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**The Potential of Regional Integration Agreements (RIAs)  
in Enhancing the Credibility of Reform:  
The Case of the Syrian-European Association Agreement**

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# **The Potential of Regional Integration Agreements (RIAs) in Enhancing the Credibility of Reform: The Case of the Syrian-European Association Agreement**

## **Abstract**

The effect of 'locking-in' economic reform and enhancing its credibility is generally regarded as one of the most important potential effects of regional integration. Based on a detailed review of the theoretical debate, this paper develops a general framework for assessment to evaluate the ability of RIAs to serve as effective mechanisms for 'commitment' and 'signalling'. In the second part, this assessment framework is applied to the case of the Syrian-European Association Agreement (AA). Syria initialled an AA with the European Union in October 2004, but two and a half years later, this agreement is still pending formal signature. The empirical findings of this study show that despite several shortcomings, the Syrian-European AA, if it were to come into force, should be able to deliver an appropriate mechanism for signalling and commitment and thus to improve the credibility of the Syrian process of reform at home and abroad. A major loophole of the agreement, however, is represented by its lack of incentives to increase the 'rewards for good policy'.

**Key words:** Regional integration, Credibility, Commitment, Signalling, European Mediterranean Partnership, Syria

**JEL Code:** F 15: Economic Integration

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## **Zusammenfassung**

### **Das Potential von Regionalen Integrationsabkommen (RIA) für eine Erhöhung der Glaubwürdigkeit von Reformen am Beispiel des Syrisch-Europäischen Assoziierungsabkommens**

Der Effekt der Verankerung von Reformen und die Erhöhung ihrer Glaubwürdigkeit (Lock-in-Effekt) gilt allgemein als einer der wichtigsten Effekte der regionalen Integration. Aufbauend auf einer detaillierten Betrachtung der theoretischen Debatte zum 'Lock-in-Effekt' wird in diesem Papier ein allgemeiner Analyserahmen entworfen, der dazu dient, die Fähigkeit von RIA als Mechanismen der Signalisierung und Selbstbindung zu bewerten. Im anschließenden zweiten Teil wird dieser Analyserahmen auf das Beispiel des Syrisch-Europäischen Assoziierungsabkommens angewendet. Syrien initialisierte im Oktober 2004 ein Assoziierungsabkommen mit der Europäischen Union. Zweieinhalb Jahre später ist dieses Abkommen noch immer nicht formell unterzeichnet. Die Ergebnisse dieser Studie zeigen, dass das Syrisch-Europäische Assoziierungsabkommen – sollte es in Kraft treten – trotz einiger Mängel einen adäquaten Mechanismus der Signalisierung und Selbstbindung liefern und dazu beitragen kann, die Glaubwürdigkeit des syrischen Reformprozesses in- und außerhalb des Landes zu verbessern. Eine wesentliche Schwäche des Abkommensentwurfs liegt allerdings in mangelnden Anreizen für eine 'Belohnung der guten Politik'.

# **The Potential of Regional Integration Agreements (RIAs) in Enhancing the Credibility of Reform: The Case of the Syrian-European Association Agreement**

Anja Zorob

## **Article Outline**

1. Introduction
2. Theoretical Framework: 'Locking-in' Reform and Enhancing Its Credibility
3. The Case of the Syrian-European Association Agreement
4. Conclusion

## **1. Introduction**

The effect of 'locking-in' economic reform and enhancing its credibility is generally regarded as one of the most important potential effects of regional integration. A sufficient level of credibility is required because investors, in particular foreign companies, are likely to stay away or respond negatively to reforms if they expect future back-sliding. This, in turn, encourages domestic interest groups opposing economic reform to urge the government to retract measures announced and/or conducted.

Like many other countries of the Middle East the Syrian Arab Republic has experienced several phases of economic reform since the beginning of the 1970s. Despite the fact that in each phase foreign trade and exchange policies played a major role and that reforms have accelerated considerably during the last two or three years, the current state of the Syrian foreign trade system is still highly restrictive. Reforms in general, and deregulation of the foreign

trade and exchange regime in specific, have followed a cautious, gradual and selective approach so far. This approach reflects primarily the many politico-economic constraints the Syrian process of economic reform is generally facing. As a consequence, the most important feature characterizing Syrian reform seems to be its lack of credibility at home and abroad. To escape this trap or, in other words, to 'check' these constraints to a certain degree and to enhance credibility of reform, the Syrian government has several options, among them to accept legal commitments by signing an RIA. This in fact seems to have been, even if only indirectly, the policy option chosen by Syria when it started in 1998 as the last of all Mediterranean Partner Countries (MPCs) to negotiate an Association Agreement with the European Union (EU) in the framework of the European Mediterranean Partnership Initiative. The draft agreement was initialled by the chief negotiators of both parties in October 2004. Whereas this was to formally mark the end of the years-long negotiations, the AA as such, however, is since then awaiting approval by the European Council and, as a result, still pending formal signature.

The structure of the paper will be as follows. Chapter 2 starts with a comprehensive review of the theoretical debate on the lock-in effect including a discussion of the costs and causes of a lack of credibility. Based on this, a general framework for assessment of RIAs to serve as an effective mechanism for 'commitment' and 'signalling' as a means of improving the credibility of a country's reform policy is designed in the second part of Chapter 2. Chapter 3 opens with an overview of the previous two phases and the ongoing third phase of economic reform in Syria analyzing its general features and highlighting the major constraints with special focus on liberalization of foreign trade and export orientation. This is followed by an evaluation of the ability of the Syrian-European Association Agreement to catalyze and anchor reforms in trade and other fields of the economy and to enhance the credibility of reform by applying the framework for assessment developed in chapter 2. Chapter 4 concludes by highlighting the main findings of the study and suggesting some policy conclusions.

## **2. Theoretical Framework: 'Locking-in' Reform and Enhancing Its Credibility**

### **2.1. The Costs and Causes of a Lack of Credibility**

'Locking-in' economic reform and enhancing its credibility is generally regarded as one of the most important effects of regional integration. *Fernández/Portes* denoted this effect as one of the potential 'non-traditional' benefits of regional integration with special reference to agreements involving a strong Northern partner or North-South-RIAs (see *Fernández/Portes* 1998). Gov-

ernment policy can be viewed as 'credible' if the expectations of private economic actors match the reform announcements stated by the government (see Funke 1991: 175). Without a sufficient level of 'credibility' the process of reform might fail to produce the expected benefits in part or in whole or even spur on negative effects. This prompted *Rodrik* to argue that reform lacking credibility could prove worse than no reform at all (see *Rodrik* 1989: 3).

There are different potential effects or costs of insufficient credibility. If private business fears that adjustment measures announced by the government are of a transitory nature and anticipate a future backsliding, they might prefer to adopt a wait-and-see-attitude. Alternatively they could try to benefit from the change in relative prices which they perceive to be temporary. This will be specifically the case in countries with a long tradition of protectionism and/or bad or no record of reform. On the supply side, efficiency gains of trade liberalization will at the very least be lower than hoped for. The distorted inter-temporal structure of relative prices acts as a disincentive for private entrepreneurs wanting to adjust and shift from former import substituting to export oriented activities. In the worst case, no adjustments will be made and there is no supply response. Investment in the export sector is burdened with additional risks creating an implicit tax on investment. On the demand side the reduction in import tariffs perceived as temporary might induce an import boom building up pressure on the current account and leading to a reduction in private savings. Without access to international finance, domestic interest rates will rise and exert a negative impact on investment and, accordingly, on the prospects for long-term growth (see *Bender* 1995: 155-156; *Rodrik* 1989: 2; *Steingröver* 1998: 15). Besides price distortions, the lack of credibility could prompt private economic agents to spend additional funds on obtaining information. Furthermore, it may encourage different interest groups within society to try to influence the government's reform policy for their own benefit, probably forcing the process of reform to be blocked partially or wholly or even to be reversed altogether (see *Funke* 1991: 176-177).

