Policy Reform and Convergence Prospects in the Broader European Union Neighborhood

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Abstract

The accession of eight Eastern European countries to the European Union in May 2004 has confirmed that sound macroeconomic management, deeper trade integration, and the alignment of the domestic regulatory framework and institutions with the EU *Acquis* hold the potential of transforming transition economies to functional market economies that are able to compete in the EU single market, participate in the EU institutions, and progressively catch up with the EU. This paper examines the EU neighborhood countries' readiness to leverage the European Neighborhood Policy initiative to promote faster economic and social convergence with the EU. The paper reviews comparative progress on macroeconomic stability, development of human capital, and across a broad array of structural policies that affect private investment and productivity growth: (i) the quality of the regulatory framework for doing business; (ii) trade policy reform; (iii) financial sector reform; and (iv) development of key infrastructure services. The comparative quality of governance is also emphasized because good governance is an overarching factor that affects the investment climate, the management of human assets, and the capacity to maintain sound macroeconomic policies for sustained periods of time. Country rankings across these various policy dimensions highlight the readiness of EU neighborhood members to start a convergence process with higher-income economies by strengthening economic management and taking advantage of the single EU market for the promotion of trade, productivity, and investment. The analysis highlights policy reform areas in individual EU Neighborhood countries where significant gaps exist with respect to new EU members regarding the quality of policies and institutions. Such gaps point to priorities for structural reform in individual countries, in order to take advantage of the European Neighborhood Policy initiative as a means of accelerating growth and promoting convergence.

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1. Introduction

The accession of eight Eastern European countries to the European Union in May 2004 has confirmed that sound macroeconomic management and strong commitment to market-oriented reforms is the key to transforming transition economies to functional market economies that are able to compete in the EU single market, participate in the EU institutions, and progressively catch up with the EU. These countries have successfully leveraged trade integration and the alignment of the domestic regulatory framework and institutions with the EU *Acquis* to strengthen the investment climate and bolster the credibility and momentum of the reform process. Can this successful experience be replicated elsewhere in the broader neighborhood of the EU?

The European Neighborhood Policy initiative (ENP) was launched with the aim of addressing this challenge, by supporting reforms that promote stability and economic and social convergence within and beyond the borders of the EU single market. It is intended to the EU neighbors to the East and the South. The ENP initiative aims to promote convergence by addressing a broader reform agenda than the preferential trade agreements initiated in the 1990s (such as the Association Agreements with MENA countries under the Barcelona process), which have been relatively slow in delivering the expected development results. Experience from other developing countries suggests, indeed, that lowering trade barriers at the border is usually not enough to reap the benefits from trade in open markets. Because the location of many activities has become footloose, competition to maintain positions has increased. *A strong investment climate, strong human capital assets, and logistical excellence have been important parts of all success stories to date.* Countries that have relaxed the “beyond-the-border constraints to trade” that increase the cost of doing business, while harnessing their human capital assets, have been able to stimulate domestic investment, improve productivity, and attract significant flows of FDI as a result of their integration into broader economic areas.

This paper examines the EU neighborhood countries’ readiness to leverage the ENP initiative to promote faster economic and social convergence with the EU. The analysis draws on lessons from the vast body of empirical studies on “growth convergence”, regarding the key determinants of long-term growth potential. The paper reviews comparative progress on macroeconomic stability, development of human capital, and across a broad array of structural policies that affect private investment and productivity growth: (i) the quality of the regulatory framework for doing business; (ii) trade policy reform; (iii) financial sector reform; and (iv) development of key infrastructure services. The comparative quality of governance is also emphasized because good governance is an overarching factor that affects the investment climate, the management of human assets, and the capacity to maintain sound macroeconomic policies for sustained periods of time. On the basis of the analysis, a set of aggregated indicators of 'convergence readiness' is constructed which clusters the different EU neighboring countries according to their relative ability to take advantage of the EU single market in order to speed up their catching up process.

For the sake of the analysis, the geographical range of the EU Neighborhood has been expanded beyond its formal definition, to include not only MENA (Middle East and North Africa Neighborhood) and ECAN (European and Central Asia Neighborhood) countries, but also accession candidates to EU25 (Romania, Croatia, Turkey and Bulgaria). The performance of these subsets of ENP countries is also compared to that of the EU10 countries that gained EU accession in May 2004. (the detailed list of countries forming the groups is presented in Annex 1). Three sub-periods are selected, 1990-94, 1995-99, and 2000-02 to reflect progress on key policy reforms undertaken during the last decade.

The paper is organized as follows: section two provides a review of economic development across the sub-regional blocs (MENA, ECAN, EU25, EU10)[1]: macroeconomic performance, overall levels of human and physical capital and the current features of the economic regimes. The third section reviews progress across key fronts of structural reforms: trade policy; business environment; finance; liberalization of infrastructure services; quality of governance. The fourth section benchmarks EU neighborhood countries (together with new EU member countries for the sake of comparison) across an array of policy and institutional dimensions that are known to be critical determinants of growth and convergence. Principal components analysis is used to construct composite indicators that serve as basis of country rankings.

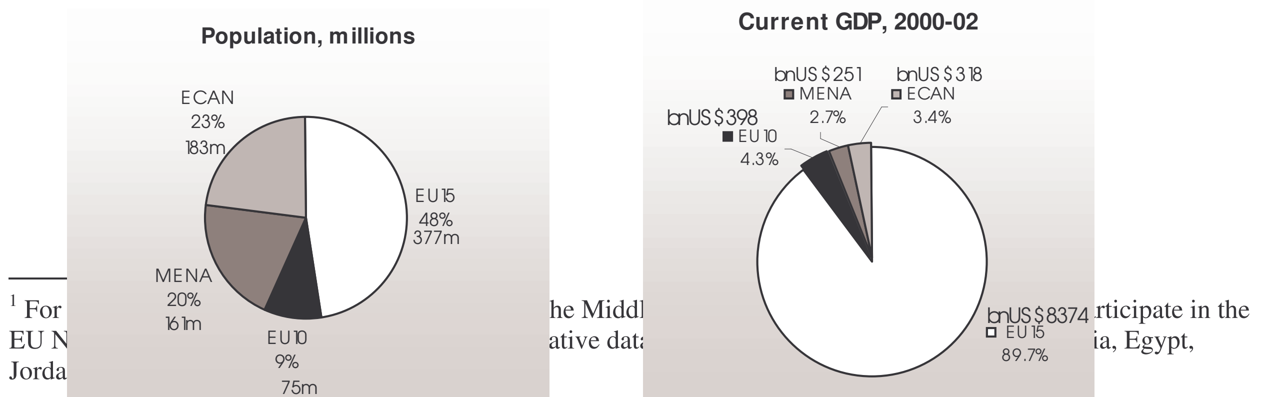
Country rankings across these various policy dimensions highlight the readiness of EU neighborhood members to start a convergence process with higher-income economies by strengthening economic management and taking advantage of the single EU market for the promotion of trade, productivity, and investment. The analysis highlights policy reform areas in individual EU Neighborhood countries where significant gaps exist with respect to new EU members regarding the quality of policies and institutions. Such gaps point to priorities for structural reform in individual countries, in order to take advantage of the European Neighborhood Policy initiative as a means of accelerating growth and promoting convergence.

2. Economic and institutional development in the wider EU neighborhood

2.1. Economy size

The population size of MENA and ECAN is comparable, at 161 million and 183 million respectively (figure below). Both regions include small and large size countries. In ECAN, Turkey and Ukraine have the largest markets with 70 and 49 million people. In MENA, Egypt leads the region with 66 million. The smallest countries in both regions are Armenia (3 million) and Lebanon (4 million). EU10 countries are smaller and more homogeneous on average with the exception of Poland, with a population of 38 million. The whole EU10 makes 75 million people. In contrast, EU15 has a much larger population of 377 million.

Economic potential is more unequally distributed across the four sub regions, with EU15 contributing 90 percent of total GDP (figure). The remaining ten percent is fairly shared between the three other regions, with MENA only contributing to 2.7 percent of the total production.



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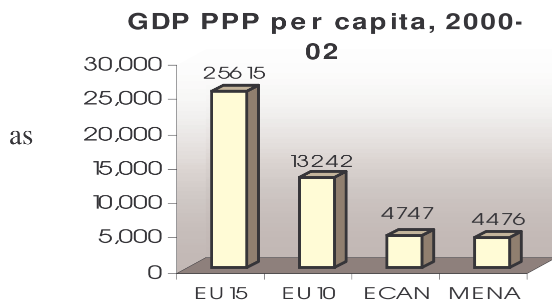
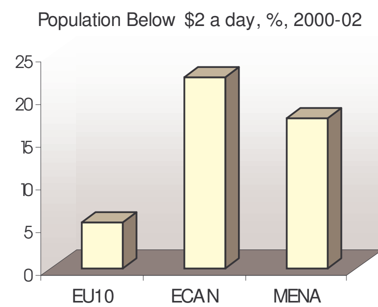
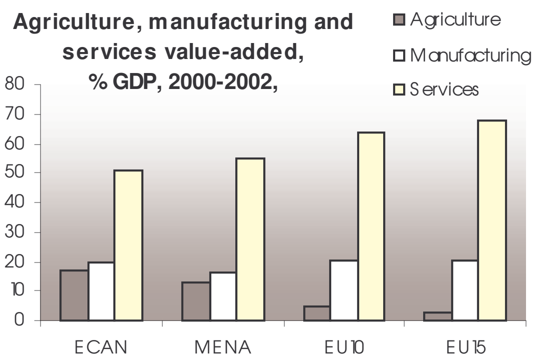
EU10 countries are ahead of ECAN and MENA in terms of per capita income. GDP per capita in EU10 is $6530, against $1931 and $1570 in MENA and ECAN respectively. However, when income is measured in PPP terms, the picture is different (figure). ECAN's per capita GDP triples in PPP terms and slightly exceeds MENA's. ECAN displays a great deal of heterogeneity in terms of per capita PPP GDP. At one extreme of the spectrum, Croatia enjoys the highest GDP PPP per capita. Moldova lies at the opposite side of the spectrum, displaying the lowest per capita GDP PPP in ECAN. In between, one can find countries such as Georgia, Armenia and





Azerbaijan, all of which have per capita PPP GDP below $US4000. MENA displays a more uniform per capita PPP GDP, with Tunisia displaying the highest level, estimated at $US6700. In essence, EU neighborhood countries have still long way to go before converging with European countries- MENA and ECAN adjusted for purchasing power parity income per capita are 17 and 19 percent of EU15 and around 35 percent of EU10.

In EU15 and EU10, less than 0.5% and 5.4% of the population respectively live below the poverty threshold of $2 a day. ENP countries, by contrast, display considerably higher levels of poverty. In MENA, on average, 17.5% of the population lives below the poverty line defined as $2 a day. In ECAN, the rate is even higher, estimated at 22.4%. These rates are high for countries ultimately trying to converge toward EU levels, such as Turkey (10.3 percent), Bulgaria (16.2 percent), and Romania (20.5 percent).



Regarding the sectoral distribution of value added, services hold the largest portion of the GDP in all four sub-regional blocs, contributing to at least 50% to the economy (figure).[2] Yet, EU neighborhood countries lag behind EU countries, where services provide more than 60% of the economy value-added. These two regional blocs diverge also in terms of agriculture output. EU countries have low ratios for agriculture value added, 2.9% for EU15 and 4.5% for EU10[3]. In contrast, agriculture contribution is three to four times larger in ECAN and MENA. These two sub-regional blocs are formed by developing economies, more dependent on agriculture than the EU members. In the majority of ECAN countries (Moldova, Georgia, Armenia, Romania and Azerbaijan), the agriculture sector provides jobs for more than 40% of the employees.

The four sub-regional blocs converge in terms of the manufacturing sector's contribution to national output, with the exception of MENA (where the contribution of manufacturing to GDP is estimated at 16 percent) compared to 20 percent for the three other regional blocs. Algeria and Lebanon are pulling down the MENA regional average with 8 and 10 percent respectively. Belarus (33 percent) and Syria (26 percent) have the highest levels in the EU neighborhood. For some EU neighborhood countries, the contribution of mining and quarrying to the economy is significant. In Azerbaijan and Algeria, both oil-producing countries, the sector value added represented 30 and 36 percent of the GDP respectively over the period 2000-02.

2.2. Macroeconomic Management

Macroeconomic stability is a key underpinning of a predictable business framework, conducive to greater private investment, increased efficiency, and better mobilization of savings for the financing of investment. Prudent and forward-looking macroeconomic policies are, thus, a precondition for fast and sustained growth.

2.2.1 Growth and inflation

The three sub-regional blocs (MENA, ECAN, EU10) bordering the core EU15 experienced different patterns of macroeconomic adjustment, structural reform, and growth during the 1990s. Most of the EU10 and ECAN countries went through a turbulent period of transition in the early 1990s, with broad-ranging market-oriented reforms, public enterprise restructuring, sharp retrenchment of government from economic activity, and tight fiscal policies to meet the challenge of declining fiscal revenues in the face of large public expenditures. Thus, most EU neighborhood countries saw sharply declining growth in the initial phase of the transition and, in some cases, prolonged periods of stagnation owing to acute financial crises and/or hyperinflation (Bulgaria, Romania, Moldova, Ukraine).

