DCFTA. Although this may be at a lower level than what is associated with *acquis*-based agreements, to some extent this will be offset by that fact that the country will not need to incur all of the costs associated with implementing EU rules and norms.

These questions require case-by-case analysis and the answers will depend on the objectives of partner countries, their geography and the structure of their economies. As mentioned, in practice, decisions to pursue a DCFTA may have less to do with economics and center more on political and foreign policy motivations – e.g., a hope to eventually accede to the EU (notwithstanding clear statements from the EU that this is not on the table); or a desire to become less dependent on – vulnerable to – Russia. Even so, an economic perspective should inform the trade strategy of ENP countries, implying a need to assess the potential economic effects of a DCFTA, and identifying and comparing this with alternative options that may be available.

The primary tool that has been used to assess possible effects of entering into a DCFTA are sustainability impact assessments (SIAs) undertaken for the European Commission.¹⁹ One goal of the SIA exercise is to identify areas where complementary measures may be needed to deal with potential

¹⁸ There is substantial scope for a WTO member to make commitments that go beyond basic tariff bindings and market access and national treatment commitments for services. The WTO gives incentives for countries to use international product standards and permits scheduling of regulatory commitments if countries desire to do so (Hoekman and Mavroidis, 2016).

¹⁹ See ECORYS (2013a,b; 2014a,b) and ECORYS and CASE (2007; 2012; 2013).

adverse consequences of implementing a DCFTA. SIAs use computational general equilibrium (CGE) models, more qualitative analysis of potential social and environmental effects, and consultations with stakeholders. The CGE models are used to simulate the impacts of different scenarios, including a baseline ‘business as usual’ scenario. The model is used to assess the effects of implementing a DCFTA, and mostly focuses on the impacts of lowering trade barriers – the (gradual) removal of most tariffs; expanded access to agricultural markets; measures to increase the contestability of services markets, and liberalize cross-border investment (the right of establishment); and, of course, actions to adopt the *acquis* in different areas, which are associated with a presumed reduction in trade costs for firms. The standard approach to quantifying the latter dimensions are to convert the effect of prevailing (baseline) policies into a ‘ad valorem tariff equivalents’ (AVEs)²⁰ and then to apply, based on judgement, a conservative estimate of how much a DCFTA would reduce these AVEs. The models generate information on how the mix of tariff and AVE reductions impact on product prices, which in turn feed into effects on output and wages.

The SIAs are limited in scope. Analysts charged with undertaking SIAs are constrained by the terms of reference given to them and guidelines on how to assess possible impacts in the ‘SIA handbook’ (European Commission, 2006). SIAs do not assess alternative options in any depth, for example. Although understandable given the presumption that the aim of the exercise is to conclude a DCFTA, assessing outside options and potential reactions by other countries is important. This was illustrated by the reaction by Russia to DCFTA negotiations with EaP countries, but the broader question of whether there are alternative, potentially superior, trade policy options for partner countries is not asked. Analyses by independent academics and think tanks can complement SIAs by devoting more attention to alternative options.²¹

The SIAs generally point to the importance of liberalization of FDI inflows (establishment), trade in services and trade facilitation and logistics. The models show that reducing the incidence of NTBs is particularly important for generating welfare increases, but this is done by assuming that convergence towards EU law will result in a certain reduction in estimated AVEs. There is limited empirical evidence on which to base these assumed reductions in AVEs. Moreover, the costs associated with implementation are essentially ignored, although the models do identify sectors that will win and potentially lose from changes in AVEs (and tariffs). More important, empirical research in development economics has shown that what matters for trade liberalization to support higher growth (increasing real incomes) is improving economic governance and related institutions.²² Insofar as the basic premise of convergence towards EU norms is that this is associated with better institutions, it is important for the SIAs to consider whether this will indeed result from a DCFTA. A basic problem here is that it is not possible to model much of what a DCFTA may do in this regard. This is recognized in the SIA handbook, which notes that modelling trade in services, trade rules and investment can only be done very imperfectly, if at all (EU, 2006). This is even more difficult for changes in regulatory regimes and convergence to the *acquis*.