Assuming that economic agents act rationally, several major sources or broad explanations for a lack of credibility are distinguished in the literature. The first of them refers to the issue of *unclear motives of the government* in where economic agents don't know or are not sure about the real intentions or will of the government to pursue reforms. In other words the lack of credibility is caused by informational asymmetries. Doubts about the 'authenticity' of the government's commitment to reform often stem from a legacy of failed reform initiatives or policy reversals and/or from the fact that the same politicians who had formerly been the protagonists of protectionism are later trying to push for free trade. Another source causing insufficient credibility is provided by *inconsistent economic policies*. In this case the government fails to take into account or tries to violate fundamental budget constraints and accounting identities in the design of reforms or it attempts to pursue different political goals

simultaneously. One prominent example of the latter which almost certainly gives rise to conflicts between policies and most importantly between trade liberalization and macroeconomic stabilization is constituted by an over-valued exchange rate. The problem of *dynamic or time-inconsistency*, the third explanation for a lack of credibility, arises when the government is tempted to backslide on reforms already undertaken after the private sector has started to adjust. If the government is capable of doing so, private economic actors will anticipate opportunistic behaviour of the government and the reform plan will become dubious. Incentives for backsliding include a deteriorating fiscal balance as a result of trade liberalization prompting the government to re-impose tariffs (see Funke 1991: 179; Rodrik 1989: 4-7; Steingröver 1998: 15-16).

It has been noted above that in case a government's programme lacks credibility, different interest groups could try to exert pressure to block or even reverse reforms. Taking the other way round it could be argued that the very existence of powerful interest groups that oppose trade liberalization and the government's dependency on these interest groups for the sake of its own 'survival' automatically robs the government's reform policy of credibility no matter how it is designed and communicated in public. This applies in particular to those countries where the transfer and maintenance of power is not determined by political elections. In authoritarian systems in which several family clans dominate political as well as economic life and the framework of action is structured along networks of clientelism and patronage, public welfare is most probably not the leading motive driving economic decision-making. Instead, and in line with the above mentioned assumption stipulating that political and economic agents are trying to maximise their own benefit, the government or ruling elite is rather first and primarily interested in its own hold on power or its political 'survival' (see Nienhaus, 2000: 274). Against this background regime security is determined by the ruling elite's ability to prevent other mechanisms that transfer power, like revolution, coup d'état or the surrender of political power to a successor. In such a setting it is much more important for the government to consider the impact of foreign trade liberalisation and adjustment on the interests of different groups of the society on which it relied in the past or is going to rely on to secure its own survival in the future.

In general, it is possible to distinguish between interest groups that oppose or support trade liberalisation. Among those that could be regarded as reform opponents are any domestic industry engaged in import-substituting production, the import business, the public organs enforcing administration of import substitution, state-owned enterprises (SOEs) and the trade unions. These groups are expected to lose access to rents which are generated by protecting the domestic market and by strictly controlling foreign trade. They benefit, for example, from monopolistic market structures, income and employment in SOEs and corrup-



tion in the public administration of foreign trade. The supporters of trade liberalisation consist of exporters and local consumers. The more the ruling elite depends on the loyalty of the groups expected to lose, the more its call for reforms will lack credibility. An additional factor contributing to a lack of credibility is that those in the government and administration who are responsible for the design and implementation of reforms are also to be counted among those losing out because of reform. Public officials risk being deprived of at least some of their personal privileges and fortunes derived from the stake they have in business or from being closely related to those people who do. Against this background it is questionable whether the government is willing and able to go for and communicate comprehensive trade liberalisation and structural adjustment. If it is willing to engage in comprehensive reform, the government needs to acquire approval for its plan from a sufficient number of interest groups concerned. Such an endeavour, however, usually requires making compromises as regards magnitude, choice and speed of measures to be conducted. Alternatively, but even more risky, the government could try to substitute some of the groups previously belonging to its 'supporting coalition' and thus opposing liberalisation with new groups supporting or set to benefit from opening the domestic market to international competition (see Bäcker 1996: 41-42; Nienhaus 2000: 275).

One way to escape this trap and to raise the credibility of reform vis-à-vis domestic interest groups as well as companies and investors at home and abroad could be for the government of a developing country in general, and the MPCs in specific, to sign a trade agreement with a strong Northern partner like the EU (see, for example, Galal/Hoekman 1997a; Hoekman 1999, Nienhaus 2000). At the same time such a treaty offers the government of the developing country the opportunity to blame the Northern partner for the economic hardships to be expected from opening the domestic market.

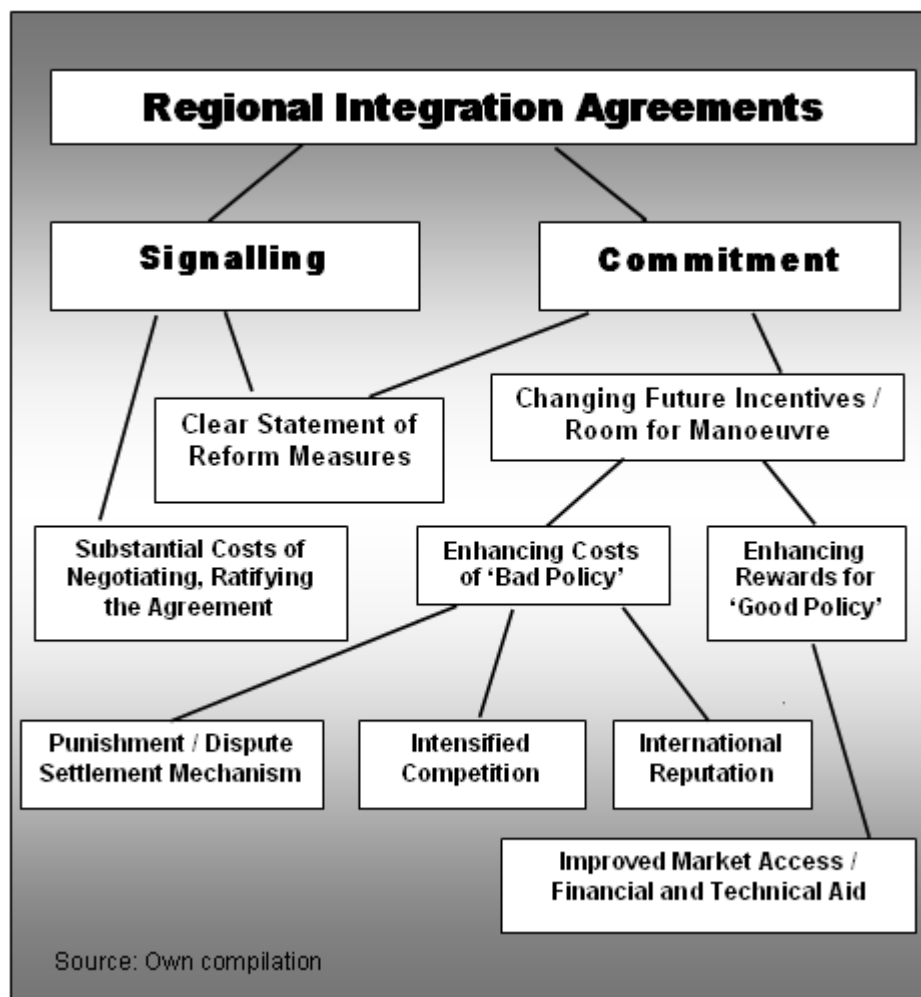
## **2.2. RIAs as Signalling and Commitment Mechanisms**

According to several authors an RIA can contribute to enhancing the credibility of reform by delivering a *commitment* and *signalling mechanism* for trade and other policy reform measures (see Fernández/Portes 1998: 202-209; Schiff/Winters 2003: 107-113). For this to take effect, however, an agreement must meet several conditions as regards form, content and the choice of partner or 'anchor-sponsoring' country.

In order to deliver a commitment mechanism to overcome problems of time-inconsistency, an RIA should help to alter the future incentives for the government to act and to restrict its room for manoeuvre as illustrated in *Figure 1*. There are several potential ways of achieving this. On the one hand, an agreement could boost the 'rewards for good policy'. On the other

hand, it may raise the 'costs of bad policy'. In general, for an RIA to function as a credible commitment mechanism, however, it needs to be as 'complete' as possible to guard against a future gradual erosion of the commitments made in the treaty and thus limit possible 'exit-options' for both partners (for details on the concept of 'incomplete contracting' see Majone 2001; Williamson 1985) and/or to ensure that the costs the 'anchor-seeking' government has to face in case it decides for a full or partial exit from the agreement are higher than the benefits it is expected to gain from such a step (see Fernández/Portes 1998).