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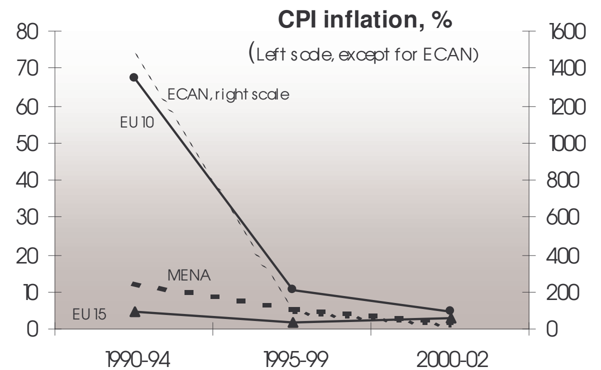
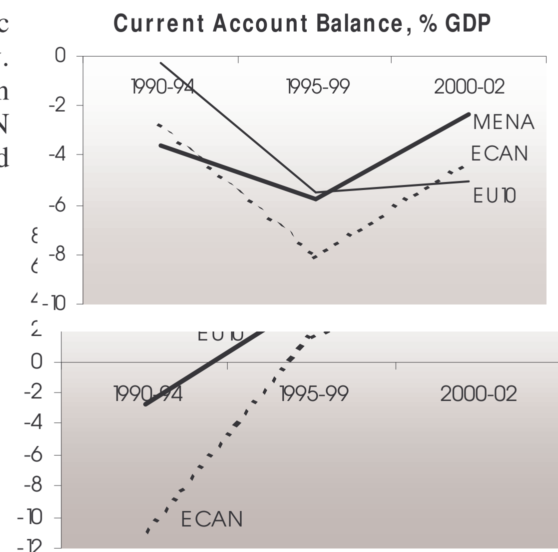
[2] Services comprise wholesale and retail trade (including hotels and restaurants), transport, and government, financial, professional, and personal services such as education, health care, and real estate services. Also included are imputed bank service charges and import duties.

[3] Data on value-added was not available for two EU10 countries, Cyprus and Malta.

Since the mid nineties, structural reforms and the rising role of the private sector had significant pay offs. Growth in the EU10 countries resumed faster than in ECAN, and in the second half of the 1990s these countries that gained EU membership in 2004 were growing by 4 percent on average per year. The recovery in ECAN countries was more gradual, but by 2000-02 that region too was growing by 5.6 percent per year on average, the highest among the three regions (Figure). Structural reform has been more gradual and piecemeal in MENA countries participating in the EU Neighborhood, and has yet to deliver the expected growth dividends. On average, MENA growth has declined compared to the early 1990s, but has been set on a more sound footing as it is driven more by productivity improvements and less by unsustainable increases in domestic demand. MENA growth has been more adversely affected by the post-September 11 turbulence compared to the other regions.



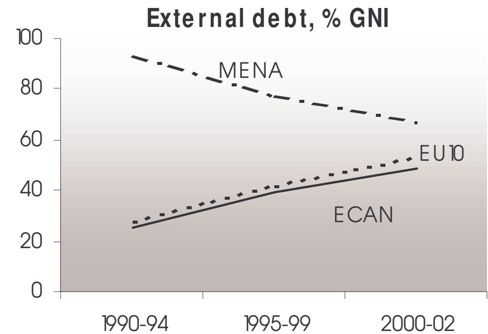
Macroeconomic stability has generally improved across the three regions during the 1990s, as shown by the steady reduction in the inflation rates (Figure). EU10 and ECAN countries started with very high levels of inflation during the first half of the 90s, as a result of the transition to the market, or endemic macroeconomic imbalances in some market economies such as Turkey. Armenia and Ukraine experienced hyperinflation. Inflation remained relatively more entrenched in some ECAN countries such as Belarus, Turkey, Romania, Moldova and Ukraine, although it recently reached single-digit levels in Turkey. Reflecting prudent macroeconomic management, inflation rates in MENA declined to levels comparable to those in the EU15, although in some countries administered prices still represent a significant part of the CPI.



2.2.2 External and internal balances

External current account movements in the three sub-regional blocs of the broader EU neighborhood display two broadly similar patterns: (i) a worsening of the external situation over the second half of the 1990s, reflecting gradual strengthening of domestic demand after the shock of the transition in EU10 and ECAN, and (ii) sharply lower trade protection that boosted the demand for imports. In MENA, prudent macroeconomic management prevented a sharp worsening of the current account—with the exception of Lebanon, and to a lesser extent, Egypt—despite the lower price of oil that has depressed export revenues of countries such as Algeria and Syria. The reduction of current account imbalances in 2000-02 mirrors the general strengthening of the macroeconomic framework. It has been supported by stronger export performance in ECAN, by higher oil prices that have boosted export earnings of oil producers, and significant inflows of worker remittances.

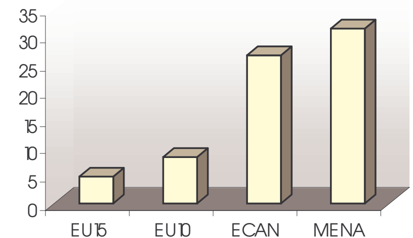
Progress in managing budget imbalances has been uneven across the sub-regional blocs under analysis. Budget deficits were sharply reduced in MENA countries over the period 2000-02, owing to large government oil revenues in oil producer countries and, also reflecting a tightening of fiscal policies in some resource-poor countries, such as Tunisia. Progress in reducing the budget deficit was also registered in EU10. But significant budget imbalances still remain in the ECAN bloc of countries. While some ECAN countries (Bulgaria, for example) registered lower budget deficits, this was somewhat concealed by the very large budget deficit that persisted in Turkey (15.5% of GDP), reflecting the large interest payments on this country's public debt.



2.2.3 External debt

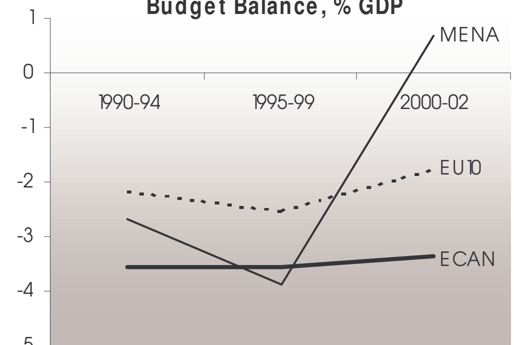
External debt shows similar patterns for EU10 and ECAN. In both sub-regions, external debt-to-GDP ratios increased steadily, to almost double their level in the early 1990s. This trend reflects the worsening of the external current accounts discussed earlier. By contrast, in MENA the external debt-to-GDP ratio declined over time, reflecting an external current account deficit kept at a moderate level during the 1990s and sharply reduced over 2000-02. However, despite this improvement, the external debt-to-GDP ratio in MENA remains higher than in the other two sub-regional blocs of the EU neighborhood. High external debt-to-GDP ratios raise considerable risks for debt sustainability owing to the vulnerability of MENA countries to terms-of-trade shocks and their high reliance on other volatile sources of revenues (tourism, remittances) that affect their external positions.

Infant Mortality rate per 1,000 live births, 2000-02



2.3 Human capital

People's health and skills affect their ability to contribute to sustained and faster growth. The availability of skilled and healthy workers also shapes the decisions of firms to adopt new and more productive technologies, expand, or enter new markets. Education improves health through greater awareness of health disease prevention. Health in turn strengthens the incentives and ability to invest in education.

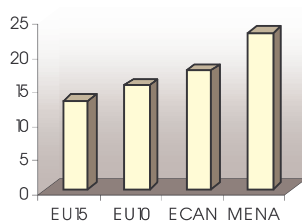


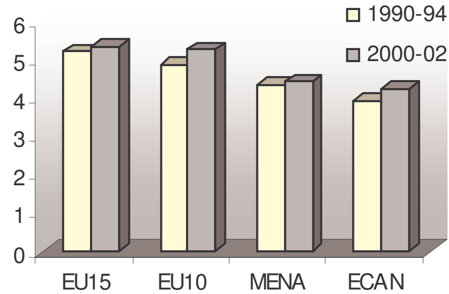
2.3.1 Health

Infant mortality rates remain high in the broader EU neighborhood, and well above EU member countries average rates. On average, 30 infants per 1000 live births die in the ENP regional bloc, while the norm is less than 10 for EU countries. Differences are less striking between

EU neighboring countries and EU countries regarding life expectancy at birth. People expect to live up to 70 and 78 years old in average respectively.

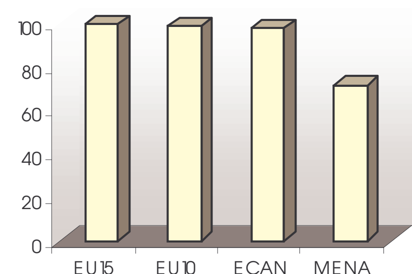
2.3.2 Education





MENA lags well behind the other sub-regional blocs in terms of adult literacy rates. These are consistently below 90% for MENA countries, with Morocco displaying a record low rate of 45%. ECAN, by contrast, enjoys much higher adult literacy rates, at above 98%, comparable to EU15 rates. A closer look at the EU15 data indicates that all countries which joined the EU had a high level of literacy rate prior to the accession. MENA countries need to improve the education level of its population, for men as well as for women (for which illiteracy rates are even higher), in order to have the prerequisite educational level to embrace sustainable economic and social development.

In MENA, the overall level of expenditure on education as a percentage of GNI is comparable with other EU neighboring countries' level, although it is the only sub-region whose expenditure share hasn't increased since the early 90s (left figure). In spite of a relatively large share of education expenditure, MENA has the lowest adult literacy rates in the EU neighborhood, and the highest teacher-to-students ratios (right figure), suggesting low efficiency of spending.

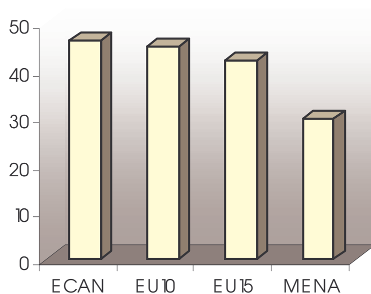


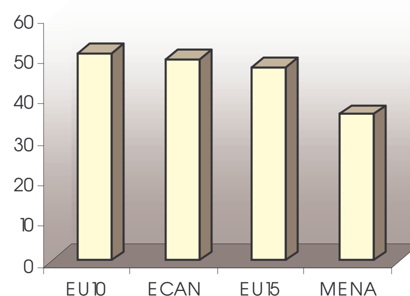
2.3.3 Labor force

MENA countries in the EU neighborhood are characterized by a large pool of young people. This can be a blessing or a curse. Unfortunately, it is currently a curse in

MENA countries where unemployment rates are relatively high. As indicated in the following figures, MENA labor force, as a percentage of the population, is the lowest compared to the other regions. Only 36 percent of the population forms its labor force, while rates are much higher for ECAN, where the labor force represents 50 percent of the population. Nevertheless, this condition has been improving since the early 90s when the labor force in MENA made 32 percent of the population.

The situation appears even more problematic when bearing in mind that female participation into the labor force is the lowest in MENA countries. On average, women make up 30 percent of the labor force in the region, where the maximum posted are in Morocco and Tunisia, with 35 and 32 percent for the 2000-02 period. In contrast, female participation varies between 40 and 50 percent in EU15, EU10 and ECAN (the lowest is in Turkey with 38 percent). The high participation of women in ECAN could be related to their relatively higher reliance on the agricultural sector. The weak contribution of women in MENA's economies prevents the region from a great source of labor force and potential growth.

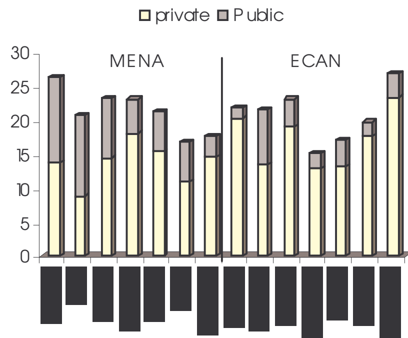


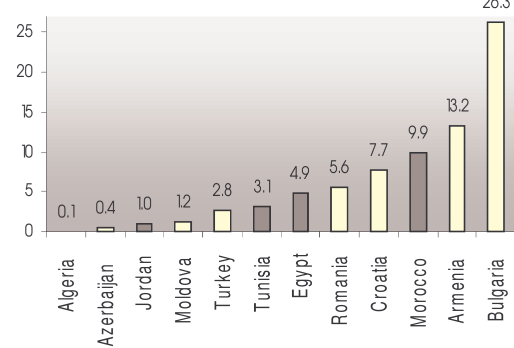


2.4. Capital Formation: Public versus Private Investment

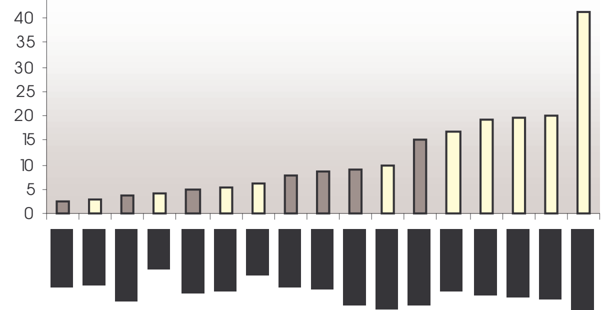
MENA is the region where public capital investment is the highest, more than double of ECAN and seven times EU15 level. A key difference between the two groups of ENP countries is the predominant role of the private sector relative to the public sector. As shown in the left figure, only a small part of the investment is undertaken by the government in ECAN, except for Bulgaria. By contrast, public investments are more important in MENA,

particularly in Tunisia and Syria, where half or more of the investment is financed by the government. In new European members (EU10), the private sector plays a more predominant role, as illustrated in the right figure. Bringing in more private investment will create more jobs for new graduates without imposing fiscal constraints on the government.





This difference between MENA and ECAN respective levels of private investment partially arises from the discrepancy in the pace of privatizations in both ENP sub-regions. Indeed, with the exception of Morocco, MENA countries lag behind their peers in terms of service privatization. The following figure shows privatization's proceeds as a percentage of GDP (period average for 1990-99). Eastern European countries have been more aggressive in terms of furthering the privatization agenda. An extensive empirical literature comparing public and private enterprises in industrialised countries concludes generally, but not uniformely, that private firms display higher productivity and better performance than public enterprises. Even in countries that have been slower to privatize, such as in Poland, bold macroeconomic reforms imposing financial discipline on state companies, and increased competition as a result of a larger number of new private firms, enabled the economy to achieve and sustain high growth rates.