The adoption of elements of EU law may increase costs of domestic production, and as a result force less efficient firms to shut down. Firms that are able to incur the adjustment costs may find it harder to compete in their traditional export markets if consumers there do not value higher-standard products. Approximation to the EU *acquis* may entail more costs than benefits. For example, a necessary element for EaP countries in converging towards EU norms is to move away from the

²⁰ An alternative is to assume so-called iceberg trade costs, which entail modeling NTBs as a fixed cost that works so as to ‘melt’ away a share of the value of a product. This implies that NTBs generate social waste.

²¹ See, e.g., Afontsev (2014); Jensen and Tarr (2012); Institute for Economic Research and Policy Consulting (2011); Movchan and Shportyuk (2012); Movchan and Giucci (2011).

²² See, e.g., Freund and Bolaky (2008) on how the investment climate impacts on the benefits of reducing barriers to trade in goods, and Beverelli, Fiorini and Hoekman (2015) on the role of economic governance quality in determining the magnitude of the productivity impacts of lower barriers to trade in services.

GOST standards that may still be in place and that continue to apply in Russia.²³ GOST standards are inconsistent with WTO rules insofar as they regulate aspects of products unrelated to safety, are outdated and often are not science based. Application of EU food standards to sales on the domestic market may impact negatively on the food sector, as well as increase food costs. Messerlin et al. (2011) estimate that harmonization of food safety norms and processes to EU levels could increase food costs in Georgia by 90 percent. Reporting on the experience of the Eastern European countries that acceded to the EU, the World Bank (2007, p. 65) notes that despite substantial assistance from the EU, large parts of the food industry were forced to exit the market because of the costs of the upgrades needed to meet EU requirements. The report concludes that harmonization with EU food safety and agricultural health legislation is neither necessary nor realistic for EEU and other Central Asian countries and that they are best served by carefully prioritizing actions in this area based on assessments of costs, benefits, and trade opportunities. This recommendation is bolstered given that the scale of financial and technical support that was provided to accession countries is not available for EaP countries. Presumably recognizing the high costs of adjustment, the chapter in the DCFTAs dealing with sanitary and phytosanitary measures refers to adoption of EU standards as a process. Adopting some parts of the *acquis* may be important from an export perspective; for others it may be better to defer until incomes are higher, thereby providing a domestic market for more expensive products.²⁴ The general point is that a case-by-case approach may be most appropriate with respect to issues that involve regulatory reform.

An area of particular importance from a growth perspective that is covered by DCFTAs is trade and investment in services. For ENP countries to be competitive on global markets, participate effectively in international supply chains and attract related investments, they must offer efficient transport, financial, logistics and communications services.²⁵ A DCFTA will usually imply significant reform of services policies. From a DCFTA perspective service sectors can be divided into three groups: those regulated by comprehensive EU Directives such as financial services and telecommunications; those subject to Services Directive 2006/123/EC; and other sectors such as public (health, education) and cultural services. In assessing the potential impacts of a DCFTA it is necessary to determine to what extent prevailing policies conform to the applicable EU Directives, including in the case of distribution and professional services, the Services Directive.

Aligning a country's regulatory regimes to those of the EU is complicated as the agenda spans mobility, licensing, and approvals. Cross-border movement of service providers is politically sensitive as it involves people. Non-accession-eligible partner countries will never have unfettered access to the EU labour market, but allowing greater movement of suppliers is part and parcel of liberalizing trade in services. The potential for raising incomes in partner countries through this route is very large (Jensen and Tarr, 2012; Shepotylo and Vaklitov, 2012) suggesting it is important to consider different forms of enhanced labour mobility as part of a trade agreement – see e.g., Hoekman and Özden (2010) and Walmsley et al. (2011). That said, a focus on the EU *acquis* on services will by itself not suffice to ensure policies are most conducive to support substantial productivity improvements. Much will depend on national policy choices on a sector-by-sector basis, and the quality of economic governance more generally (Beverelli et al., 2015).