**Figure 1: RIAs as Signalling and Commitment Mechanisms**



To increase the costs of bad policy and restrict the government's room for manoeuvre an RIA should allow punishment by the other member(s) to the agreement in case it fails to fulfil the agreement's requirements. On a more direct level, the threat of losing international reputation as a result of the agreement's suspension or termination may raise the costs of bad policy to such a degree that it outweighs the benefits of a short-term return to the 'time-consistent' policy of the government concerned. Furthermore, an agreement enhances the

costs of bad policy if it leads to intensified competition on the domestic market thereby 'penalizing' bad policies such as a restrictive FDI policy, a general poor investment climate or weak fiscal consolidation. For the costs of bad policy to be increased effectively, however, not only competition on the anchor-seeking country's market must be intensified to a substantial degree as a result of the agreement's implementation. The anchor-sponsoring country or group of countries need to dispose of significant leverage on the international level and should be able as well as willing to exert pressure on the anchor-seeking country by way of punishment. This, in turn, requires that the agreement offers distinct possibilities and incentives for punishment, that the partner countries are stable and large enough, and that they are sufficiently interested in securing the RIA, to call the anchor-seeking country to discipline. In addition, reform measures to be implemented should be explicitly and clearly stated in the text of the agreement so as to give punishment a formal legal basis (see Schiff/Winters 2003: 108-110; Tomz 1997: 6). It has to be noted, however, that unilaterally applying sanctions against the partner risks triggering a subsequent cycle of mutually protectionist countermeasures. To prevent such a scenario RIAs should include a detailed dispute settlement mechanism. This mechanism, if designed appropriately, could deliver an effective instrument to distract the parties from breaching the agreement and, in case a dispute arises, to impede the parties from having immediate recourse to retaliation. According to Szepesi a 'good' dispute settlement mechanism prepares the basis for consultation and arbitration, and makes sure that 'sanctions are used only as a measure of last resort' (Szepesi 2004: 1).

Besides restricting the room for manoeuvre, a change in the government's future structure of incentives necessitates a shift in the government's tax collection and political basis from declining (import-substituting) sectors to growing (export-oriented) branches of the economy. In other words it is of major importance to what extent an RIA is able to contribute to enhancing the 'rewards for good policy'. This could be achieved through an agreement if it improves access to the partner country(-ies) market(s) and/or by providing the anchor-seeking developing country with technical and financial assistance. Finally, problems of time-inconsistency are not limited to possible changes in the incentives of the government who actually signs the treaty. *Political time-inconsistency* describes a situation in which the current government must expect its successors or future governments to have a different objective function calling for a reversal or dismissal of the former government's policy. In this case, the government signing the RIA has the chance to 'tie the hands' of future governments (Fernández/Portes 1998: 207).

By serving as a commitment mechanism an RIA, however, helps not only to minimize problems of *time inconsistency* but is also able to send signals to economic agents. By 'tying the hands' of the government involved it gives a clear indication of the genuine will of the po-

litical leaders. Nevertheless, an agreement can signal a government's will or 'true type' even without binding commitments provided that it costs a great deal to negotiate and get approval of the agreement 'at home'. In addition to showing its true type a government might wish to send signals regarding good future relations with the countries(-s) with which it wants to sign the RIA (see Schiff/Winters 2003: 111; Tomz 1997: 5). The more detailed and clearly articulated the commitments in the agreement are and/or the higher the political and other costs which must be afforded to enter the agreement, the more pronounced will be its *signalling effect*.

Some authors emphasize that the credibility of a government's policy will hardly be improved by way of concluding an RIA if it is not already committed to reform (see Schiff/Winters 2003: 111). In this regard 'anchoring' has to be equated with a legal or contractual binding of liberalization measures the anchor-seeking country has already introduced before signing the RIA. Others argue, however, that a distinction should be made between two types of countries and therefore also types of agreements. The second category consists of countries in which 'significant liberalization and policy reform remain to be achieved' (Galal/Hoekman 1997b: 3). Those countries could benefit from entering RIAs with its major trading partners as part of their strategy to liberalize the economy. Thus the primary objective of the agreement is not to 'anchor' or 'lock-in' reform but to 'catalyze' measures of liberalization and other policy reforms.

Apart from the form and content of reform commitments, the success of trade reform depends on the appropriate 'timing' and 'sequencing' of measures to be adopted. There are two different opinions about the pace or speed of liberalisation – the shock approach or 'cold-turkey strategy' proposed by *Rodrik* versus the policy of gradual liberalisation introduced by *Froot* (see Rodrik 1989: 11-13). Whereas the 'shock-therapy' entails potentially unbearable short-term adjustment costs for the developing country's economy, the gradual approach runs the risk of reforms being accompanied by a lack of credibility and opponents trying to undermine the programme. In practice, and despite the initial advantages of higher credibility, trade liberalisation seldom seems to be conducted in a very swift manner or as a 'shock-approach' (see Abdalla 1997: 273; Bäcker 1996: 37-38; Bender 1995: 148-150). To deliver a sufficient degree of credibility it is important, however, that a gradual programme starts with a decisive and comprehensive first phase of measures combined with the announcement of a thorough and unequivocal schedule for further steps (see Bender 1995: 157; Steingröver 1998: 14-15). Many RIAs seem to follow this thinking by incorporating schedules for dismantling trade barriers on a gradual basis.

Finally, there is the issue of complementary measures of structural adjustment in fields other than trade and solid macro-economic management. Measures of this kind are required to

create the conditions necessary for a supply response and thus generally regarded to be of major importance for the success of trade liberalization. Moreover, liberalization of trade should be accompanied by measures to mitigate the negative effects on production, income and employment and by the establishment of social safety nets for affected income groups also as a means to appease domestic opposition against it (see Abdalla 1997: 273-275; Bender 1995: 157-158). Thus, to assess an RIA's ability to improve the credibility of reform it could be asked to what extent it includes measures of macro-economic cooperation, adjustment in fields other than trade and supporting measures to cushion the negative effects of liberalization. In this context it should be kept in mind, however, that if different trade liberalization, stabilization and complementary measures of reform need to be implemented simultaneously, the problem of *inconsistent policies* which was mentioned above as one of the major sources for a lack of credibility is set to aggravate almost inevitably. Accordingly, appropriate sequencing of trade and other reforms becomes a crucial issue. Furthermore, since the problem of inconsistent policies arises when the government tries to violate fundamental budget constraints and accounting identities the 'degree of preparedness' of a country entering an RIA must be taken into account. Last but not least, it should be emphasized that concluding an RIA, regardless of its design and the partners involved, is not a panacea. According to Galal/Lawrence a trade agreement 'can provide opportunity and stimulus, but domestic policy must follow through' (Galal/Lawrence 2005: 40). In other words, an RIA can't substitute for domestic reform. Instead, trade agreements should form an integral part of a comprehensive national reform programme that pursues a strategy of economic opening, liberalisation and adjustment.

### **3. The Case of the Syrian-European Association Agreement**

#### **3.1. Economic Reform in Syria: The Current State of Play and General Features**

Like many other countries in the MENA region, Syria experienced two phases of economic reform between the end of the 1960s and the beginning of the 1990s. The scope and sector coverage of measures conducted in both periods remained relatively limited when compared to regional neighbours. Whereas the latter in most cases opted for cooperation with the IMF and the World Bank to implement programmes of stabilization and structural adjustment, Syria refused external intervention. In the mid-1990s, the process of economic reform came more or less to a halt after the Syrian economy started to recover from the deep crisis it had to face during the preceding decade.

Despite the fact that trade reforms played a major role in both periods, the government in general abided by the strategy of import-substituting industrialization. High customs duties, numerous quantitative restrictions and other non-tariff barriers combined with a system of multiple exchange rates, complex procedures for financing imports and the fact that foreign trade was mainly administered by public organizations kept the Syrian market highly protected from foreign competition. Export promotion was officially declared an objective during the second reform phase. Measures implemented to reach this goal, however, remained piecemeal and failed to stimulate a significant supply response by Syrian private business. Compared to the *Infitah* of the 1970s, reforms conducted during the second phase were larger in scope and in sector coverage. The general approach of reform nevertheless remained cautious, gradual and selective. In addition to being implemented without external support, reforms did not seem either to have followed a pre-determined programme or to have a clear target for transformation. Although Syrian economists had started discussions about a social market economy as the preferred system to be attained, the Syrian administration came up at the beginning of the 1990s with the system of 'economic pluralism' in which private, mixed and public sectors were to be regarded as 'equal' partners in development. This reflected more or less the ambition of the government to officially adapt to what had happened in the second phase (and the preceding economic crisis) which had strengthened the role of the Syrian private sector. At the same time SOEs still contributed a large part of the GDP and the issue of privatisation remained out of discussion. The large public sector and administration in combination with instruments like subsidized imports and privileges granted to selected members of Syrian private business helped maintaining the social basis of the Syrian regime which had been established during the 1970s as a fully organized network of patronage relationships (for a detailed account of the first two phases of economic reform in Syria see Zorob 2005).