MENA also lags behind other EU neighborhood countries in terms of the level of foreign direct investment. Between 1992 and 2002, MENA countries received less FDI net inflows (% of GFCF) than ECAN countries despite the privatization programs launched in early reformer countries, such as Morocco and Tunisia. Large inflows to some ECAN countries reflects the transition from social to market-led economies, with heavy privatization programs involving sales to foreign investors. In some countries, such as Azerbaijan, large FDI inflows were driven by investments in the oil sector. Hungary and Estonia fully opened their firms and banks to foreign investors, that led to higher levels of investment, know-how and competition (World Bank, 2002). A recent study of sources of growth in Eastern Europe for the period 1995-2000 shows that FDI was paramount for growth (Tondl and Vuksic,

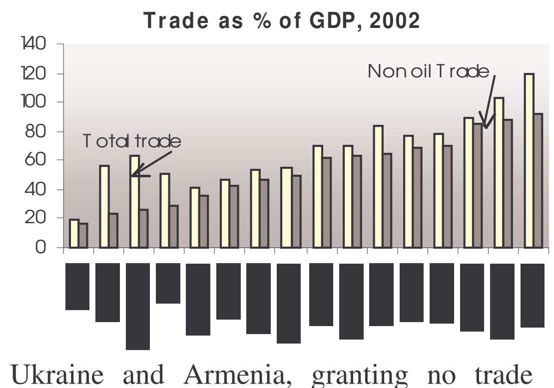
2003). The study reveals that regions with twice as much FDI than others have almost 6 times higher growth rates.

3. Progress on structural reforms

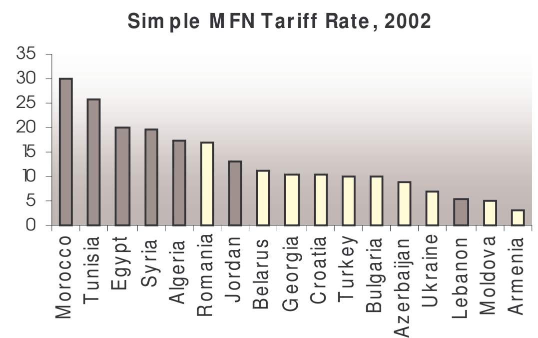
Structural reforms are defined as the set of public policies and institutional reforms aimed at increasing an economy's market orientation, productivity and competitiveness. For the purposes of this paper, progress on structural reforms will be assessed across the following dimensions: trade openness, service liberalization (with particular emphasis on key 'backbone' services: telecommunications and finance), and 'behind the border' constraints to trade and investment, as reflected in the quality of public sector governance and the business environment.

3.1. Trade openness

Since 1995, the EU15 has put in place Free Trade Agreements with countries of the Southern Mediterranean. However, because these agreements have a narrow scope and coverage[4] and that the larger tariff reductions are to be taken in the final years of the agreements, evidence suggests that they have not allowed these countries to gain market shares in the EU. When they are expanded to services and trade in agriculture such as in the Accession Agreements signed with future EU members, more positive impact will be expected. With Eastern Neighborhood countries, the EU has only Partnership and Cooperation Agreements in force with Ukraine and Armenia, granting no trade preferential treatment.



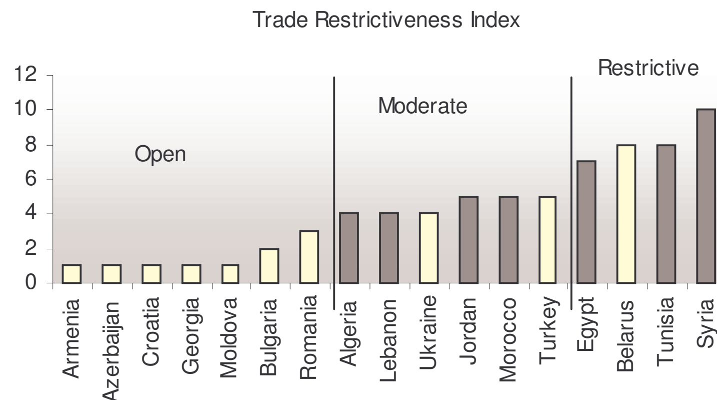
MENA countries trade less than ECAN countries in percentage of GDP, especially when oil trade is excluded, and are, as a consequence, less integrated into the world economy than their comparators (left figure). Only Tunisia and Jordan post rates superior to 50 percent, but still lower than three ECAN top traders (Bulgaria, Moldova, and Belarus). Some countries in the neighborhood heavily trade oil. Trade increases more than twice as a share of GDP in Algeria and Azerbaijan when oil exports are taken into account.



[4] The Euro-Med agreements do not include trade in agriculture, services, and labor. They suffer for the lack of harmonization of standards, and stringent rules of origin for some manufactured goods that have export potential, such as textiles and clothing (World Bank, 2003a).

MENA countries have the highest unweighted[5] average tariff rates in the ENP (Lebanon is the exception). Rates range from 13 percent for Jordan to 30 percent for Morocco (26 percent for Tunisia). This is an unexpected result for two top reformers in MENA. In contrast, European comparators within the ENP have much lower MFN rates, reduced upfront unilaterally, and varying between a record low of 3 percent for Armenia to 17 percent for Romania.

MENA countries have also high non-tariff barriers, which translates in high trade restrictiveness index (TRI which is an indicator combining tariff and NTB estimation). It is defined by a 10-point scale, from the least to the most restrictive trade policy (see for more details). Syria, Tunisia and Egypt, along with Belarus, are the most restrictive, while the most open economies are from the ECAN region (following figure). MENA countries are characterized by higher tariff and NTBs rating, which makes it the most restrictive area. Surprisingly, ECAN region seems to be less restrictive than EU10 countries, which fall in the moderate group with an overall rating of 4. All EU10 countries present the same pattern: open economies in terms of tariffs but moderate in terms of NTBs.



3.2. 'Behind the border' constraints to trade and investment

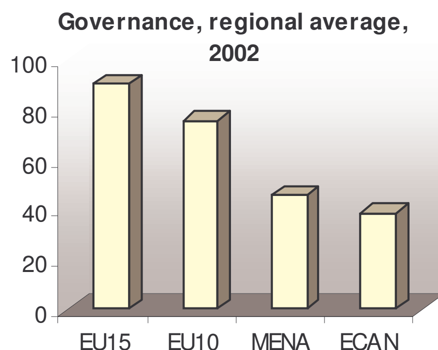
The process of global integration and economic development requires investment supply responses that are influenced not only by macroeconomic fundamentals and border price signals but also by a host of behind-the-border investment climate factors that affect the domestic costs of production. Hence it is useful to make a distinction between "border barriers" and the "behind the border" reform agenda. The first focuses on reducing the average level and the dispersion of border protection, eliminating NTBs, and strengthening the public institutions needed to ensure that goods cross frontiers with low transactions costs (i.e., efficient customs regimes that do not create anti-export biases).The second revolves around the institutional and regulatory framework affecting the investment decisions of firms. Important issues here include investors' perceptions about the quality of governance (rule of law, bureaucratic efficiency, public accountability) and administrative barriers to business entry, operation and exit.

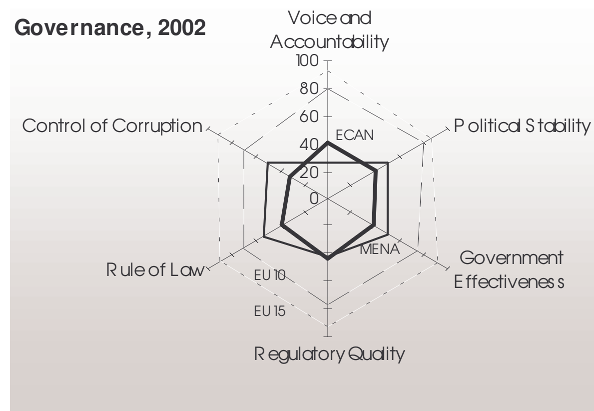
3.2.1. Governance quality

[5] Weighted tariff rates are slightly lower. However, the ranking and the discrepancy between countries are the same.

Governance refers to the rules and process governing the exercise of authority in the name of a constituency. Since it affects government policy formulation and implementation, the quality of governance determines to a great extent the attractiveness of the business environment for investment and production. Good governance makes it easier to start, run and close a business. It reduces transaction costs and improves the predictability in the application of government rules and regulations. Poor governance, by contrast, is associated with weak growth. Simulations find that if MENA[6] had matched the average quality of administration in the public sector for a group of good-performing Southeast Asian countries, its growth rates would have been higher by about one percent. If the region had grown as fast as Hungary, average incomes would be twice what they are today (World Bank, 2003c).

The following charts give a snapshot on investors' perceptions of the governance quality[7] in the four sub-regional groups of the EU neighborhood, on average. Governance quality is measured according to six broad indicators developed by Kaufman, Kraay and Mastruzzi (2003). These indicators are: voice and accountability, rule of law, control of corruption, regulatory quality, political stability and government effectiveness (see annex for the detailed definitions). Country rankings are presented in percentiles. Figures X show the percentage of countries worldwide that rate below the selected country/region (subject to a margin of error) at a certain level of confidence. For instance, a rate of 75% means that 75% of the countries rate worse and an estimated 25% of the countries rate better than the considered region/country.





Along with high incomes, EU15 countries perform the best in terms of governance. Indeed, all studies on governance find that governance improves with income. New EU members present a good level of governance as well. On average, they do better than 75% of the rest of the countries. In contrast, ENP countries have a lesser quality of governance with slightly better records for MENA. MENA and ECAN countries perform worse than half of the countries. The former specifically under-perform in terms of

[6] In the study, MENA refers to the whole MENA region.

[7] Governance is difficult to collapse into a few empirical measures that can be compared across countries. Many measures are based on observer perceptions and opinions, making the measures subjective. Besides, the lack of data on the quality of governance in MENA compounds the difficulty of measuring governance empirically.

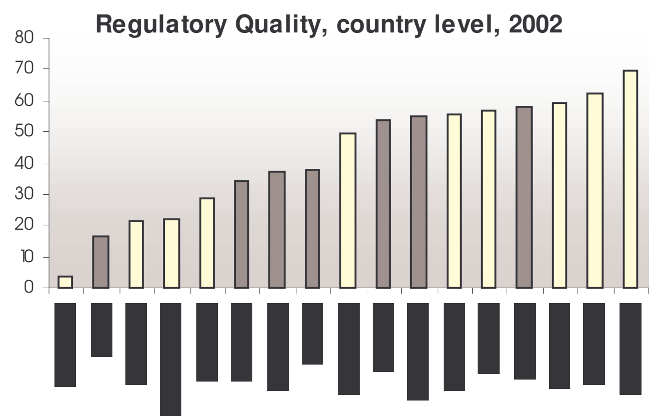
voice and accountability, reflecting the lack of political openness in some countries of the MENA region. In ECAN, deficiencies related to predictability and effectiveness of the judiciary and the enforceability of contracts, as well as the presence of corruption, are the most serious hurdles to business development and growth. Both regions tend to be perceived as 'bureaucratic' and providing lower-than-expected quality of public services given their income levels. In MENA, lack of public accountability rather than lack of bureaucratic capabilities seems to be at the core of the region's governance deficiencies (World Bank, 2003c).

ECAN and MENA weakly perform in terms of regulatory quality. This indicator measures the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development. However, data at the country level shows a better level of regulatory quality in most ECAN countries. Five out of six top performers are part of the ECAN countries' group (figure). The regional low average is mainly driven by the very low performance of Belarus. Within MENA, Jordan, Morocco and Tunisia do better than the other countries. Yet, these countries have still a long way to go to converge toward European Union countries, in terms of the quality of their business environment.

MENA countries have seen their regulatory index deteriorating in recent years. As illustrated in annex, the regulatory quality percentile for all MENA countries, except for Algeria, is lower in 2002 than in 1998 and 2000. As to ECAN countries, their regulatory quality has improved between 1998 and 2002, after experiencing a draw back in 2000. The only country that has seen a fall in its percentile is Belarus. This trend is disturbing for stable and open market countries such as Morocco and Tunisia. One could tentatively explain it by the pace of reforms in these countries and the region as a whole. Positive signals of strong market reforms in the late 90s were not sustained and foreign investors still perceive MENA as a region burdened by excessive regulation.

3.2.2. Business environment: barriers to business entry, operation, and exit

Relying on aggregate indicators of regulatory quality provides limited insights into the heterogeneity of institutional arrangements within countries and the impact of those arrangements on the investment decisions of different firms. These limits inspired the search for more disaggregated evidence on the quality of investment climate. The World Bank is contributing to this work in several ways, including the launching of investment climate surveys and the Doing Business Project (World Bank, 2003b). Doing Business Project reports on the time and costs of doing business across various areas of regulation, including: business registration, contract enforcement and labor regulation. This section provides a brief overview of the relative rankings of EU neighborhood countries across these dimensions. Overall, ECAN countries enjoy a more favorable environment for doing business than MENA countries (see Tables below).



Simpler and low-cost regulation encourages firm entry. Although it might take a little bit longer to start a business in ECAN, it costs a lot more in MENA than in any of the other sub-regional blocs of the wider EU neighborhood. In MENA, the minimum capital requirement is very high, as well as the collateral cost, presenting a serious obstacle to starting a business. MENA entrepreneurs must deposit, on average, 1173% of GNI per capita (when Syria is excluded, the ratio decreases but remains very high at 526%) in a bank to obtain a business registration number. The cost of starting a business in ECAN is comparable to EU10's levels. However, these regional averages mask wide variation across countries. A number of EU neighborhood countries made significant improvements to increase the ease of starting a business. Turkey, for example, launched one-stop registration, by combining 7 procedures to register a company into a single visit to the company registry. As a result, the time to start a business was cut from 38 days to 9. The cost fell by a third. And the number of registrations shot up by 18 percent. MENA countries (Morocco, Tunisia, Lebanon, Jordan) also introduced similar administrative reforms. Other EU neighborhood countries will benefit from greater simplification of business registration regulations.