²³ What follows draws on Hoekman, Jensen and Tarr (2013).

²⁴ A “differentiated approach” has been adopted by some Latin American countries in free trade agreements with the U.S. These involve a dual production structure for some products where companies that export to the U.S. must meet the higher U.S. standards and products that meet these standards are admitted; but, crucially, for products where adaption to U.S. standards would be excessively costly, companies that produce according to less costly standards are permitted to sell domestically.

²⁵ Using a large firm level dataset, Shepotylo and Vakhitov (2012) show there is a strong impact on the productivity of Ukrainian firms from better access to services following services liberalization.

3. Towards Greater Differentiation

The geo-political and security context has deteriorated significantly since the launch of the Barcelona process in 1995 and the ENP in 2004. The waves of EU enlargement that brought about the integration of immediately neighbouring former-communist Eastern-bloc economies was accompanied by significant volatility in economic relations with and between Russia and the Eastern Partnership countries. The establishment of the Eurasian Economic Union (comprising the Republics of Armenia, Belarus, Kazakhstan and the Russian Federation) is a direct response by Russia to the pursuit of deepening economic, social and political relationships between the EU and EaP nations. The creation of the EEU changed the trade landscape for EaP countries, while the conflicts in Iraq, Syria and the Caucasus (Georgia, Ukraine, the seizure of the Crimea by Russia), the “Arab Spring” and subsequent political turmoil in Egypt and Tunisia, and chaos in Libya have all pushed economic integration initiatives on the back burner.

There has also been much change globally as a result of the high rates of economic growth of emerging economies in Asia and elsewhere since the late 1980s. This has decreased the relative importance of the EU as a source of demand and investment and capital, which was further impacted negatively by the financial and Eurozone crises and their after effects. China’s “One Belt, One Road” initiative and the end of sanctions on Iran may change trade incentives for a number of ENP countries given the aim to improve the physical connectivity between Europe and China and the rising importance of trade with and investment from China. The 2009 US pivot towards Asia and the successful negotiation of a Transpacific Partnership (TPP) in 2015 that excludes the EU and ENP countries will affect Europe and the neighbourhood. The EU has responded to these developments by launching trade negotiations with major OECD nations and large emerging economies. Agreements with South Korea and Canada and ongoing talks with Japan, the US and other countries will have implications for ENP countries as they are likely to affect the locational (investment) decisions of companies.

In 2015, the EU revamped its approach under the ENP. Following the 2015 ENP Review the EU moved away from the emulation of the accession/enlargement modalities that was the basis of DCFTAs (European Commission, 2015). In the future the approach will be more *à la carte* and case-by-case. The annual monitoring reports assessing the state of play on approximation of the *acquis* and related EU norms will be replaced with country reports that focus on the specifics of the cooperation that is agreed with the EU. These more issue-specific reports will be complemented by thematic assessments that review developments across countries with respect to core values such as the rule of law and fundamental rights. For countries that are not willing or interested in using EU law as a focal point for reforms and cooperation the EU will pursue alternative options where feasible. An example is the pursuit of bilateral Agreements on Conformity Assessment and Acceptance, which would permit free movement of industrial products for covered sectors. European Commission (2015) makes explicit mention of the WTO as a framework for such initiatives – the WTO permits, and indeed, encourages such arrangements, as long as they are open to all WTO members that are interested in participating and that are able to satisfy the required conditions – which must apply on a non-discriminatory basis.