The ongoing third phase of economic reform started some time before Bashar al-Assad came to power following his fathers' death in June 2000. Reforms accomplished since then have included most notably measures to unify the exchange rates and to devalue the Syrian currency. In January 2007, after years of consecutive marginal steps, the Syrian minister of finance announced that exchange rate unification has been completed. This was accompanied by the introduction of a system of managed float of the Syrian pound and a shift from the former US dollar peg to a mixed basket composed of Euros, US dollars, pounds Sterling and Yen (see MEES 2007: 27). Earlier in the third phase the administration had legalized the possession of foreign exchange and abolished the rule that Syrians must finance the import of specific goods from foreign exchange earned through exports. Concerning foreign trade regulations, the monopoly of import agencies was eliminated and provisions to prohibit,

monopolise or limit imports were reduced on a product-by-product basis. In addition, customs duties were decreased for selected goods, mainly raw materials and other inputs for production.<sup>1</sup> Moreover, Syria signed bilateral free trade agreements with several Arab countries and Turkey. It became a member of the *Greater Arab Free Trade Area (GAFTA)*, which began operating fully, at least officially, in 2005 (for details on bilateral agreements and the GAFTA see Zorob 2006c: 110-133). In 2001, the Syrian administration applied for membership of the World Trade Organization (WTO) and renewed its application in 2004/05. Further measures to promote exports included the institution of a duty-drawback system and the creation of an export promotion agency within the Ministry of Economy and Foreign Trade (see Directorate-General for Economic and Financial Affairs 2006: 123).

Other reforms concentrated primarily on banking and insurance. Private banking was allowed in Syria for the first time since its nationalisation in the 1960s. This was followed by new laws on banking secrecy, the revitalisation of the 'Monetary and Credit Council' (CMC) and the subsequent first change in interest rates in more than 22 years. In addition, the Syrian insurance market was opened to the private sector in 2005. In the same year the government established the 'Syrian Securities and Exchange Commission' to prepare a law for the launch of the Damascus Stock Exchange, which was finally approved by the President in October 2006 (see The Syria Report 2006a). In the field of investment, Investment Law No. 10 was most recently replaced by a new law. In addition, Syria joined the Multilateral Investment Guarantee Agency. The new investment law (Decree No 8/2007) ends all tax exemptions offered by its predecessor, but guarantees, among others, full repatriation of profits without any restrictions and allows domestic and foreign investors to own land for their activities (see The Syria Report 2007b). As regards fiscal policy, a new personal and corporate income tax law was issued for the first time in 2003 and amended again in 2006, both times substantially lowering tax rates. A new 'Basic Finance Law' was signed by the President at the beginning of October 2006. This law provides, among other things, for SOEs to obtain financial independence from the state budget (see The Syria Report 2006b). Altogether, economic reforms gained again in scope and sector coverage in the third phase as compared to the previous periods. Nevertheless, the gradual and selective approach was generally retained in particular in the field of foreign trade. In addition, several new laws and regulations initially proved difficult to implement. Moreover, there are several 'hot issues' like privatisation of SOEs, which are still being banned from the official agenda of economic reform or, alternatively, remain 'under study' as Syrian officials would say. Syrian industry is in urgent need of a major overhaul to be able to withstand enhanced competition on the do-

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<sup>1</sup> For foreign trade legislation newly issued since 2004 see the official website of the Syrian Ministry of Economy and Foreign Trade [<http://www.syrecon.org/>].

mestic market and to take advantage of improved access to foreign markets as a result of free trade agreements signed with neighbouring and other countries. Furthermore, monopolistic market structures need to be broken up and competition rules be introduced. According to Syrian economists the main negative outcome of reforms implemented during the ongoing third phase is that former public monopolies have simply been replaced by private monopolies. The whole system, they continue to argue, regardless of level or sector, is more corrupt than ever before (see, for instance, Aita 2006; Sukkar 2005).

**Table 1: Tariff Rates in Arab Mediterranean Partner Countries**

	Most recent year	Simple Mean Tariff <sup>1</sup>	Weighted Mean Tariff <sup>2</sup>
<b>Algeria</b>	2003	17.9	12.0
<b>Egypt</b>	2002	18.9	13.9
<b>Jordan</b>	2003	14.4	11.4
<b>Lebanon</b>	2002	7.2	6.3
<b>Morocco</b>	2003	28.3	24.9
<b>Syria</b>	2002	14.6	15.5
<b>Tunisia</b>	2004	25.3	22.3

1 Un-weighted average of effectively applied rates or MFN rates for all products subject to tariffs calculated for all traded goods.

2 Average of effectively applied rates or MFN rates weighted by the product import shares of each partner country.

Source: Own compilation based on World Bank, World Development Indicators 2006.

Despite the above mentioned liberalization, the Syrian foreign trade system must still be classified as restrictive. As *Table 1* shows, the simple average tariff stood at 14.6% in 2002 and was thus lower than in most other MPCs. Furthermore, as indicated in the previous section, tariff rates have been significantly lowered on a product-by-product basis in recent years. According to the 2006 IMF Staff Report customs duties have been unified and maximum rates reduced to 65% as compared to 255% at the beginning of the current decade. There is, however, on the one hand, wide dispersion of tariff rates and high tariff escalation. Since an updated complete tariff schedule incorporating all the changes made during the last two or three years seems currently not available, the number of tariff categories is estimated to be at around 20 (see IMF 2006b: 43-44). On the other hand, the use of non-tariff barriers is still pervasive. Although the number of import prohibitions and public import monopolies has been reduced further during the last two years, the list of prohibited goods as of May 30, 2006 remains exceptionally long (see Ministry of Economy 2006). In addition, there are other non-tariff barriers like import quotas, import licensing requirements and costly customs clearing procedures despite several efforts in recent years to streamline the



system. According to estimates, quantitative restrictions alone raise the domestic price of goods imported to Syria by more than 19% on average (see Chemingui/ Dessus 2004). Measures to promote exports, finally, are also still weak according to a report compiled for the *Institutional & Sector Modernisation Facility (ISMF)* which is funded by the EU (see Owen 2005). Export prohibitions, export licences and prior approvals for most goods to be exported have been abolished. Syrian free zones, however, have not proved very successful to date on account of cumbersome administrative controls and porous boundaries that support fraud and inefficient investment (see IMF 2006b: 48).

That domestic interest groups oppose the dismantling of protectionism, and in particular non-tariff barriers, is best illustrated by looking at the issue of quotas. The system of industrial quotas set by the Ministry of Industry, and reportedly largely misused in the past by the companies benefiting from quotas, was abolished in 2006 but shortly after readopted again. Actions of this kind, of course, reduce the credibility of the government's future plans to further deregulate the foreign trade system. In a similar manner the Syrian authorities tried for a long time to delay the elimination of goods exempted from the scheme of tariff reductions allowed for in the provisions of the GAFTA Executive Program. The exemptions originally had to be ended in September 2002. Whereas other countries like Jordan or Lebanon reportedly lifted the exemptions as scheduled, Syria maintained them. Only after pressure from other GAFTA members did the Syrians seem to have decided in 2004 to finally abolish at least most of these exemptions (see Zorob 2006c).

### **3.2 Past and Present Reform Constraints**

One notable change, however, has occurred in the ongoing third phase of economic reform; the Baath Party's last regional congress in June 2005 recommended the transition of the Syrian system into a 'social market economy'. In addition, in May 2006 the president approved the tenth five year plan (10<sup>th</sup> FYP) which is viewed by many observers as a comprehensive programme for liberalisation and adjustment (for details see SPC 2006; IMF 2006: 36). There is, however, deep scepticism about whether the Syrian government is willing and/or able to fully implement all the measures mentioned in the 10<sup>th</sup> FYP prepared by the Syrian State Planning Commission (SPC). This is because the major constraints which the Syrian process of economic reform faced in the past still exist in one form or another. Probably the most important constraint is domestic opposition to liberalisation. Those who will inevitably lose from trade liberalisation are domestic industry producing for the local market, import businesses, the public administration and the SOEs. Since most, if not all of those groups, traditionally form part of the government's so-called 'rentier social contract' built up continuously during the past decades, the ruling elite might fear to be deprived of their loyalty and

in the worst case to lose its own power if it pushes too far with liberalisation (see Bank 2004: 168-172). But there are other groups or agents with 'vested interests' in maintaining the system as it is. Among them are public sector managers, the security services or those in the private sector whose success in business depends in large part on a 'privileged relationship' to public sector companies and/or the administration. Even members of the government or, in other words, those who are responsible for the design and implementation of economic reforms are most probably afraid to forgo personal privileges and fortunes. Moreover, the alternative, which in theory is to replace some of the above mentioned groups with new groups whose interests are more compatible to the interests of the government if it indeed wishes to go for liberalisation, i.e. private sector companies engaged in export business and consumers, might prove to be difficult. Consumers constitute too large an interest group to effectively organise and exert political influence. Private companies, including those producing for export, are not only small in size. The private sector as a whole, according to the analysis of *Haddad*, has been more or less prevented from taking collective action in the political as well as purely economic realm by a carefully designed system of positive and negative incentives (see Haddad 2006: 21-24).