Starting a business

	Time to Start a Business (days)	Cost to Start a Business (% of GNI per capita)	Minimum Capital (% of GNI per capita)	Collateral Cost
EU15	31	9	36	7
EU10*	44	13	73	6
ECAN	43	16	39	8
MENA	32	47	1173	29

* Data is not available for Cyprus and Malta.

Weak enforceability of contracts increases uncertainty in investment decisions and the costs of doing business. In ECAN, courts are faster and more efficient than in MENA. Enforcing a contract in MENA requires more procedures and it will cost more than anywhere else (Table below). Yet, the ability to enforce a contract is critical for businesses to engage with new borrowers or customers. In the absence of efficient courts, fewer investments and business transactions take place. Those that do involve a small community of people who have developed informal relations through kinship, repeated dealing with each other, or through the security of available assets (World Bank, 2003). The fewer procedures, the lower the cost, the shorter the time to resolve disputes, the more likely that business are to go the judge when a dispute arises. As confidence in dispute resolution rises, entrepreneurs become more willing to enter contracts beyond their narrow circle of known business partners. Trade increases and business expands, fostering economic growth.

Enforcing Contracts

	Procedures	Duration	Cost (%Debt)
EU15	21	276	12
EU10*	25	466	12
ECAN	29	316	17
MENA	38	403	21

* Data is not available for Cyprus and Malta.

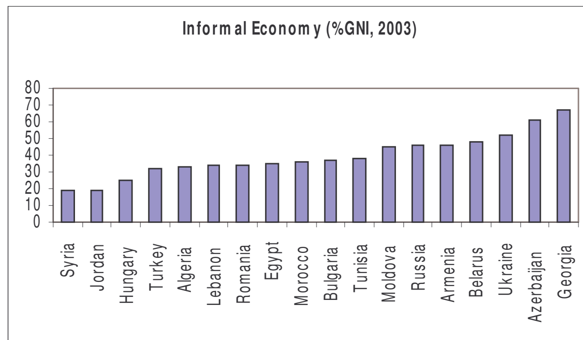
Labor market flexibility in a number of EU neighborhood countries is hampered by relatively rigid labor market regulation, especially employment protection legislation. ECAN countries have an edge on MENA countries regarding the labor market regulation (Table below). Although both sub-regional blocs compare favorably in terms of flexibility in hiring, MENA is doing poorly regarding the flexibility in firing, displaying the highest firing index and cost. In MENA, termination rules are more rigid and protective. Entrepreneurs do not have incentives to hire as it is difficult and costly to fire workers. It also prevents firms to react quickly to market demand by hiring when demand peaks and firing when demand is low. However, firms try to overcome this obstacle by offering short-term contracts rather than long-term and stable ones. MENA countries have more flexible regulations on working hours requirements than in ECAN and EU15, making available more part-time and fixed-term contracts.

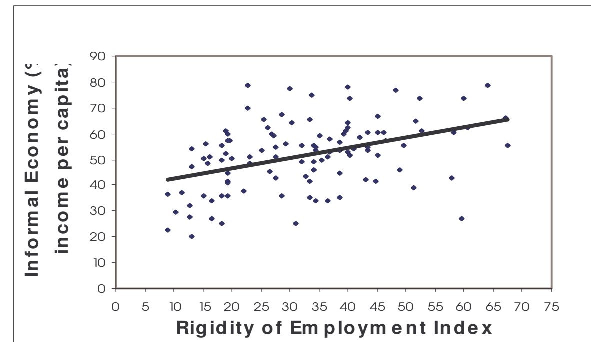
Labor market flexibility

	Hiring Index	Firing index	Rigidity of Hours	Firing Cost
EU15	35.7	34.3	62.9	50.1
EU10	27.0	47.5	37.6	31.8
ECAN	38.0	53.0	53.0	51.1
MENA	38.9	62.9	40.0	83.0

* Data is not available for Cyprus and Malta.

International evidence shows that rigid labor market regulation is associated with informality and unemployment –especially of young workers and women (Djankov et al, 2002). As a result of rigid employment regulation, private enterprises find it difficult to restructure, and small firms often find solutions outside the legal framework. They hire informal workers and avoid providing social benefits (World Bank, 2004). Heavy labor market regulation is also associated with greater size of the informal economy in the EU neighborhood (see Figures X). In Tunisia, an estimated 38 percent of business takes place in the informal sector, and in Belarus, Ukraine and Georgia, over 50 percent of businesses operate in the informal economy. Rigid employment regulationis also likely to hamper private investment. Firms in the informal secotr do not operate at full capacity, while their counterparts in the formal sector suffer from unfair competition and may thus not expand capacity at potential (Anos Casero and Varoudakis, 2003).





3.3. Liberalization of key 'backbone' services: telecommunications and finance

International experience suggests that good quality and low cost backbone services (such as telecommunications and finance) are key elements of deeper market integration. Competitive backbone services reduce the cost of exporting and strengthen the linkages with global production networks. Regulatory reforms that inject more competition in markets for services and network industries are, in turn, instrumental in forcing operators to improve efficiency and pass on the lower production costs to users. But because in many developing countries domestic providers of services often operate below international efficiency standards, opening up markets to competition has to go in tandem with lowering trade barriers in services and making room for increased foreign entry in domestic markets.

The efficiency of service sectors is also a key determinant of the competitiveness of national firms and international experience has revealed the potential synergies between the liberalization of trade in services on the one hand and the liberalization of trade in merchandised goods on the other. Liberalization of trade and investment in services should therefore be a major element of policy reform strategies in the EU neighborhood. More efficient 'backbone' services would permit EU neighborhood countries to more closely integrate in European production networks and thus increase the export response of tariff reductions.

3.3.1. Telecommunications liberalization

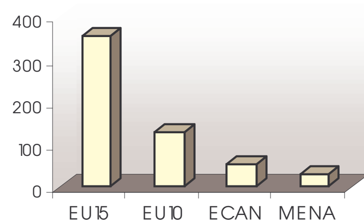
International experience indicates that openness of the telecommunications sector to competition and pro-competitive regulation is associated with better competitiveness and international trade benefits, including the development of electronic commerce (Schware and Kimberly, 1995, 2000; Rossotto and al, 2003). Telecommunications also play a key role among backbone services because they affect efficiency and growth across a wide range of user industries. The quality and price of telecommunication

services directly affects business costs, but also affects the capacity of firms to network and compete in foreign and domestic markets. Good quality and low cost of leased lines and backbone networks also facilitates internet penetration and the spread of IT applications in businesses that spur productive efficiency. Moreover, services are intertwined: Efficiency in transport and finance, key services that facilitate trade, depends on information technology, and thus on the performance of the ICT sector.

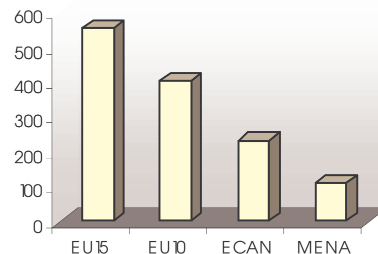
In terms of telecommunications infrastructure, MENA countries lag behind their eastbound EU neighborhood comparators. Croatia's telephone mainline coverage is nine times better than Morocco's. Lebanon has the best main lines coverage within MENA and it is ranked only seventh out of the eighteen countries considered in the analysis. The rest of the MENA countries are among the last in the ranking. Overall, the EU neighborhood countries have the lowest level of personal computers per 1000 people. Within this group, continental countries do better than Mediterranean countries. The combined insufficiencies of main lines and personal computers translate into a low number of internet users, particularly startling within MENA countries. The number of internet users depends considerably on the public access to the internet.

MENA countries are late-comers in terms of internet adoption. Most of MENA countries started introducing the internet during the second half of the nineties, when most European countries, even transition economies were already connected to the web. Despite the recent surge in internet users in MENA countries, internet access is still not widespread. Mediterranean countries also stand apart in terms of internet hosts numbers as well. Internet penetration in MENA—as measured by the number of internet hosts—remains far below levels seen in the other sub-regional blocs in the EU neighborhood. Restrictive market access may be a factor, as internet penetration is particularly sensitive to access pricing and to the regulatory framework in internet service provision. Frequent government content controls in some MENA countries are another factor that impedes the spread of the internet, as measured by the number of hosts. Yet, it is easy to circumvent content controls by having websites hosted in foreign countries, rendering internet host controls ineffective.

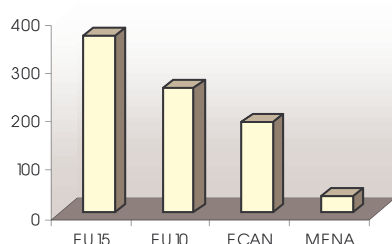
Number of personal computers per 1000 inhabitants, 2002



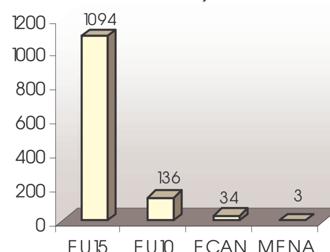
Main lines per 1000 inhabitants , 2002



Estimated internet users per 1000 inhabitants, 2002



Number of internet hosts, thousands, 2002



The fact that a large number of MENA enterprises decide to host their website abroad reflects the weakness of MENA's telecommunications infrastructure, both in terms of higher cost and regulatory impediments. International evidence shows that internet penetration falls short in countries with the least open telecommunications markets. MENA countries, with the weakest levels of internet penetration, lag behind the other EU neighborhood countries in terms of their progress on regulatory reforms to liberalize markets in services. Rossotto et al (2003) computed and index of market penetration in telecommunications that included three main dimensions: (i) degree of effective competition, (ii) openness to FDI, and (iii)pro-competitive regulation and independence of the regulatory bodies. Most MENA countries are clustered around the lowest levels of this index of telecommunications liberalization, with the exception of Morocco (See following Table).

International evidence shows that "full market openness" would boost internet penetration of MENA countries dramatically, by up to 18 hosts per 10,000 people on average, from about only 2 hosts currently. Baseline per capita real income growth of 2 percent per year over a 5-year period could further raise that ratio to about 23 hosts per 10,000 people. This would bring internet penetration close to levels now seen in EU15 countries.

Indicator of Market Openness in Telecommunications Services (1998-99)

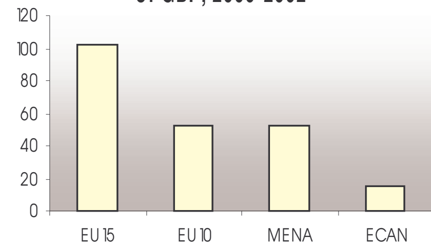
Restricted market access (openness indicator=1)	**Limited degree of market openness** (openness indicator=2)	**Moderate market openness** (openness indicator=3)	**Full market openness** (openness indicator=4)
Tunisia (MENA) Yemen (MENA) Algeria (MENA) Syria (MENA) Armenia (ECAN) Cyprus (EU10)	Egypt (MENA) Jordan (MENA) Lebanon (MENA) Georgia (ECAN) Romania (ECAN) Croatia (ECAN) Turkey (ECAN) Azerbaijan (ECAN) Belarus (ECAN) Moldova (ECAN) Slovenia(EU10) Latvia (EU10) Malta (EU10)	Morocco (MENA) Ukraine (ECAN) Bulgaria (ECAN) Poland (EU10) Hungary (EU10) Estonia (EU10) Slovak Republic (EU10) Spain (EU15) Ireland (EU15)	Czech Republic (EU10) Lithuania (EU10) Belgium (EU15) France (EU15) Austria (EU15) Denmark (EU15) Finland (EU15) Germany (EU15) Italy (EU15) Netherlands (EU15) Sweden (EU15) United Kingdom (EU15)

Source : Rossotto et al (2003)

3.3.2. Financial sector development

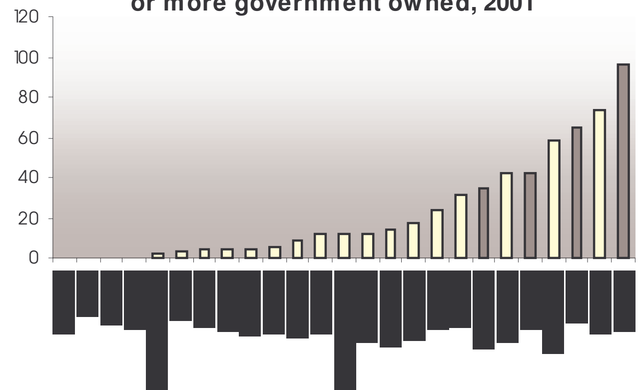
A well-developed financial system promotes growth by enhancing the efficiency of intermediation by reducing information, transaction, and monitoring costs. A modern financial system spurs private investment by identifying and funding good business opportunities, mobilizes savings, monitors the performance of managers, enables the trading, hedging, and diversification of risk, and facilitates the exchange of goods and services. Empirical research supports the idea that financial sector development is positively related to levels of income and growth, although the causality direction is not crystal-clear (Creane and al., 2004). It is also an area where there are important discrepancies among countries which makes its study pertinent to our sub-regional analysis.

A first look at the level of the domestic credit to the private sector[8] as a percentage of the GDP indicates that the financial market support to the private sector is the least developed in ECAN compared to MENA and EU10. The relatively low levels of private sector credit in ECAN can be explained by heavy privatizations and the existence of an important informal economy. However, the reading of this indicator should be cautioned by the fact that it might include credit to public enterprises, which are still numerous in MENA countries.



An alternative reading of the relative higher levels of domestic credit to the private sector in MENA is that these countries benefit from a more efficient banking and financial sector. Yet, available evidence points to the opposite conclusion, revealing that MENA suffers from weakly developed financial markets (Nabli, 2000). Only two countries, Lebanon and Jordan, have a well developed, profitable, and efficient banking sector. In most MENA countries, the government dominates or holds significant stakes in the banking sector (figure). Having a large proportion of state ownership in the banking sector has been found to reduce overall access to financing, reduce competition, worsen the allocation of credit, and increase the likelihood of financial crisis (World Bank, 2004). It is also associated with slower financial development and lower growth of per capita income and productivity. While government financing through its banks can encourage savings and capital accumulation, the projects the government finances are likely to be inefficient and have an adverse effect on productivity growth (La Porta and *al*., 2002).