A less *acquis*-centric approach towards trade cooperation is consistent with the discussion in Section 2 above and the changing geo-political landscape. DCFTAs are best considered as one element of a broader menu. For countries that do most of their trade with EU it may make sense to adopt EU law, but this is not a necessary condition for trading with the EU: Asian exporters to the EU have greatly increased trade with EU without adopting the *acquis*. From the perspective of partner countries, deeper integration with the EU should support greater engagement with the rest of the world as well, not just the near neighbourhood (the EEU, regional integration of Arab countries), but also dynamic countries in Asia. An alternative focal point is cooperation that is premised on regulatory convergence towards international as opposed to EU standards. In some areas there may be substantial overlap between the status quo in the EU and international norms, but in most cases there will be

idiosyncratic dimensions associated with implementing the *acquis* that may not be needed to attain international good practices.

Good regulatory and trade policy practices are increasingly the focus of modern vintage PTAs. These include commitments to open access to FDI (right of establishment), remove explicit barriers to provision of services by foreign suppliers; elimination of discriminatory government purchasing policies, and adoption of international standards. The subject coverage of recent PTAs such as the EU-Korea PTA or CETA overlaps to a significant extent with DCFTAs, but does not involve agreement to adopt EU regulations. Analysis of other trade agreement contexts and international economic cooperation initiatives involving the EU suggests that contrary to what is frequently held to be the case, the EU often does not (is not able to) export its norms (Young, 2015). A more ‘generic’ PTA approach may well be more appropriate in supporting economic development prospects, insofar as it results in adoption of norms that (can) also figure in agreements with other trade partners (Hoekman, 2011; Messerlin et al. 2011; Dreyer, 2012).

There are many potential areas for relations with a broader set of trading partners to be based on intergovernmental agreements. They include deepening cooperation on border control procedures to facilitate trade; permitting foreign investment in services; mutual recognition of product standards and technical regulations; agreements to accept the certification of conformity assessment authorities in the partner country; or mutual recognition agreements of the qualifications of professionals providing services (e.g., for accountants, engineers, and so forth). A benefit of using international standards as the focal point for cooperation is that initiatives in these areas may be more easily extended to include additional near neighbours and countries in other parts of the world to the mutual benefit of all concerned. The potential net welfare gains from trade policy-related reforms are greatest if such reforms apply to all trading partners. DCFTAs cannot maximize welfare because they are discriminatory. Jensen and Tarr (2012) for example conclude that potential real income gains for Armenia could be tripled if the reforms implied by the DCFTA were applied on a non-discriminatory basis. Adoption of international standards and internationally agreed good regulatory practices may therefore generate much greater benefits than a DCFTA.

Whether an EU partner country pursues the DCFTA option or alternative forms of deeper integration, it is important to prioritize across policy areas. Ademmer (2014) notes that there can be substantial scope for cooperation between the EU, EaP countries and EEU members, but that this must go beyond narrow economic considerations. Much will depend on the vulnerability of EaP countries in a given issue area to Russian policies, for example, as well as the incentives confronting EEU countries to adopt and apply international standards. How to identify areas and approaches that lend themselves best to different types of cooperation then becomes the challenge. This calls for extensive interaction with the private sector from the countries concerned so as to build the political support needed for implementation of deeper integration efforts. This is also needed to inform the choice between DCFTA vs. PTA-based deeper integration efforts. While consultations with stakeholders are an element of the SIAs, these tend to be rather pro-forma as opposed to the type of public-private partnership-based approaches that are arguably needed.

The EU’s engagement with accession candidates has focused on convergence with EU equivalent regulations and bolstering administrative implementation capacity. To a significant extent the same approach has been followed in DCTFAs and the ENP context. Research has demonstrated that progress in regulatory convergence depends on changing the incentives confronting domestic coalitions and interest groups. Much depends on how international norms and engagement by international organizations empower or limit the participation of a range of domestic public and private actors to pursue and contest alternative institutional experiments (Bruszt and McDermott, 2014). Langbein (2014) argues that international financial institutions and donors were better at eliciting reform in Ukraine than the EU because they empowered both state and non-state domestic actors, who in turn demanded and enforced new rules in their home markets. She argues that EU engagement with ENP countries – in contrast to what was the case with accession candidate countries

– has tended to focus on State agencies and neglected private sector operators, whereas international development agencies such as the EBRD or World Bank do more to include the private sector in projects and programs. A similar conclusion emerges from a case study of the adoption of EU norms for industrial products (Langbein and Wolczuk, 2012). Overall, because the EU largely limits itself to intergovernmental co-operation while international agencies often focus on specific sectors, the result is often piecemeal regulatory change in EaP countries.