Besides the domestic opposition, there are other constraints at work such as regional political instability and growing international pressure on Syria. 'Factors' of this kind have traditionally been used as an excuse for postponing further reforms thereby clearly showing the primacy and major influence of Syrian foreign policy on other fields of political decision making and among them economic policy. In May 2004 the president of the United States of America, signed an executive order implementing sanctions against Syria provided for within the framework of the *Syria Accountability and Lebanese Sovereignty Restoration Act* which accused the Syrian government, among other things, to support international terrorism, occupying its neighbouring country Lebanon, pursuing weapons of mass destruction (WMD) and undermining US and international efforts for the stabilization of Iraq (for details on the Syrian Accountability Act and the 2004 Executive Order see The Syria Report 2004a/b; on the US political 'background' leading to the approval of the (new) sanctions see Hinnebusch 2004). The US sanctions, the UN Security Council's Resolution No. 1559/2004 against Syria and its successors plus the pending investigation of the assassination of the former Lebanese Prime Minister al-Hariri have not stopped reforms in Syria in recent years. They have had, however, negative consequences, for example, restricted access to the import of high technology and energy sector equipment from the US. Second, and more important, the threatened future sanctions will most probably create additional problems on the political, economic and financial level. To name only one aspect, they will further complicate access to international finance and assistance provided by Western donors which is badly required to

build up domestic capacity for design and management of reform (for potential forms and impact of future sanctions see Tabler 2005, Zorob 2006b). In this respect it is to be noted that the Syrian administration was assisted in the preparation of the 10<sup>th</sup> FYP by several international development organisations (for details see Zorob 2006a). Finally, other constraints are represented by the lack of appropriate social safety networks needed to mitigate the negative effects of liberalisation and the absence of a strong external actor. The Syrian administration and the IMF and World Bank have intensified cooperation in recent years. This cooperation has stopped short, however, of agreeing on a structural adjustment programme, which could have offered conditioned access to long-term lending and an instrument for enhancing the credibility of reform. Moreover, due to its international isolation and reportedly 'stiff resistance' from the US, Syria's accession to the WTO is not on the cards, at least not in the short to medium term (see OBG 2006: 29).

In a nutshell, there still seem to be so many factors constraining the process of economic reform in Syria and which contribute to undermining the credibility of the Syrian government's programme of liberalisation and adjustment irrespective of how it is announced and in which form it is started. One way out of this dilemma could be provided by its signing an Association Agreement with the EU. An agreement of this kind would not only offer the opportunity to justify unpopular reforms vis-à-vis opponents to reform and the population at large. It might serve as an effective device for catalyzing and anchoring the measures which are required to liberalise the Syrian trade regime and enhancing the credibility of reform both domestically and internationally. To achieve this role, the Syrian-European AA, however, must fulfil certain conditions as outlined in the previous chapter.

### **3.3 The Potential Role of the Syrian-European AA for 'Locking-in' Reform**

According to *Hoekman* the major advantage of the European-Mediterranean Association Agreements is its potential to deliver a commitment mechanism and thus to provide more credibility to a gradual process of economic reform. Without binding commitments in the areas of investment and supply of services, combined with the exclusion of government procurement and the maintenance of antidumping rules and safeguard provisions as found, for example, in the AA concluded with Tunisia, however, the AAs with the MPCs would not go significantly beyond the disciplines agreed to in the framework of the WTO (see *Hoekman* 1999: 97-98). In the Syrian case this is obviously not, at least not initially, the interesting question since it does not belong to the WTO and as mentioned above its accession is currently not on the cards. Moreover, the contents of the Syrian-European Association Agreement initialled on October 19, 2004 are much broader in scope and depth than the provisions included in the AAs with the other MPCs. *Table 2* shows the general structure of the draft

agreement and emphasizes those titles and chapters (italicised and shaded lines) in which the Syrian-European AA contains broader and/or deeper provisions than the AAs concluded with the other MPCs. In general, the agreement consists of provisions for each of the three 'baskets' of the European-Mediterranean Partnership (EMP) as agreed to by the EU and its Mediterranean Partners at the Barcelona Conference in November 1995 (see European Commission 1996).

**Table 2: General Structure of the Draft EU-Syria Association Agreement**

<b>Article 2</b>	<b>Respect for the Democratic Principles and Fundamental Human Rights</b>
<b>Title 1</b>	<b>Political Dialogue and Cooperation</b>
	◦ Article 3: Regular Political Dialogue
	◦ Article 4+5: Weapons of Mass Destruction
<b>Title II</b>	<b>Free Movement of Goods</b>
	◦ Chapter 1: Elimination of Customs Duties
	◦ Chapter 2: Common Provisions
	◦ Chapter 3: Customs and Related Matters
<b>Title III</b>	<b>Right of Establishment and Services</b>
	◦ Chapter 1: Right of Establishment
	◦ Chapter 2: Cross-Border Supply of Services
	◦ Chapter 3: General Provisions
<b>Title IV</b>	<b>Payments, Capital Movements and Other Economic Matters</b>
	◦ Chapter 1: Payments and Capital Movements
	◦ Chapter 2: Competition
	◦ Chapter 3: Government Procurement
	◦ Chapter 4: Other Economic Matters
<b>Title V</b>	<b>Dispute Settlement</b>
<b>Title VI</b>	<b>Economic Co-operation</b>
<b>Title VII</b>	<b>Co-operation in Social and Cultural Matters</b>
	◦ Chapter 1: Social Dialogue
	◦ Chapter 2: Social Co-operation Actions
	◦ Chapter 3: Cultural Co-operation
<b>Title VIII</b>	<b>Co-operation in the Fields of Justice, Migration, and the Fight against Organised Crime</b>
<b>Title IX</b>	<b>Co-operation on Counter-Terrorism</b>
<b>Title X</b>	<b>Financial Co-operation</b>
<b>Title XI</b>	<b>Institutional, General and Final Provisions</b>

Source: Own compilation based on European Commission (2004b): Proposal for a Council Decision on ... a Euro-Mediterranean Association Agreement between the European Community and its Member States and the Syrian Arab Republic.

As regards trade liberalisation, the Syrian-European AA offers opportunities to send clear signals about the Syrian government's preparedness to open the domestic market and to embark on a strategy of export-oriented development. The AA's provisions stipulate a whole range of measures which have to be implemented by the Syrian administration immediately after the treaty has come into force and which allow a clear break with the past. These measures consist of the elimination of all import or export restrictions on trade between Syria and the EU, including prohibitions, quotas and import or export licensing requirements, other than customs duties and taxes.

Customs duties and other surcharges applicable to the import of industrial products into Syria will be reduced in a linear manner to zero according to different schedules over a transitional period of 12 years starting from the date on which the agreement enters into force. All tariffs on products covered by the Information Technology Agreement as well as chemical products falling within HS chapters 35-38 will be abolished immediately. Except for cars, all duties above 50% will be brought down to 50% at the beginning of the transition period and be abolished in twelve years. Tariff rates for cars at 255% (145%) shall be reduced to 150% (65%) in the first three years and then be eliminated by the end of the transition period.