State-ownership of banks is frequently associated to weak governance and poor procedures for debt collection. In Tunisia and Egypt for instance, the banking system is heavily burdened by high level of non-performing loans. These two countries are currently restructuring their banks in order to process to their privatization. But so far, the process has been slow in Tunisia. In contrast, government stake in the European countries is generally low, if not nil, except in Belarus and Azerbaijan. The dominance of state-owned banks is usually associated with a small involvement of foreign banks. Almost without exception, the share of foreign bank entry turns out to be very low in those state-dominated banking countries (the exception is Romania where the government and foreign banks share the assets).



In MENA, the banking sector is still largely restricted to foreign banks. As of 2001, only Jordan stands out in terms of foreign ownership in the banking system. At the other extreme, no foreign banks are present in Syria (figure). In Tunisia, the share of majority-owned foreign banks has increased to 20.5 percent at the end of 2002, following the privatization of UIB, and could further increase to around 26 percent when the privatization of the *Banque du Sud* is finalized. By contrast, most European economies in transition have modernized their banking system with a significant involvement of foreign banks. International experience shows that foreign banks presence have helped improve the quality of financial services in a number of ways: by increasing competition and cutting excessive loan pricing; by helping domestic banks assimilate superior banking techniques; and by training staff to modern banking (World Bank, 2001).

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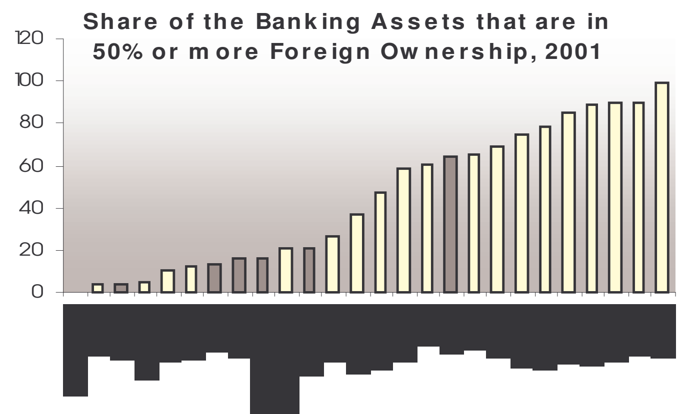
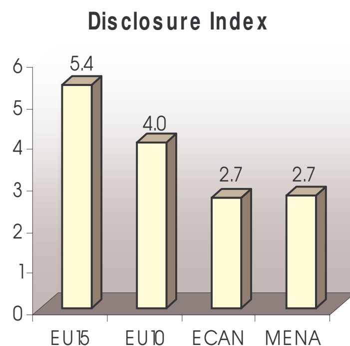
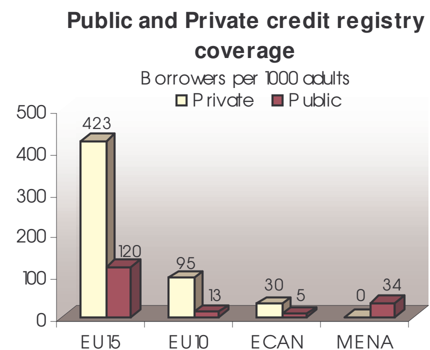
[8] The indicator refers to financial resources provided to the private sector. However, for some countries, it includes credit to public enterprises.

A prerequisite to foreign entry in the financial sector is the privatization of domestic banks, based on strong institutions that respect creditor rights and ensure financial transparency and accountability. In their absence, the banking system can hardly succeed in attracting funds to finance private projects. In most countries, banks will not extend credit without assurances that borrowers are creditworthy and that it will be possible to recover the debt if there is a default. As a consequence, entrepreneurs with promising business opportunities cannot obtain loans if the bank does not have enough information on the value of property and the credit history of the borrower- and where the legal system does not protect creditors enough in case of bankruptcy (Djankov and al, 2002). On the other hand, cross-country evidence shows that the overall effect of insufficient information sharing and lack of creditor rights is to reduce access to credit (La Porta et al, 1998). Sharing credit information reduces default rates and improves bank efficiency by reducing loan processing time and costs over 25 percent (World Bank, 2004).

Various indicators relative to the credit information sharing place both MENA and ECAN countries in a relatively weak position (figures below). A low credit information index indicates that credit information is poorly available. In MENA and ECAN there are no private credit bureaus (with the exception of Turkey), which hinders the access to credit information. In contrast, in the EU15 countries and most of EU10 countries, the information in mainly handled by private bureaus. Credit information sharing is also limited in MENA and ECAN because public credit bureaus only make available positive information (total loans outstanding, assets and personal information). In Tunisia for example, there is a public credit bureau supervised by the Central Bank and established in 1958. However, its significance is questionable since credit information is limited to the creditors' own customers (Anos-Casero and Varoudakis, 2004).



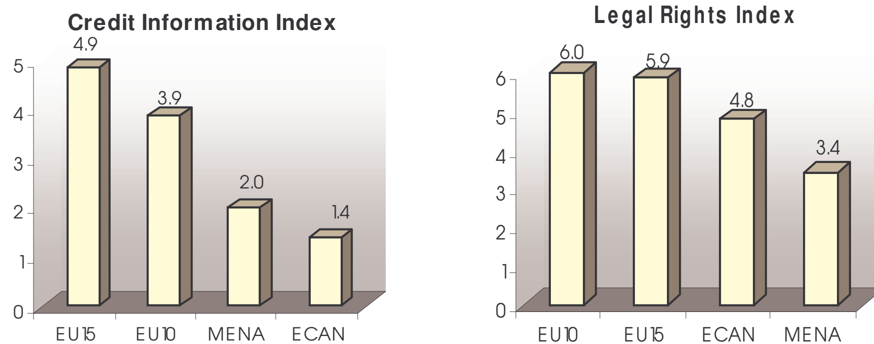




Preventing expropriation from taking place, and exposing it when it does, requires legal protections of small shareholders and enforcement capabilities. And it requires that the business disclose information on ownership and financial performance and on the precise nature of business transactions. Low disclosure

index9 in MENA and ECAN reveals a less transparent environment leading to more corruption and malpractice by managers of firms, hindering effective protection of investors (figure below). The uneven level of investor protection helps explain the variation in access to external equity finance and the number of public listings across countries in MENA and ECAN. In the 1990s, ECAN countries established stock exchanges to list privatized companies. But because ownership of these companies is concentrated in the hands of a few large shareholders, and there are few legal rights to protect small shareholders, voluntary de-listings are common.

Creditor rights protection is also uneven across the wider EU neighborhood. In deciding whether to extend a credit and at what interest, lenders need to know what share of debt they can recover if the borrower defaults. Collateral laws enable firms to use their assets as security to generate capital and strengthen the incentives of debtors to repay their loans. By providing creditors with the right to an asset on default, collateral also reduces a lender's costs of screening loan applicants. Costs to create collateral are high in MENA (Egypt, Jordan, Morocco, Tunisia, Syria) and ECAN (Georgia, Turkey, Azerbaijan). MENA countries rank at the bottom of the legal rights protection index (figure). Weak protection of legal rights leads creditors to either increase the price of loans to adjust for the additional risk or decrease the amount of loans. Surprisingly, data shows that on average EU10 are doing slightly better than EU15, where the index is pulled down by three relatively bad performers, that is Greece, Italy and France which indexes are 1, 2, and 3 respectively (the index ranges from 0 to 10). Nevertheless, the results for France are in line with a cross-country study revealing that French-civil-Law countries offer creditors the weakest protections in comparison to common-law countries (La Porta and al, 1998). Individually, ECAN countries have higher indexes than MENA countries since in ECAN, Turkey is the only country having a low index of 1.



Although collateral laws provide creditors with the right to an asset on default, over-collateralization can restrict access to credit by the private sector, particularly for small firms (see the following section on business environment). Without sharing information and appropriate creditor legal rights, the banking sector is unlikely to develop and lend securely to private sector. Broader sharing of credit information, stronger legal rights in and out of bankruptcy and more efficient enforcement of collaterals mean more

[9] The disclosure index indicates the extent of which ownership and financial information of the firm is being announced, revealed and opened for public information

credit. In countries such as Tunisia, Egypt or Turkey, inefficient enforcement of collaterals has led the banks to accumulate increasing amount of non-performing loans and reduce the number of loans.

4. EU Neighborhood countries: readiness for convergence

Box. Some of the the EU's Copenhagen criteria:
- Free interplay of market forces; Prices, as well as trade are liberalized.
- Barriers to market entry and exit are absent
- Legal system, including the regulation of property rights, is in place. Laws and contracts are enforceable.
- Macroeconomic stability has been achieved, including adequate price stability and sustainable public finances and external accounts
- Financial sector is sufficiently well developed to channel savings toward productive investments
- A sufficient amount of human and physical capital, including infrastructure, education and research, at appropriate cost.

The main purpose of this section is to benchmark the EU neighborhood countries across an array of policy and institutional dimensions that are known to be critical determinants of economic growth and income convergence. These policy areas are also broadly reflected in the EU "Copenhagen criteria" that have served to define a "functioning market economy" and "capacity to withstand competitive pressures and market forces", used in the EU accession negotiations with the ten new member countries (see Box). The analysis thus highlights the relative positioning of the neighborhood countries, compared to the new EU members, regarding their readiness for starting a convergence process with the EU.

The analysis is based on country rankings across seven composite policy indicators selected to portray the relative degree of 'readiness for convergence'. These composite indicators have been obtained using a principal component analysis. "Outcome" and "policy" variables have been combined, so as to rank countries not only according to current 'outcomes' of past policies, but also in terms of relative progress in key policy reforms that are expected to speed up the 'catching-up' process.[10]

The composite policy indicators measure performance across four fundamental sources of growth as identified in various strands of growth theory and empirics:[11] (i) Macroeconomic stability; (ii) well-functioning product and factor markets; (iii) progress towards a knowledge-based economy; and (iv) quality of governance—an overreaching issue for improving economic management and strengthening the investment climate.

- **Macroeconomic stability**: experience has demonstrated that in the absence of a sound macroeconomic framework sustained growth is not achievable, economic efficiency, productivity growth, and the investment climate remain weak, while structural reforms are likely to be short-lived and reversible.

  A Macroeconomic Stability indicator is defined by the inflation rate; external debt-to-GDP ratio; and budget and external current account balances in percent of GDP during the period 2000-2002.

[10] An example of an 'outcome' variable is labor force participation, which is combined with the quality of labor market policies and regulations—a 'policy' variable.

[11] International evidence shows that structural reforms have significant positive impact on economic growth (De Melo et al., 2001; Berg et al., 2001; Heybey and Murrell, 1999). Despite different initial conditions, growth rates among economies are likely to converge because the impact of initial conditions will decrease. However, countries that undertake minimal reform levels are likely to fall behind (Falcetti, Raiser and Sanfey, 2002 for economies in transition). International experience also reveals the growth-enhancing impact of structural reforms that lead to well-functioning institutions (governance), accompanying policies to trade liberalization (business environment and removal of behind-the-border obstacles), and enhancement of the knowledge base. These policy reforms aim at reinvigorating private investment that has the potential to create jobs and lead to sustainable and healthy economies.

However, it should be noted that, owing to the relatively short period considered, comparative country performance according to these criteria turns out to depend on the particular position of each country in the economic cycle, as well as on the availability of oil resources—reflecting the upward trend in the price of oil in 2000-02.

- **Well-functioning product and factor markets**: Flexibility and competition in product and factor markets are prerequisites to a dynamic economy that is able to foster innovation and productivity growth. Trade openness and exposure of domestic firms to the international competition are two crucial channels to improve efficiency and productivity. Yet, firms need flexibility to be able to adjust and compete in the global markets. Obstacles in the business environment such as difficulties for market entry, business operation, and market exit create bottlenecks to investment and impede firm and sector restructuring and the realization of productivity gains. Malfunctioning and uncompetitive credit markets hamper the financing of domestic investment and prevent domestic firms from reaping benefits from trade integration. Similarly, flexibility in the labor market is necessary to allow firms to restructure in the face of competition. Four composite indicators addressing these issues are calculated:

  Trade Openness defined by trade intensity as the ratio of exports plus imports to GDP; Most Favored Nation tariffs; and Trade Restrictiveness index (defined in annex 3).

  Factors affecting the operation of businesses: Two governance indicators, on the rule of law and broader regulatory quality (see Annex 2 for definitions), have been combined with indicators that more directly measure the cost of doing business. The selected measures are the minimum capital needed to start a business as a percentage of the per capita income; the cost to enforce a contract as a percentage of the debt; and the cost to register a property as a percentage of the transaction.

  Financial markets: Three sets of variables have been combined. (i) three variables related to the business environment in the financial sector—an index of creditor rights; an index of the availability of information on the quality of borrowers; and the cost of collateral as a percentage of the debt. (ii) Two variables measuring the relative shares of public and foreign banks in total commercial bank assets. (iii) Broad money supply (M2) in percentage of GDP.

  Labor markets: The overall labor force participation rate and female labor force participation are combined with four indicators measuring the flexibility of labor markets: rigidity of employment index; rigidity of working hours; difficulty of firing; and firing cost (variables are defined in annex 2).

- **Knowledge**: The extent to which economies will be able to benefit from technology spillovers, take advantage of EU cooperation, and thus compete in the knowledge-based economy, will depend on their readiness to absorb and use superior technologies—mainly on the availability of qualified workers and the development of the information infrastructure. Three variables are used to compare the degree to which these countries are moving towards a knowledge-based economy: Educational attainment; efficiency of the innovation system; and availability of ICT infrastructure.

- **Governance**: Good governance is an overarching issue in economic management: it is crucial in order to ensure a transparent and competitive business environment; maintain a sound macroeconomic framework; promote a sound banking system; foster the development of human

resources. The composite indicator is calculated based on three indicators: Voice and Accountability; Government Effectiveness; and Control of Corruption (see Annex 2 for definitions).