Greater engagement with the communities with a strong stake in reducing trade barriers and frictions, as well as those with concerns that international cooperation to do so may affect them negatively, should inform cooperation. Hoekman, Jensen and Tarr (2013) suggest adoption of a more ‘supply chain based approach’ could help focus attention on how different policy areas — e.g. border management procedures, product standards, licensing, certification, documentary and data reporting requirements, regulation of transport and distribution (logistics) services etc. — jointly impact on the operation of important value chains for a given partner country. The idea is that a supply-chain informed deliberation that includes all groups with a stake in a given value chain, from suppliers to transporters to distributors, can help to identify areas where significant gains could be achieved through cooperation. Governments may not know enough about how and where deep integration can help attain common growth objectives and which of a range of possible types of cooperation will generate the greatest gains. Deliberation has been used in a variety of contexts as an instrument to support more informed decision-making by a polity or group of stakeholders. Building in greater ‘space’ for employing deliberative approaches can contribute to identifying (prioritizing) policy domains where deeper integration should have high payoffs for stakeholders from both the EU and partner countries (Hoekman, 2015).

4. Concluding Remarks

The original vision underlying DCFTAs was that they would serve as mechanisms through which ENP countries could not only open up their markets on a preferential basis to EU suppliers (and in turn obtain access to the EU on a preferential basis) but also gradually adopt the EU *acquis* in specific areas. The presumption was that the *acquis* was a good thing in and of itself. This approach was recognized as being too limited in the 2015 review of the ENP (European Commission, 2015), and in the future a more *à la carte* approach will be pursued. Convergence with EU law and regulation may not be the most effective mechanism for partner countries that are not eligible for accession to the EU to support their economic growth and development objectives. It is also not necessarily the most efficient instrument to attain greater regulatory coherence. More differentiated approaches that target areas of economic policy and cooperation that have clear payoffs for both sides may be superior in making progress on the fundamental security and development objectives that motivate EU engagement with its neighbourhood.

At the end of the day a DCFTA is a specific type of PTA. What matters from the perspective of both the EU and partner countries is to identify forms of international cooperation that help provide a good focal point as well as an effective ‘anchor’ for desirable policy reforms. If EU accession is not on the table, a focus on improving economic governance through adoption of international standards may be more appropriate than one that is centred on EU law and practice. This can be pursued with the assistance of international development organizations, where there is some evidence that these may be more successful than the EU in supporting reforms. Trade agreements have an important potential role to play in reducing policy uncertainty and enhancing the credibility of reforms, but it is not clear whether a DCFTA generates greater credibility than a PTA that is premised on the adoption of international standards and good regulatory practices. Whatever form a PTA takes, it is important to consider that the benefits of reforms will be greater if they are applied to all trading partners. In this regard more ‘generic’ trade agreements and cooperation that is centred on international good practices and standards may be more easily extended to other countries.

The 2015 review of the ENP recognizes that one size does not fit all. However, the *acquis* remains the ‘default’ focal point for the EU. Shifting gears to focus more on international standards and good regulatory practices will therefore require leadership by the partner countries. In some areas the *acquis* cannot be avoided – e.g., conformity assessment agreements for tradable products will be conditional on a partner country establishing the equivalence of its regime with that in the EU. But even in the area of technical standards relaxing the ‘*acquis* constraint’ can allow greater flexibility and diversity in how EU norms are satisfied. Ultimately what matters is equivalence – achievement of the regulatory objectives that motivate standards – and this need not require harmonization. The recent vintage PTAs between the EU and non-neighbourhood countries illustrate this point: the latter do not involve partner countries harmonizing their laws and regulations with those of the EU.

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