Reciprocal trade in agricultural products, processed agricultural products and fisheries between the EU and Syria shall be liberalised progressively. Syria, however, has committed itself to a far-ranging opening of its agricultural market. Similar to industrial goods, customs duties applicable to imports of agricultural products into Syria will be reduced to zero in a linear manner within 12 years according to different schedules. Annual tariff quotas at zero duty have been established for EU's export of several sorts of oranges and mandarins as well as fresh apples. Duties on the import of fisheries and processed agricultural products into Syria will be reduced to zero according to different schedules in a linear manner by the end of the twelve year transition period at the latest as well. Quotas at reduced MFN – duty levels have been set for EU – exports of mineral water, soft drinks, spirits, cigarettes and tobacco. In addition to the elimination of tariff and quantitative barriers, trade between Syria and the EU will be bound by the principles set out in the WTO Agreement on the Application of Sanitary and Phytosanitary (SPS) measures as well as the WTO Agreement on Technical Barriers to Trade. As regards standards, the Parties agreed to take steps to encourage the use of EU standards and technical regulations in Syria with the aim to conclude agreements on conformity assessment. Moreover, Syria committed itself to comprehensively reform and modernise customs procedures. To enhance efficiency of the customs administration, customs legislation and procedures are to be simplified, computerized and harmonised with EU and international standards and be based on the principles of non-discrimination, transparency and the need to prevent unnecessary procedural obstacles to trade. As out-

lined in the first section of Chapter 3, import prohibitions for selected goods have been lifted in recent years, customs duties for cars and other goods, mainly inputs for production, have been reduced and the first steps needed for the streamlining of customs procedures have been taken. Besides anchoring these measures the agreement offers to catalyze many additional reforms which are required for the opening of the domestic market and deregulation of the Syrian trade regime.

Additional clear signals are provided by commitments in fields other than merchandise trade. Syria grants European investors national or MFN treatment (whichever is better) for establishment in Syria. The branches excluded from the general right of establishment include primarily the production of goods and services which were reserved for government monopolies at the time of negotiating the agreement. In other sectors like wholesale trade, transport or construction a minimum Syrian ownership is required which in most cases is set at 25 %. Furthermore, within a year of the treaty coming into force Syria committed itself to put forward a schedule for opening the telecommunications industry within six years at the most. Besides the right of establishment the parties undertake to allow, except in cases of serious balance-of-payments difficulties, all payments for current transactions to be made in a freely convertible currency and shall ensure the free movement of capital relating to FDI as well as free liquidation and repatriation of capital and profits. As regards competition rules, Syria committed itself to taking into consideration the EU rules when formulating its own law. Moreover, and in contrast to the agreements concluded with the other MPCs, the parties will cooperate on the enforcement of competition rules. As far as government procurement is concerned, and again contrary to the other MPCs, the parties agreed to open procurement activities and to grant national treatment to the other party's goods, services and suppliers for a list of entities annexed to the agreement. The effective opening of procurement markets will be reviewed regularly. With respect to intellectual, industrial and commercial property rights, the partners committed themselves to granting and ensuring their protection in accordance with the highest international standards including the principles set by the WTO-Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). For this purpose Syria agreed to accede to a number of multilateral conventions according to a specific calendar. Finally, the trade and trade-related provisions of the treaty will be applied by both partners in advance pending its entry into force by means of an interim agreement.

Since the above mentioned commitments are not only clearly stated in the agreement, but are in most cases also accompanied by detailed rules for their implementation, the Syrian-European AA is capable of delivering an effective signalling mechanism. This view could be given further credence by the Syrian government's willingness to bear the substantial costs

of negotiating the agreement although Syria's participation in the Barcelona process from the beginning was mainly motivated by political concerns. The Syrian-European AA lacks, however, in a similar manner to the agreements concluded with the other MPCs, directives for coordinating macro-economic management and commitments on complementary structural reforms like privatisation or restructuring of the financial sector.

In addition to signalling the 'true motives' of the government, the clear statement of reforms in an RIA's provisions is likewise an essential precondition for its functioning as a commitment mechanism. As outlined in Chapter 2, measures explicitly stated in the agreement give a formal legal basis to punishment in cases where the other party breaches the agreement's obligations or fails to fulfil them. The possibility for punishment is provided in the Syrian-European AA by the so-called 'non-execution clause' and in the framework of the agreement's dispute settlement mechanism. The non-execution clause allows either party to take 'appropriate measures' in case of non-fulfilment of an obligation by the other party. It delivers the basis for a mechanism to settle disputes by bilateral consultations within the association council and, in combination with the 'essential elements clause', a mechanism to suspend the agreement without prior consultation. The AA can be suspended by one of the parties without prior consultation if the other party violates an 'essential element' of the treaty. In line with the relevant provisions of the *Vienna Convention of the Law of the Treaties* the violation of an essential element may be defined as a material breach of the agreement entitling the other party to suspend the agreement in whole or in part or to terminate it. What is referred to as an 'essential element' in all AAs is laid down in the 'essential element clause' and covers the respect of democratic principles and fundamental human rights. The Syrian-European AA widens this definition to include cooperation on combatting the proliferation of WMD and the fight against terrorism. The paragraph on cooperation to counter through full compliance with existing obligations under disarmament and non-proliferation treaties the proliferation of WMD and their means of delivery represents in itself a novelty in RIAs signed by the EU with third states. To include the WMD clause might be politically necessary and justifiable. For the Syrian-European AA to function as an effective commitment mechanism for economic reform, however, its definition as an essential element and the potential it provides for both parties to use it as an 'exit option' seems inappropriate.

In contrast to the AAs concluded with the other MPCs, the Syrian-European agreement includes in addition to the non-execution clause a separate and detailed mechanism for settling disputes in trade and trade-related matters. Similar to the mechanisms included in the 'most-developed' bilateral agreements which the EU has concluded so far with Mexico and Chile, the sophisticated dispute settlement mechanism with its detailed procedures, time limits and code of conduct should contribute effectively to deterring the parties from breach-

ing the agreement's provisions and from immediately retaliating by using protectionist measures in case of a dispute. Moreover, the mechanism provides a way of preventing disputes being resolved by expression of political and economic power. The Syrian administration, however, should bear in mind that detailed dispute settlement provisions regardless of the advantages they offer require the appropriate institutional and personal equipment. It has been mentioned in the theoretical framework that besides the existence of formal punishment and dispute settlement mechanisms the anchor-sponsoring country or entity should be able and willing to exert pressure on the anchor-seeking country. This condition is best met if the partner is stable and large enough and is sufficiently interested in securing the RIA to discipline the anchor-seeking country. Certainly the EU is both a 'large' and 'stable' partner. Moreover, Syria as one of the countries east of the Mediterranean is a geographical neighbour of the EU. Therefore the EU might be anxious to cling to the AA once it is finally signed mainly for political reasons such: the maintenance of security and stability at the EU's borders, the containment of illegal migration and the fight against terrorism. In addition, although Syria is too small to play a prominent role as an export market for European goods, the EU might nevertheless be interested in regaining the share of the Syrian market it increasingly lost to competitors in recent years.

As outlined above, the costs of bad policy might be enhanced on a direct level if international reputation is lost or bad policies are penalized by intensified competition. Taking into account the scope of leverage which the EU is enjoying in the international arena the Syrian government would risk a large and probably unbearable loss of international reputation if it decided unilaterally to breach, suspend or revoke the treaty. Despite several shortcomings in the agreement's provisions such as the retention of antidumping and safeguard clauses as well as the enormous restructuring which Syrian institutions must undergo to develop the necessary capacities required for the implementation of the numerous reform commitments, competition on the domestic market nevertheless is expected to increase significantly. In other words, the AA together with the other free trade agreements signed with neighbouring Arab countries and Turkey should boost pressure on the Syrian government to refrain from 'bad policies'. Otherwise Syria runs the risk ending up on the losing side of the current inter- and intraregional integration initiatives and becoming the poor man of the region.

Besides increasing the costs of bad policy, future incentives of the anchor-seeking country's government might be altered by enhancing the 'rewards for good policy'. The agreement's channels for enhancing the rewards for good policy comprise of measures to improve access of the anchor-seeking country's goods and services to the market(s) of the other party(-ies) and to provide it with technical and financial assistance. According to Tovias/Ugur the AAs concluded in the framework of the EMP do not deliver enough incentives or are not 'incen-



tive compatible' for MPC's governments to effectively 'tie their hands' (see Tovias/Ugur 2004). In particular, improvement of market access granted by the EU would not only be insufficient in magnitude but would also be 'back-loaded' meaning that the concessions would benefit the MPCs only in the longer term. Like the agreements signed with the other MPCs, the Syrian-European AA's potential contribution to increasing the 'rewards for good policy' is obviously quite limited. As regards market access it must be noted that Syria has been granted duty-free access to the European market for its industrial goods in the framework of the 1977 cooperation agreement. In the case of agricultural produce, fisheries and processed agricultural goods, the AA includes substantial new concessions. Particularly for those products, however, which the Syrian administration defined as 'strategic', preferences are mainly subject to quotas and/or seasonal restrictions. In addition, improved market access to the European market is impeded by the EU's right to resort to contingent protection measures and by complex and restrictive rules of origin to name only the most important potential NTBs. The *Paneuromediterranean System of Cumulation of Origin*, in turn, which supposedly significantly mitigates the restrictiveness of the rules of origin incorporated in the AAs, might in fact only be of limited benefit at least if its current design is retained. Moreover, harmonization of standards or rather mutual recognition, is mentioned as a general target but not elaborated on in detail in the AA's provisions. Anyhow, agreements on mutual recognition and their potential benefits can be expected to materialise only in the long run and only if the EU is prepared to provide substantial technical and financial assistance to Syrian institutions to build up the required capacities. Contrary to most of the agreements concluded with the other MPCs the provisions of the Syrian-European AA stipulate also rights of establishment with which investors from both parties are granted national or MFN treatment in all branches not included in the parties' reservation lists. In addition, the goods, services and suppliers of both partners are offered national treatment for selected entities in public procurement. Given the reciprocity of these concessions, however, it will certainly be European companies that benefit the most from these concessions.