Overall, seven composite policy indicators were calculated. Country rankings across each of the indicators are shown in the table below. Countries that outperform according to each criterion receive higher rankings. Countries that seem to lag behind are shown in grey for each policy indicator. In view of the country rankings, the following observations can be made:

a) Generally, new EU members rank better across all policy indicators—an expected outcome in view of the progressive alignment of the regulatory framework and institutions in these countries with the EU *Acquis*.

b) To the extent good governance is a precondition for sustained implementation of sound policies and strengthening of the investment climate, progress on this criterion could be considered as a prerequisite for convergence. EU candidate and neighborhood countries appear to be split in three broad groups depending on their performance on this fundamental criterion: (i) countries with relatively superior performance in terms of the quality of governance (Bulgaria, Croatia, Jordan, Turkey, Tunisia); (ii) countries with poor governance ratings (Algeria, Azerbaijan, Belarus, Georgia, Syria, Ukraine); (iii) borderline countries, in-between the two preceding groups (Romania, Armenia, Moldova, Lebanon, Egypt).

c) Countries with poor governance (group II) appear to also under perform in two other key areas of structural reform—the quality of the regulatory environment for doing business and financial sector reform. The presumption that good governance is a precondition for successful implementation of structural reform seems thus to be supported by the evidence across countries.

Table: Country ranking across seven composite indicators

	Macro	Business Environment	Trade	Financial market	Labor market	Governance	Knowledge
Algeria	1	24	21	25	20	22	24
Armenia	23	15	6	17	5	19	20
Azerbaijan	6	17	8	24	8	25	
Belarus	14	18	15	23	13	24	8
Bulgaria	12	12	7	11	3	13	13
Croatia	15	6	5		17	12	
Czech Rep.	8	3	4	5	2	3	5
Egypt	11	22	25	19	25	15	19
Estonia	10	1	1		11	5	7
Georgia	19	23	19		12	20	18
Hungary	22	5	11	10	10	2	6
Jordan	17	20	18	6	16	9	17
Latvia	21	4	9	9	7	8	12
Lebanon	25	21	14	7	9	16	16
Lithuania	7	8	2	13	6	6	11
Moldova	20	13	10	21	14	18	22
Morocco	5	19	22	15	24	11	23
Poland	16	2	17	12	4	4	3
Romania	18	11	20	18	21	17	14
Slovak Rep.	9	10	3	8	1	7	10

Slovenia	4	7	13	14	15	1	4
Syria	3	25	23		18	23	25
Tunisia	13	14	24	20	19	10	21
Turkey	24	9	16	16	22	14	15
Ukraine	2	16	12	22	23	21	9

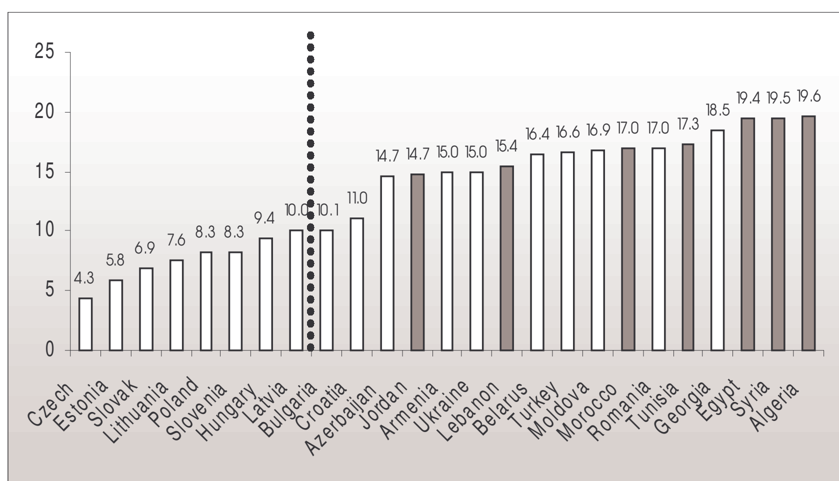
d) Countries in the first group, with stronger governance performance, would be relatively well positioned to take advantage of the European Neighborhood policy initiative through the alignment of their policies and institutions with the EU *Acquis*. By contrast, the poor quality of governance could be a serious factor limiting the potential of countries in the second group to take advantage of the ENP initiative. Improvement in governance could be the single most important policy priority in the case of the "borderline countries", as this could "make or break" their potential for successful implementation of policy reforms that foster growth and convergence.

e) In the two reform areas that are more directly related to the investment climate—quality of the regulatory framework for doing business and financial sector reform—a few countries seem relatively well positioned: Bulgaria, Croatia, Turkey, and Romania in promoting a conducive regulatory environment for doing business; Bulgaria, Jordan, and Lebanon in promoting financial sector reforms.

f) It is worth noting that rankings in labor market reforms seem to be weakly related with those in business environment and financial sector reforms. Although Bulgaria and Lebanon are among the outperforming countries in labor market reform as well, countries with weak performance in business and financial sector reforms, such as Armenia, Azerbaijan, and Georgia, have made progress in terms of labor market regulation. MENA countries receive poor ratings in this area, not only because of labor market rigidities but also owing to structural low participation of women in the labor force.

g) Reforms in education, the innovation system, and the ICT sector, that underpin the emergence of the knowledge-based economy are both costly and long-term endeavors, but at the same time may provide a significantly high pay-off in terms of growth. Because these reforms are costly, higher-income new EU members rank generally better in this area. Ukraine, Bulgaria, Romania, and Turkey seem to be relatively well positioned, next to the new EU member countries. MENA countries appear to under perform in this respect, with the exception of Jordan and Lebanon that are relatively better positioned.

An overall country ranking was also established based on the seven indicators, without imposing any arbitrary, non-verifiable weighting on the data. Although absolute values should be interpreted with caution, this exercise allows comparing countries relatively to each other. The overall ranking illustrates the far-reaching reforms undertaken by the new EU members before joining the EU (data is for 2000-02). These countries present the lowest average ranking across all variables. Bulgaria (a EU



accession country) and Croatia (a candidate country) appear to be the best positioned to converge with the EU. In contrast, Romania (another accession country) and Turkey (a candidate country), seem to still lag behind in terms of policy framework alignment with the new EU member countries. Ranking of both countries is hampered by poor macroeconomic performance, although the situation has substantially improved in Turkey since the recovery from the 2000-01 crisis.

Three MENA countries, Egypt, Syria, and Algeria receive the lowest overall ranking. These economies seem to be less prepared for faster economic convergence than their Eastern European neighbors. Algeria and Syria consistently lag behind their EU neighborhood peers in all the areas, except for macroeconomic performance. Both countries are oil producers and their relatively stronger macroeconomic performance is mostly explained by higher oil prices.

In the MENA region, there are two exceptions: Jordan and Lebanon. Both countries display the highest rankings among MENA countries participating in the EU neighborhood. Despite poor macroeconomic fundamentals (a high level of debt and a wide current account deficit explained by the reconstruction efforts), Lebanon has a well developed financial market dominated by the private sector and a relative flexible labor market. In Jordan, in spite of the relatively costly and lengthy business registration, legal rights are relatively well protected and enforced, relative to other MENA countries.

In the ECAN region, Georgia seems to be less ready to converge than her comparators. Despite a relatively flexible labor market, Georgia suffers from an uncompetitive business environment and a restrictive trade policy. In contrast, Azerbaijan is overall better positioned, posting a sound macroeconomic environment (also reflecting high oil revenues) and low trade restrictions, although it lags behind in terms of financial sector and business environment reforms. Armenia and Ukraine seem to be in relatively favorable position. However, in all these countries, gaps in governance could be a major brake to successful implementation of reform and convergence.

5. Conclusion and policy implications

The income gap of EU neighborhood countries with the EU15 average is still wide and in spite of experiencing higher growth rates than EU15 countries over the past few years the progress in catching-up with the EU15 in income levels has been limited in most countries. Catching-up in income levels is a long-term process, but the challenge is to speed-up the narrowing of the productivity gap and the gap in employment rates between the EU neighborhood countries and the EU15.

The Lisbon strategic goal of 'becoming the most competitive and dynamic economy' remains relevant for the wider EU neighborhood. For the EU neighborhood countries need to grow faster and create more jobs. Future ENP policy action plans for Mediterranean and Eastern European countries would need to focus on the still incomplete structural shift of their economies. Deeper integration of markets and improved competitiveness will lay the groundwork for faster growth by stimulating private investment and improving efficiency. But deeper market integration will also raise a multi-faceted growth challenge in the years ahead: securing rapid growth and job creation, while forestalling pressures on the external balance; maintaining fast productivity growth, to meet the challenge of stiffer international competition; promoting high-skill growth, to move towards knowledge-based economies and to match the rapidly changing skill mix in the labor force.

A key precondition for sustained accelerated growth and job creation is greater private investment. The paper also shows a private investment gap in most MENA countries, compared to its EU neighborhood peers. Heightened business uncertainty, reflected in low governance ratings by international investors, may have deterred investment, with little help from the incentive systems in place. Further liberalizing infrastructure, opening up markets in telecommunications and finance to competition, would help to

create more opportunities for private sector investment. This would also support competitiveness by improving the quality and reducing the cost of backbone services and business inputs. Such moves would be more effective if complemented with well-sequenced reforms to streamline and improve the investment climate. A high-quality regulatory framework would provide businesses in EU neighborhood countries needed flexibility in the face of stiffer competition, and improve attractiveness to private investment in a context of deeper trade integration.

Annex 1: Countries' definition

In this report, four countries groups have been defined:

- **EU15**: core European members except Luxembourg
- **EU10**: new European Union members.
- **ECAN** -Europe and Central Asia Neighborhood : Eastern neighborhood countries plus current candidates to the European Union membership
- **MENA**: all MENA countries participating in the ENP

EU15	EU10	ECAN	MENA
Austria	Czech Republic	Bulgaria*	Algeria
Belgium	Hungary	Romania*	Egypt
Denmark	Latvia	Turkey*	Jordan
Finland	Lithuania	Croatia*	Lebanon
France	Poland	Belarus	Morocco
Germany	Slovak Republic	Moldova	Syria
Greece	Slovenia	Ukraine	Tunisia
Ireland	Estonia	Armenia	
Italy	Cyprus	Azerbaïdjan	
Portugal	Malta	Georgia	
Netherlands			
Spain			
Sweden			
UK			

*indicates candidates to EU25

Countries that are part of the **European Neighborhood Policy** (ENP) are:

- Eastbound: Belarus, Moldova, Ukraine, Armenia, Azerbaijan, and Georgia
- Southbound: Israel, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia, as well as the Palestinian Authority

As for Russia, the EU and Russia have decided to develop their strategic partnership further through the creation of four common spaces, as defined at the 2003 St. Petersburg summit, but Russia will be eligible to receive funding from the financial instruments which support the ENP.

As for Belarus, currently an authoritarian system is in place in Belarus and the EU will only be able to develop contractual links when Belarus has established a democratic form of government, following free and fair elections. It will then be possible to extend the full benefits of the European Neighborhood Policy to Belarus.

Annex 2: Variable Definitions

Doing Business Indicators

Disclosure Index: refers to the degree of which ownership and financial information of the firm is being announced and revealed and opened for public information. If disclosure is High then there is less corruption and malpractice by managers of a firm and easier for small investors to challenge attempts at expropriation in the courts.

Credit Information Index measures the scope, access and quality of credit information available through public registries or private bureaus. It ranges from 0-6, with higher values indicating that more credit information is available from a public registry or private bureau. If a public registry or private bureau does not operate, the coverage value is 0.

Legal Rights Index: The Legal Rights Index measures how well collateral and bankruptcy laws facilitate lending. It ranges from 0-10, with higher scores indicating that those laws are better designed to expand access to credit. It is based on data collected through research of collateral and insolvency laws supported by the responses to the survey on secured transactions laws. It includes three aspects related to legal rights in bankruptcy, and seven aspects found in collateral law.

Public credit registry is defined as a database managed by the public sector, usually by the Central Bank or Superintendent of Banks, that collects information on the standing of borrowers (persons or businesses) in the financial system and makes it available to financial institutions. The coverage indicator reports the number of individuals and/or firms listed in the public credit registry with current information on repayment history, unpaid debts, or credit outstanding. The number is scaled to the country's adult population (per 1,000 adult population). If a public registry does not operate, the coverage value is 0.

Private credit bureau is defined as a private firm or a non-profit organization that maintains a database on the standing of borrowers (persons or businesses) in the financial system and facilitates exchange of credit information among banks and financial institutions. Credit investigative bureaus and credit reporting firms that do not directly facilitate information exchange between financial institutions are not considered. The coverage indicator reports the number of individuals and/or firms listed in the private credit bureau with current information on repayment history, unpaid debts, or credit outstanding. The number is scaled to the country's adult population (per 1,000 adult population). If a private bureau does not operate, the coverage value is 0.

Knowledge indicators

The Knowledge Assessment Methodology is a user-friendly tool designed to understand countries' strengths and weaknesses in terms of their ability to compete in the global knowledge economy. It is a proxy to a country's preparedness to compete in the knowledge economy through a series of relevant and widely available measures, consisting of a set of 76 structural and qualitative variables available for 121 countries. A basic scorecard consisting of twelve variables has also been developed. These variables are used as proxies for the four areas that are critical to the development of a knowledge-based economy:

► An ***economic and institutional regime*** to provide incentives for the efficient use of existing and new knowledge

► An ***educated and skilled population*** to create, share, and use knowledge well

► An efficient ***innovation system*** of firms, research centers, universities, consultants, and other organizations to tap into the growing stock of global knowledge, assimilate and adapt it to local needs, and create new technologies.

► A dynamic ***information structure*** to facilitate the effective communication, dissemination, and processing of information.

Data is available for two points in time, 1995 and the most recent year available.

Indicators come for a wide variety of sources such as Heritage Foundation, World Development Indicators, World Economic Forum, World Competitiveness Yearbook, UNESCO, World Bank, UN Human Development report, US Patent and trademark Office, ITU, etc.