According to some authors, the overall success of the AAs and, in particular, their ability to enhance the credibility of reform in the MPCs depends on the quality and magnitude of financial and technical assistance offered by the EU and its 'implicit linkage' to the implementation of the agreement's provisions (see Ghesquiere 1998, p. 20; Hoekman 1999, p. 98).

As illustrated in *Table 3*, the amounts committed or allocated to Syria by the EU in the framework of the *MEDA programme*, the former principal financial instrument of the EU for the implementation of the EMP, and its successor the *European Neighbourhood Instrument (ENPI)*, are substantially lower than the amounts provided for most of the other Arab MPCs. The same is true for lending offered by the European Investment Bank (EIB) if the period

from 1992 onwards is taken as a basis for evaluation. If actual payments or the amounts finally disbursed are assessed, the picture becomes even worse. Of the amounts committed in the framework of MEDA I only one third have been actually disbursed. Therefore to be able to encourage the Syrian government in the future by enhancing the ‘rewards for good policy’ and thus assuming an active role in locking-in economic reform, the Union and its member countries need to increase substantially their assistance in the form of grants, loans and technical assistance. Although the EU has provided little assistance to the MPCs as a group relative to the magnitude of reform and liberalization that these countries have committed themselves to within the framework of the AAs, it has to be noted, however, that the Syrian administration itself has to take some of the responsibility for the limited amounts committed and disbursed (for a detailed account of EU assistance to Syria see Zorob 2006b; European Commission 2007c).

**Table 3: Assistance in the Framework of MEDA and ENPI (€ million)**

	Algeria	Egypt	Jordan	Lebanon	Morocco	Syria	Tunisia	WBG	Regional
<b>MEDA I 1995-1999 Commitments</b>	164	685	257	182	644	107	431	106	211
<b>MEDA II 2000-2006 Commitments</b>	307	596	314	127	907	207	472	397**	688
<b>ENPI 2007-2010 Allocations</b>	220	558	265	187	654	130	300	632	343***
<b>A* MEDA I (€)</b>	1.07	2.15	10.28	10.41	4.49	1.32	8.99	7.05	0.26
<b>A* MEDA II (€)</b>	1.43	1.33	8.97	5.18	4.52	1.84	7.02		0.61

\* A = Average per year per inhabitant.

\*\* 2000-2004 only

\*\*\* Regional Programme – South

Source: European Commission (2007a): ENPI – Funding 2007–2013; European Commission (2007b): ENPI Regional Strategy Paper 2007–2013 and Regional Indicative Programme 2007–2010.

To be realistic, however, one can hardly expect the EU to back up the Syrian economy with the same amount of massive financial assistance which the USA gave to Mexico in the 1990s to help it to escape a major balance of payments crisis (for details on the US’ assistance to Mexico and the implementation of NAFTA see Francois 1997). Nor can one expect EU assistance to compensate for the high short-term adjustment costs which the Syrian economy certainly will have to face as a result of opening-up its domestic market to European competition. This is not to deny, however, that EU assistance to Syrian reform generated notable positive effects in recent years. As indicated in the first section of this chapter, European

technical assistance played a major part in assisting the Syrian administration, in particular the SPC, in drawing up the 10<sup>th</sup> FYP and in restructuring ministries and other public organs to make them capable of devising and implementing economic reforms (see Zorob 2006a). In addition, funds offered by the EU could help add substance to those issues which are only defined in broad terms in the AA's provisions and thus lack detailed rules and time tables for implementation. An example for this kind of assistance could be provided by the *Programme for Strengthening Quality Management, Capabilities and Infrastructure* mentioned in the *Syrian National Indicative Programme 2005-2006*, which is designed to support the setting-up of national capacities responsible for formulation and control of technical regulations (see European Commission 2004a).

Besides assistance and market access there might be other concessions or 'incentives' the EU could offer in exchange for Syrian reforms. These include first of all purely political concerns which are considered by many observers to be the major motive behind the Syrian decision to join the Barcelona Process. Furthermore, the AA and the agreements signed between Syria and its Arab neighbours and Turkey are currently the only instruments the Syrian government can use to credibly lock in economic reform since its application to become a member of the WTO is stalled for the time being. In addition, the agreement's implementation could help 'import' multilateral disciplines although Syria is still not a member of the WTO. This would help facilitate negotiations for accession whenever political pressure against the Syrian government begins to ease.

Finally there is the issue of complementary reforms anchored in the AA and the degree of 'preparedness' of the Syrian economy to enter an RIA with the EU. As mentioned in the theoretical framework, *inconsistent policies* are a major source causing lack of credibility. They arise when the government tries to violate fundamental budget constraints and accounting identities. For this reason the degree of 'preparedness' must be considered. The macro-economic environment has been relatively stable in recent years, at least according to the official data provided by the IMF and the Central Bank of Syria (CBS) which, however, should be interpreted with caution because of gaps and shortcomings in the quality of data collection and processing. Between 2001-2005 the Syrian economy grew roughly 3% annually on average and the non-oil GDP increased by more than 5% per year (see IMF 2006b). The current account balance recorded a surplus for the whole period according to CBS data (see CBS 2006) and most of the years according to IMF data, except in 2005 when soaring imports of goods and services mainly due to a surge in the oil import bill could only partially be compensated for by rising services revenues and non-oil merchandise exports. The exchange rate of the Syrian pound also remained relatively stable over most of the period. After the conclusion of debt reshuffling agreements with most of Syria's donors and, most

importantly, the more than 70% debt write-off by Russia at the beginning of 2005, external debt was estimated at 25% of GDP in 2005 (see IMF 2006b). Inflation is some cause for concern since it picked up considerably in 2005 and, according to most recent CBS data, rose again in 2006 to reach 9.2%. Meanwhile the official figures have been increasingly criticised in the Syrian press for being completely outdated. It is said that they do not reflect the real situation in which prices, even for basic consumer goods, have been steadily growing. These rises have been causing major discontent among the Syrian population. Although the government is urged by some writers to curb monopolistic market structures and introduce the long-awaited competition and anti-trust law, some of the other reasons given for the surge in prices, however, seem to be beyond the control of the Syrian government. These include the growth in demand caused by the inflow of Iraqi refugees, the number of which is estimated to be close to one million people (see The Syria Report 2007a; al-Iqtissadiya 2006).

Another cause for concern is represented by fiscal developments. Due to an expansionary fiscal policy and simultaneously declining oil export revenues in recent years, the budget deficit rose to an estimated 4.2% of GDP in 2005 as reported by the IMF or 5.1% as claimed by the CBS. The crucial question is, however, whether the government will be able in the years to come to contain the budget deficit at a level below 5% of GDP as stipulated in the 10<sup>th</sup> FYP. This is because oil-related revenues still accounted for some 30% of total budget revenues in 2005, although they did decline from more than 50% at the beginning of the decade. Accordingly, the non-oil budget deficit was estimated to be 13% of GDP in the same year. With oil reserves depleting and production showing a steady decline since the second half of the 1990s, Syria is expected to become a net-importer of oil during the next years. This will generate further pressure on the state budget and, of course too, the current account. In addition, the sale of fuel on the domestic market is heavily subsidised. If oil subsidies were priced in, the 2005 fiscal deficit would jump to over 22% of GDP (see IMF 2007a). To escape the fate of a major fiscal as well as balance of payment crisis the Syrian economy urgently needs to promote alternative sources of exports, growth and income away from its high dependency on oil and other rent flows. Moreover, the government should restructure public finances in order to substitute oil-related with non-oil, tax-based revenues. Such a restructuring could include as well, on the side of public spending, a cut in subsidies as recommended by the IMF and in particular fuel subsidies which are said to be wasted in part by smuggling of fuel across Syrian borders to neighbouring countries. Otherwise the problem with subsidies might even aggravate in the future caused by growing fuel imports needed to satisfy domestic demand combined with high international oil prices. Against this background one could argue that by signing the AA and as a result phasing-out tariffs in trade with the EU the Syrian administration is going to violate fundamental budget con-

straints. Given that tax revenues from international trade are traditionally low, especially if compared to other MPCs, hovering between 2-3% of GDP and 6-9% of budget revenues in the period 2001-2005 besides that there are several alternatives at hand to develop the domestic tax base, the loss of tariff revenues seems to be manageable. Furthermore, it is expected that the trade facilitating measures envisaged in the agreement with the EU and the tariffication of import prohibitions at the beginning of the agreement's implementation will more than compensate the loss of tariff revenues at least during the first years of the transition period (see Zorob 2006c).