Governance indicators

Governance can be broadly defined as the set of traditions and institutions by which authority in a country is exercised. This includes (1) the process by which governments are selected, monitored and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them.

The six dimensions of governance are: Voice and Accountability; Political Stability and Absence of Violence; Government Effectiveness; Regulatory Quality; Rule of Law; and Control of Corruption.

Voice and Accountability includes in it a number of indicators measuring various aspects of the political process, civil liberties and political rights, measuring the extent to which citizens of a country are able to participate in the selection of governments.

Political Stability and Absence of Violence combines several indicators which measure perceptions of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means, including domestic violence and terrorism.

Government Effectiveness combines responses on the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies.

Regulatory Quality instead focuses more on the policies themselves, including measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.

Rule of Law includes several indicators which measure the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

Finally, ***Control of Corruption*** measures perceptions of corruption, conventionally defined as the exercise of public power for private gain

Annex 3: Trade Restrictiveness Index

Based on Fund-supported programs, the IMF assesses countries' overall trade restrictiveness, based on a 10-point classification. It combines measures of the trade restrictiveness of import tariffs and NTBs. Five ranges are specified for import tariffs, with the lowest range (0-10%) being the least restrictive and the highest range (25% and over) being the most restrictive. NTBs are ranged in three categories: open, moderate and restrictive. This yields to 15-cell matrix (Table 1) where cells were converted to a 10-point scale. The most open import tariff and NTB regimes were given the number 1, and the most restrictive ones were assigned the number 10. The assignment places more weight on restrictiveness of NTBs which are inherently les transparent and more distortionary than tariffs. Import tariffs restrictiveness' evaluation depends on multiple factors, such as the minimum and maximum tariff rates, the number of bands and other duties and charges.

Table 1: Classification scheme for Overall Trade Restrictiveness

	Non Tariff Barriers		
	Open	Moderate	Restrictive
Tariffs			
Open	1	4	7
Relatively open	2	5	8
Moderate	3	6	9
Relatively restrictive	4	7	10
Restrictive	5	8	10

Source: IMF staff estimates

The construction of the initial index was based on Fund arrangements of two years or more that started after January 1, 1990 and ended by June 30, 1996. Since then, index numbers have been updated on an ongoing basis. The following table presents the TRI for three groups of countries: MENA, ECAN and EU10.

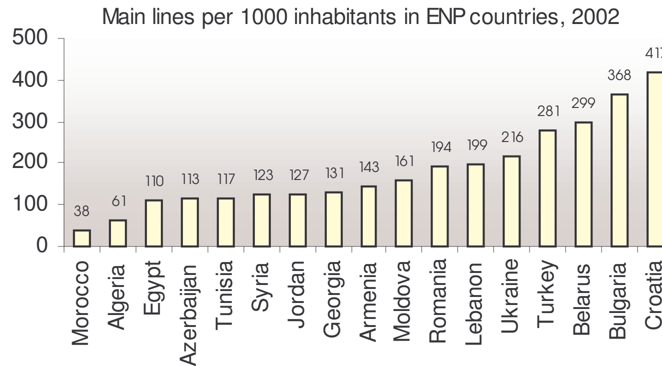
Table 2: Trade Restrictiveness Index, 2004

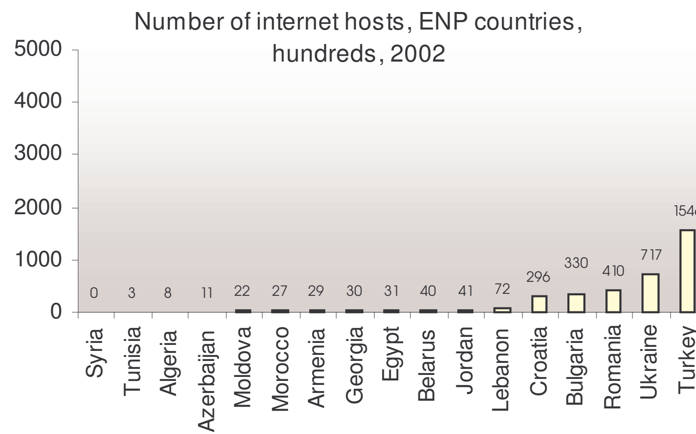
	NTB Rating	Tariff Rating	Overall Rating	Average Tariff
Algeria	1	4	4	23.7
Egypt	2	4	7	22.0
Jordan	2	2	5	13.0
Lebanon	2	1	4	4.8
Morocco	1	5	5	31.5
Syria	3	5	10	35.0
Tunisia	2	5	8	31.6
MENA	**2**	**4**	**6**	**23**
Armenia	1	1	1	3.0
Azerbaijan	1	1	1	8.7
Belarus	3	2	8	12.2
Bulgaria	1	2	2	11.1
Croatia	1	1	1	6.3
Georgia	1	1	1	8.2

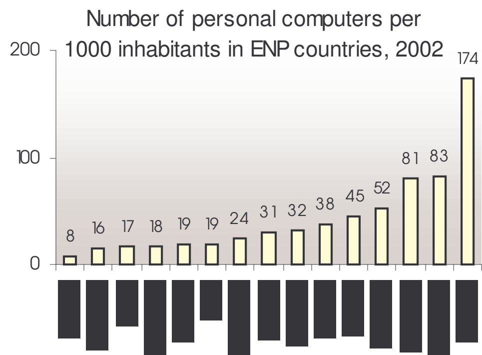
Moldova	1	1	1	6.2
	NTB Rating	Tariff Rating	Overall Rating	Average Tariff
Romania	1	3	3	16.9
Turkey	2	2	5	12.7
Ukraine	2	1	4	7.0
ECAN	**1**	**2**	**3**	**9**
Czech Republic	2	1	4	6.5
Hungary	2	1	4	6.5
Latvia	2	1	4	6.5
Lithuania	2	1	4	6.5
Poland	2	1	4	6.5
Slovak Republic	2	1	4	6.5
Slovenia	2	1	4	6.5
EU10*	**2**	**1**	**4**	**7**

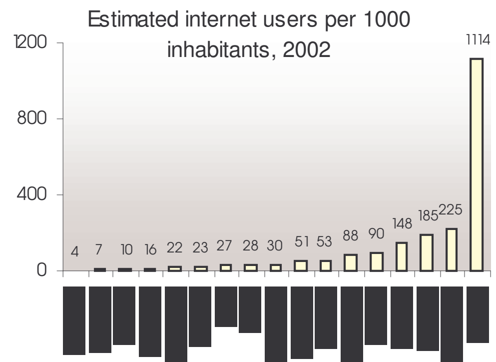
** excluding Cyprus, Malta and Estonia*
Source: IMF estimates

Annex 4: Telecommunications Indicators, country level

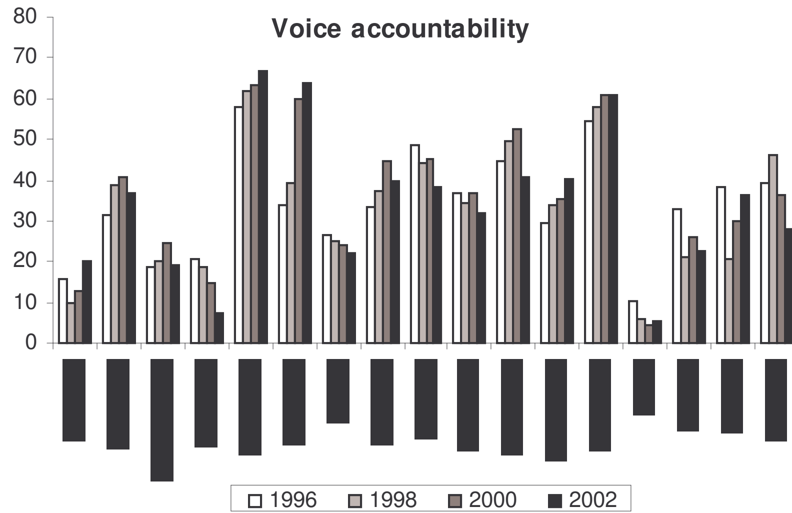


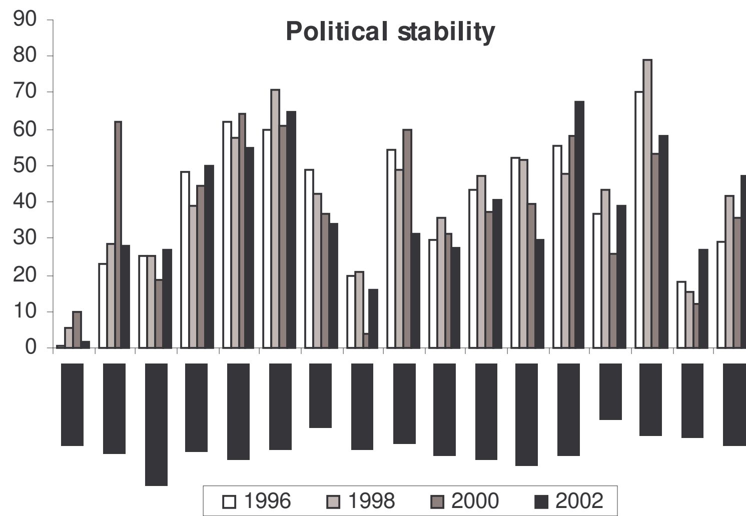


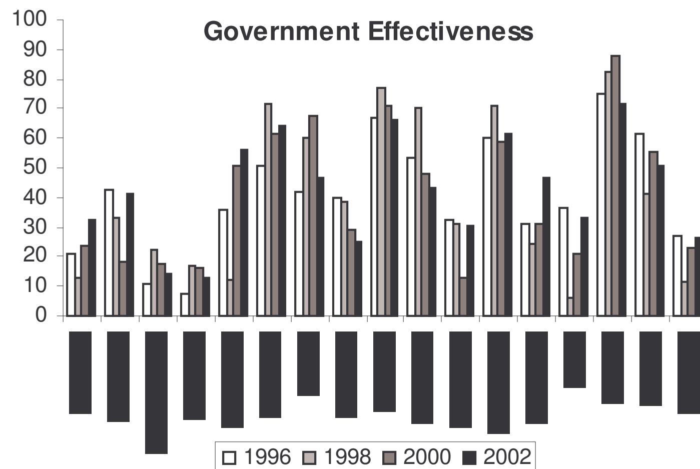


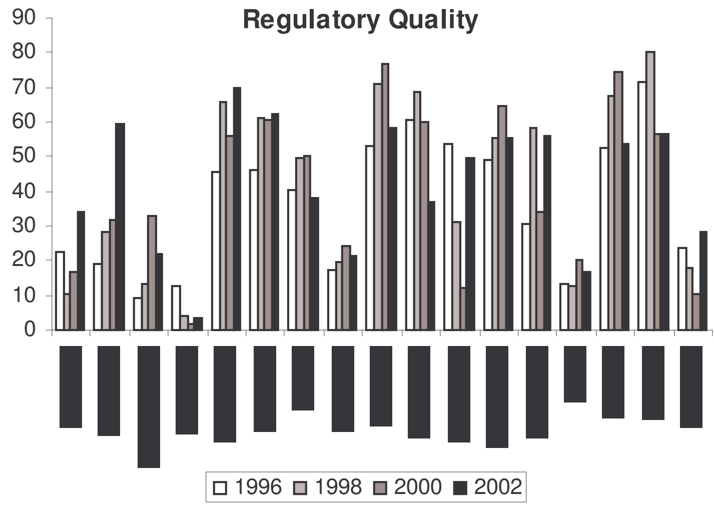


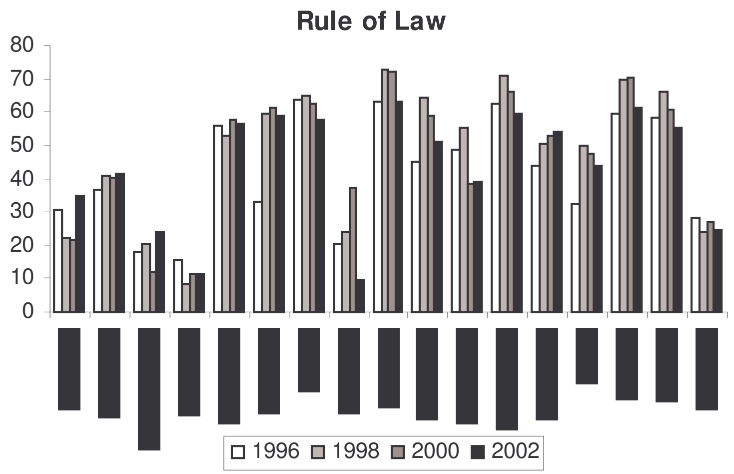
Annex 5: Governance in ENP countries, country level, 1996, 1998, 2000 and 2002

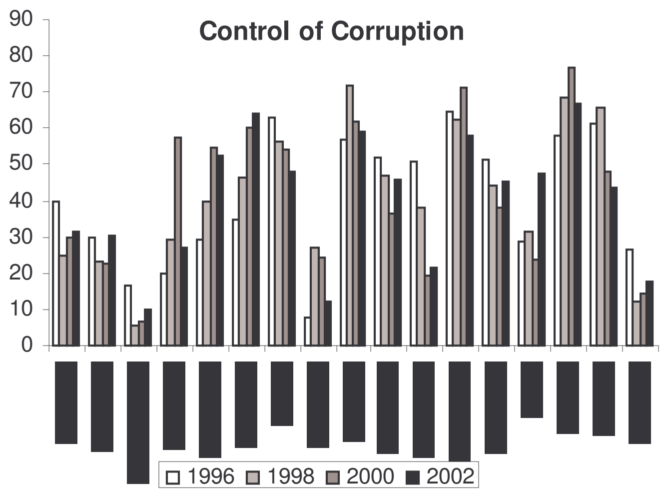







Regulatory Quality
90
80
70
60
50
40
30
20
10
0
1996 1998 2000 2002


Rule of Law
80
70
60
50
40
30
20
10
0
1996 1998 2000 2002


Control of Corruption
90
80
70
60
50
40
30
20
10
0
1996 1998 2000 2002

Annex 6: Principal Components Analysis results[12]

Knowledge

Component	Eigenvalue	Proportion	Cumulative
1	1.9799	0.66	0.66
2	0.71339	0.2378	0.8978
3	0.30671	0.1022	1

	Scoring coefficient 1
inno	0.48331
edu	0.63398
infra	0.60372

Variables (axis F 1 and F 2: 90 %)

1.5
1
0.5
0
-0.5
-1
-1.5

Inno
Edu
Infra

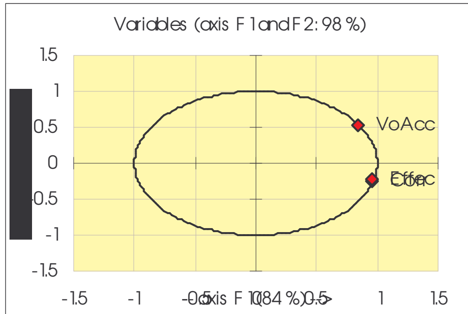
-1.5 -1 -0.5 0 0.5 1 1.5

axis F 1 (66 %)

Governance

Component	Eigenvalue	Proportion	Cumulative
1	2.51904	0.8397	0.8397
2	0.40602	0.1353	0.975
3	0.07494	0.025	1

[12] STATA and STATBOX software were used. The latter was helpful to select the variables to be included in the composite indicator. It shows graphically which variables are significantly correlated to each other, and most importantly which variables are not significant and should not be included in the composite indicator.