To promote alternative sources of income and growth, to make the agreement with the EU a success and to limit the short-term adjustment costs to be expected from the AA's implementation to the greatest extent possible the Syrian government has no other chance as to implement a whole variety of complementary reforms. Those policy measures on the one hand consist of solid macro-economic management plus structural adjustment in fields other than trade to establish the necessary conditions for a supply response by private companies and to ensure the sustainability of trade reform. The measures should also involve liberalising trade with partners other than the EU to prevent trade diversion. On the other hand, trade reform as anchored in the Syrian-European AA should be accompanied by measures to minimize the negative effects of lifting trade barriers on production, income and employment through efforts to restructure domestic productive sectors or a programme of 'mise-à-niveau' in advance of the agreement's implementation and the setting-up of social safety nets for affected income groups. This is exactly where the EU and its member countries on the bilateral level could and should provide enhanced technical and financial assistance. Support for reform of social protection is at least mentioned in the *National Indicative Programme (NIP) 2007-2010* as one of the 'priorities for action'. The NIP, however, gives no details about this and other planned projects except those to be implemented in 2007. Because of the 'difficult relations' between the EU and Syria all further interventions or priority actions scheduled for the period 2008-2010 will be presented in detail in a revised NIP to be based on the Syrian government's progress in formulating its future strategies (see European Commission 2007c). As regards complementary reforms not incorporated in the Syrian-European AA, the government's efforts during the last two years and more especially at the beginning of this year bore some fruit: the exchange rates were unified, a system of managed float was introduced, a new investment law was issued in combination with the establishment of the new *Syrian Investment Authority (SIA)* designed to offer a one-stop-shop service for domestic and foreign investors in the future (see The Syria Report 2007b). Apart from new regulations for investment, however, the general investment climate and overall conditions for doing business, in which Syria, as illustrated in *Table 4*, falls far behind most

of the other countries of the region, need to be improved. In particular the rule of law and the fight against fraud and corruption must be enhanced. Without these measures though there have been some first positive signs of increased FDI inflows in the last two years, in particular, from the Arab Gulf countries, the Syrian economy won't be able to attract the domestic, foreign and Syrian expatriate capital needed to enhance competitiveness of Syrian goods and services sectors and to improve the prospects of long-term growth based on transfers of technology through the channels of foreign trade and FDI.

**Table 4: Investment Climate Indicators in Arab MPCs, 2005/06**

	Regulatory Quality	Government Effectiveness	Starting a Business		Enforcing Contracts		Registering Property	
	(-2.5 to + 2,5)	(-2.5 to + 2.5)	Days	Proc.	Days	Proc.	Days	Proc.
<b>Algeria</b>	-0.37	-0.63	24	14	397	49	51	15
<b>Egypt</b>	-0.35	-0.47	19	10	1.010	55	193	7
<b>Jordan</b>	+0.16	+0.08	18	11	342	43	22	8
<b>Lebanon</b>	-0.28	-0.30	46	6	721	39	25	8
<b>Morocco</b>	-0.39	-0.20	12	6	615	42	46	4
<b>Syria</b>	-1.22	-1.23	43	12	872	47	34	4
<b>Tunisia</b>	-0.07	+0.43	11	10	481	21	5	57

Source: World Bank, Governance & Anti-Corruption, WGI 1996-2005 [<http://info.worldbank.org/governance/>]; World Bank, Doing Business Database, 2006 [<http://doingbusiness.org/>].

Last but not least, it has been argued in Chapter 2 that no RIA, no matter what it contains or with whom it has been signed, can be a panacea. On the contrary, it needs to be part of or integrated in a comprehensive national reform programme pursuing a strategy of economic opening, liberalisation and adjustment. The 10<sup>th</sup> FYP, which explicitly refers to the Syrian-European AA in addition to the GAFTA and the FTA signed with Turkey as integral parts of its strategy of gradual liberalization, includes many of the numerous measures of adjustment and macro-economic management which can't be elaborated in detail here but which are of crucial importance to making trade liberalization a success (see SPC 2006).

#### 4. Conclusion

The main aim of this paper was to develop a general framework for assessment to evaluate the ability of RIAs to serve as effective mechanisms for 'commitment' and 'signalling'. Such a framework is needed, because on the one hand the effect of locking-in reform and enhancing its credibility is generally regarded as one of the most important effects of regional integration. On the other hand, however, and illustrated by the case of the Syrian-European Association Agreement, this is only true if an RIA fulfils several rather tight conditions as re-

gards form, content and choice of partner. To combat problems of inconsistency and unclear motives of the government as principal causes for lack of credibility, RIAs should, among others, clearly state in its provisions the reform measures to be conducted. Moreover, to be able to contribute to changing future incentives of the anchor-seeking country's government and restricting its room of manoeuvre, RIAs should include a punishment and/or even better a detailed dispute settlement mechanism to prevent backsliding in addition to offering enhanced market access and assistance.

The case study presented in this paper was introduced by an account of Syrian reform efforts in the past highlighting their main shortcomings with special focus on the foreign trade regime and explaining the many constraints the process of economic reform is facing in Syria. To 'check' these constraints, at least to a certain degree, and to enhance credibility of reform the Syrian government could choose to sign an RIA with a strong Northern partner like the EU. The Syrian government seems to have chosen this option, albeit indirectly, when it started negotiations with the EU for the conclusion of an Association Agreement in 1998. Despite several shortcomings, this agreement should be able to deliver an appropriate mechanism for signalling and commitment and thus to improve credibility of the Syrian process of reform at home and abroad. By stipulating numerous and substantial reforms, it enables the Syrian government to send clear signals about its 'true' motives. In addition, and apart from the inclusion of the WMD clause as an essential element, the AA should provide an effective device to restrict the Syrian government's room for manoeuvre as well as to increase the 'costs of bad policy' and thus to 'tie its hands' and those of future governments. Although being at least more 'complete' than the treaties signed with the other MPCs, the AA lacks substantial incentives for increasing the 'rewards for good policy'. For this reason the agreement's potential to lock-in reform, enhance its credibility and to encourage the Syrian government to shift its tax and political basis from declining import-substituting to growing export-oriented sectors could be improved significantly if some adjustments of the agreements' provisions were considered. Those adjustments could include, for example, a further expansion of agricultural concessions, less restrictive rules of origin and the abolition of contingent protection. Moreover, to help the Syrian administration to come to terms with the high short-term adjustment costs and to strengthen domestic administrative capacities, the EU should be prepared to provide Syria with substantially increased technical and financial assistance. Far away from initiating adjustment of the AA's provisions in favour of enhancing the 'rewards for good policy, however, it is rather doubtful at present, whether Syria and the European Union – given the current international isolation of the Syrian regime – will sign the agreement in the near or mid-term future.

In a more generalized perspective, the results of this study seem to support the view that most of the North-South RIAs concluded during the ongoing second phase of regionalism are not able to live up to the hopes assigned to them in the literature. This is particularly true for both the effect of locking-in reform and the effect of (securing and) enhancing market access which are often referred to as the most important 'non-traditional' effects of regional integration. Similar to the Syrian-European AA, agreements like NAFTA or the AAs signed between the EU and the other MPCs do not add much to improve market access conditions for the Southern partner as evidenced by a growing number of recent studies. At the same time, and as a direct result of this, they have only limited power to change future incentives of the anchor-seeking government especially since they fail to promote the necessary shift of the tax and political basis from import-substituting to export-oriented sectors. Moreover, significant other provisions which are part of the Syrian-European AA, such as the detailed dispute settlement mechanism, are mostly lacking in the other North-South RIAs. Thus, these agreements do not promise to deliver significant benefits for participating developing countries in terms of locking-in reform and enhancing its credibility.



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