Scoring coefficient
1

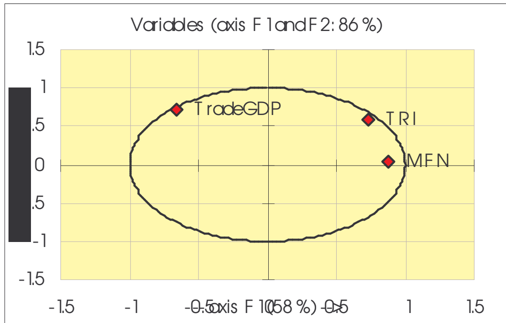
	1
corr	0.59788
effec	0.60112
voacc	0.53028

Trade Openness

Component	1	2	3
Eigenvalue	1.72578	0.85746	0.41676
Proportion	0.5753	0.2858	0.1389
Cumulative	0.5753	0.8611	1

Scoring coefficient
1

	1
tradegdp	-0.49856
mfn	0.66713
tri	0.55352

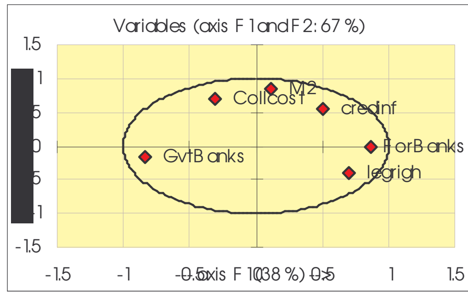


Financial Development

Component	Eigenvalue	Proportion	Cumulative
1	2.29851	0.3831	0.3831
2	1.69055	0.2818	0.6648
3	0.82693	0.1378	0.8027
4	0.62551	0.1043	0.9069
5	0.36801	0.0613	0.9683
6	0.1905	0.0317	1

Scoring coefficient	1	2
collcost	-0.20179	0.52815
legrigh	0.46368	-0.32008
credinf	0.3362	0.43369
m2	0.07664	0.64474
gvtbanks	-0.54865	-0.12122
forbanks	0.56953	-0.01181

PCfin=fin1*(0.38/0.66)+fin2*(0.28/0.66)	

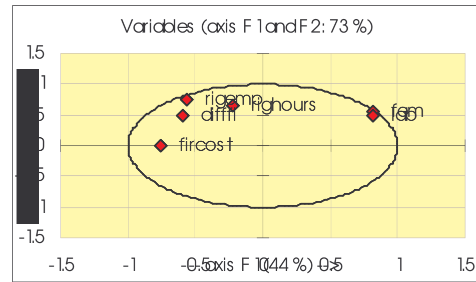


Labor market

Component	1	2	3	4	5	6
Eigenvalue	2.62409	1.73705	0.9325	0.47003	0.19792	0.03842
Proportion	0.4373	0.2895	0.1554	0.0783	0.033	0.0064
Cumulative	0.4373	0.7269	0.8823	0.9606	0.9936	1

Scoring coefficient

	1	2
difffi	0.3642	0.36788
righours	0.13542	0.48656
rigemp	0.3428	0.56744
fircost	0.46906	0.00144
fem	-0.50323	0.40855
lab	-0.50817	0.37284



PCL=L1*(0.44/0.73)+L2*(0.29/0.73)	

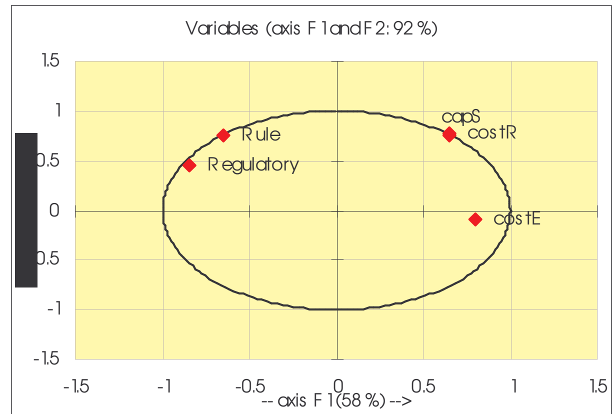
Business Environment

Component	Eigenvalue	Proportion	Cumulative
1	2.90044	0.5801	0.5801
2	1.67758	0.3355	0.9156
3	0.33198	0.0664	0.982
4	0.05954	0.0119	0.9939
5	0.03046	0.0061	1

Scoring coefficient

	1	2
coste	0.5084	-0.06365
caps	0.40359	0.53313
costr	0.39989	0.54561
rule	-0.41166	0.52794
reg	-0.49927	0.36786

BE=BE1*(0.58/0.91)+BE2*(0.33/0.91)

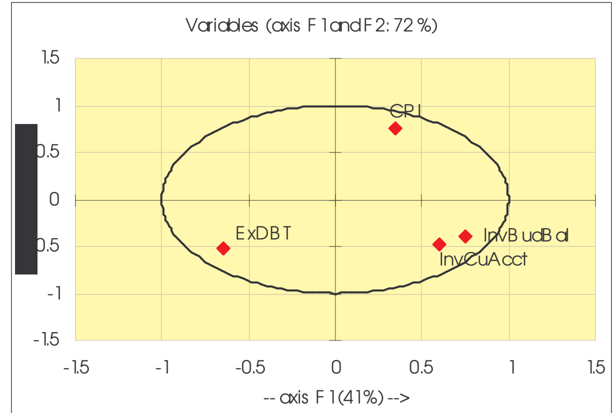


Macroeconomic Stability

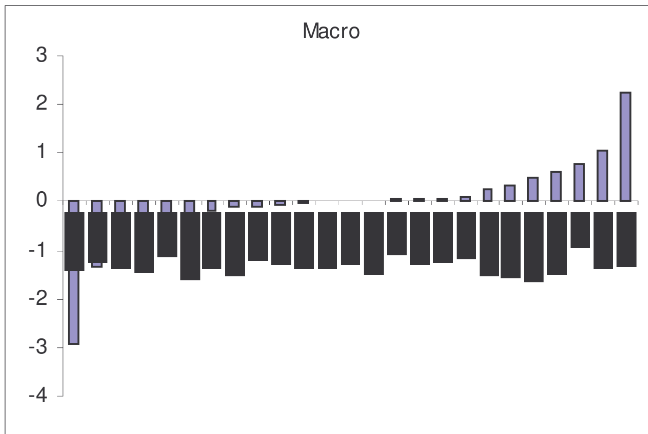
Component	Eigenvalue	Proportion	Cumulative
1	1.63291	0.4082	0.4082
2	1.26106	0.3153	0.7235
3	0.75264	0.1882	0.9117
4	0.35339	0.0883	1

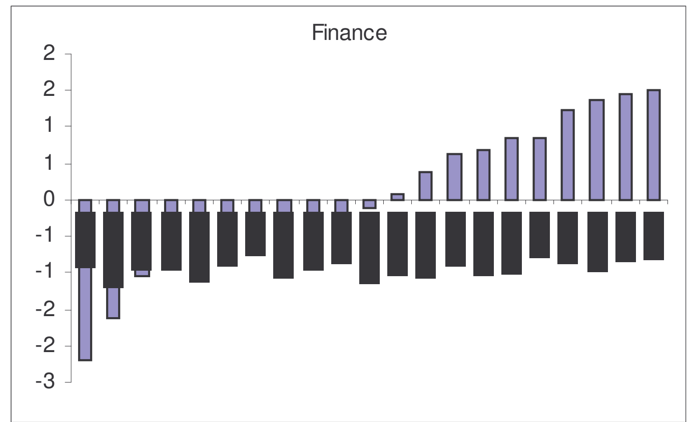
Scoring coefficient	1	2
cuacct	0.52697	0.41813
cpi	-0.27841	0.68474
BudBal	0.62298	0.34719
invexdbt	-0.50665	0.48554

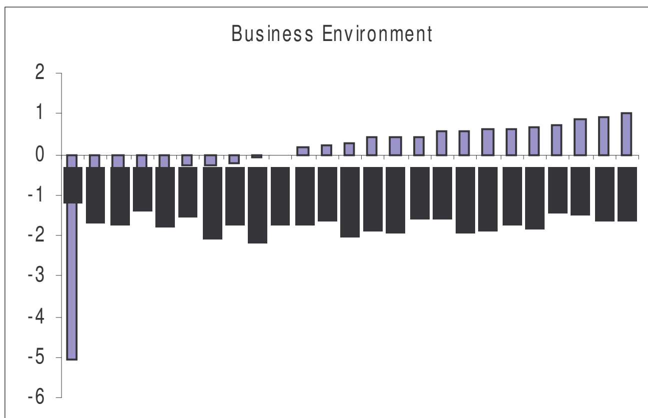
PCmac= PCmac1*(0.4/0.72)+ PCmac2*(0.31/0.72)

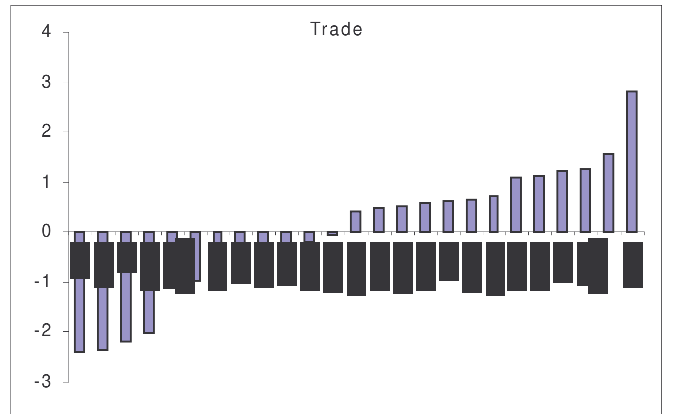


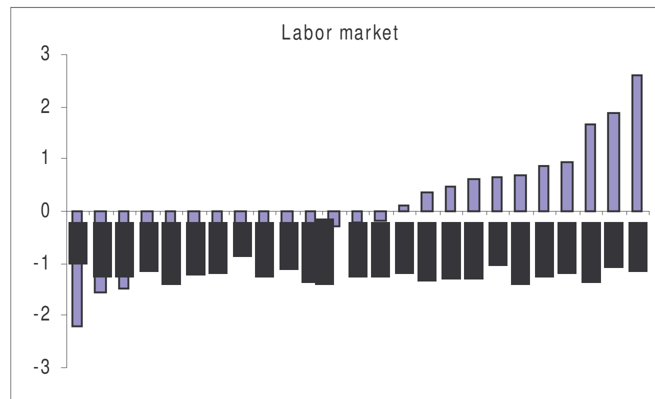
Annex 7: Governance Principal Component results, country level

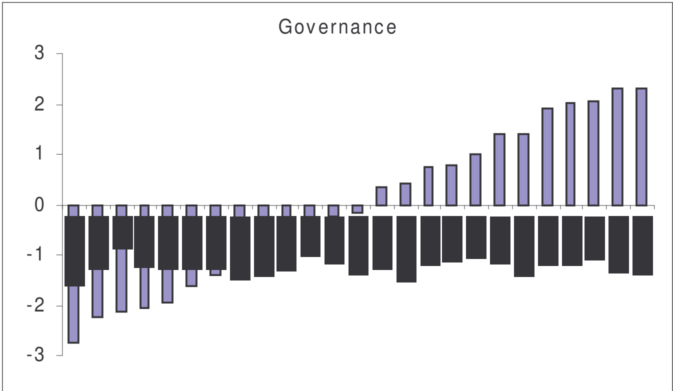


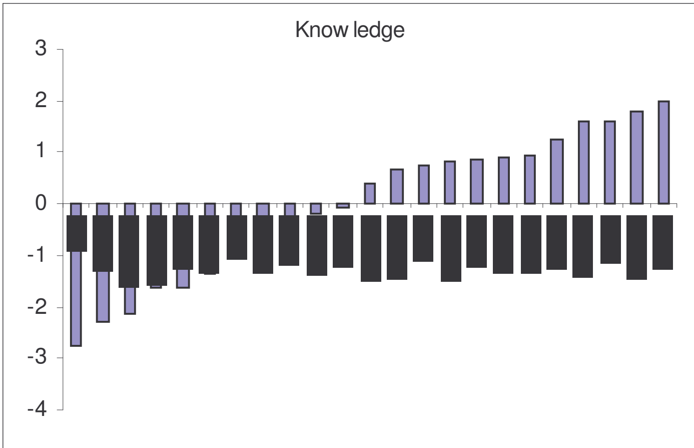









Governance
3
2
1
0
-1
-2
-3


Know ledge
3
2
1
0
-1
-2
-3
-4

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