



United Nations
University

CRIS

Comparative Regional Integration Studies

UNU/CRIS Occasional Papers

0-2003/1

Regional Public Goods or Philanthropy ?

A Critical Assessment of the EU-Balkans Economic Relations

Mehmet Ugur*

* Jean Monnet Chair in the political economy of European integration, University of Greenwich, London.

Regional public goods or philanthropy?

A critical assessment of the EU-Balkans economic relations

Mehmet Ugur*

Abstract

This paper examines the European Union's (EU's) economic relations with the Western Balkans (WB) in the light of the emerging debate on international public goods. The paper argues that the EU's philanthropic approach to transition reforms in the WB is too discretionary to be efficient and/or equitable. We think that the concept of regional public goods (RPG) provides a good benchmark against which the efficiency/equity implications of EU-WB relations can be assessed. The RPG approach suggests that the EU's trade and aid policies towards the WB will be efficient/equitable if: (i) EU policy takes account of the positive externalities associated with the transition reforms; and (ii) existing contractual arrangements reduce the scope for philanthropic discretion by the EU and free-riding by WB countries. First, we demonstrate analytically why these conditions are relevant. Then, we examine the current framework of EU-WB relations to evaluate the extent to which the EU's policy reflects philanthropic collusion or efficient/equitable provision of RPG.

Key words: regional public goods, transition, the Balkans, policy reform.

JEL Classification: F42, H73, H77, P20, P26.

* Jean Monnet Chair in the political economy of European integration, University of Greenwich, London. This paper was presented to the EUSA 8th Biennial Conference, 27-29 March 2003, Nashville, USA.

Regional public goods or philanthropy?

A critical assessment of the EU-Balkans economic relations

Introduction

The debate on regional public goods (RPG) is part of the wider debate on global public goods.¹ This debate revolves around the issue of public good provisions (e.g., environmental protection, financial stability, security, etc.) when the political domain (jurisdiction) does not correspond to the economic domain within which the public good can be consumed. In that sense, the application of RPG approach to the EU in general and EU policy towards its neighbours in particular is relevant. Irrespective of the extent to which the EU has a supranational character, we know that the EU is the example *par excellence* of the mismatch between the political and economic domains. We also know that this mismatch becomes more evident when EU policies involve redistribution in favour of non-EU countries.

The emergence of RPG as a concept in the second half of the 1990s has coincided with an increase in the perceived cost of external shocks (e.g., population movements due to wars) and/or cross-border externalities (e.g. CO2 emissions, climate change, political instability, etc.). RPG provision implies essentially distribution of policy costs between countries of a given region. On the one hand, distribution of policy costs requires solidarity. On the other hand, however, it induces shirking or burden shifting. The tendency towards shirking or burden shifting will be exacerbated if countries of the region engage in what may be described as ‘philanthropic collusion’. Philanthropic collusion refers to a common interpretation of RPG provision as a charitable commitment. This approach is too discretionary to be either efficient or equitable. The discretion implicit in the philanthropic commitment enables each country to decide unilaterally on two issues: (i) the amount of the cost to be borne; and (ii) the conditions under which such cost will be borne. Such discretion is conducive to lower than optimum provision of RPG. It is also conducive to inequitable burden sharing because the costs to be borne would depend on altruism rather than the ability to share in the burden.

In this article, RPG provision refers to intra-EU sharing of the costs resulting from support for WB policy reforms, which yield economic and political benefits for EU member-states. The political

¹ On global public goods, see Kaul et al (1999). On regional public goods, see Sandler (1998), Ferroni (2001).

benefits stem generally from political stabilisation of the region (reduced security risk) and effective border management (reduced cross-border externalities). Economic benefits, on the other hand, stem from economic stabilisation and recovery of the region – which will be conducive to a higher level of mutually-beneficial economic transactions between the EU and WB countries. The challenge for the EU here is to establish a framework of RPG provision involving two levels of distribution: (i) transfers from EU members to WB countries with a view to support WB reforms; and (ii) intra-EU distribution with a view to share the burden of supporting WB reforms. In other words, the EU is faced with a situation where the cost of reforms (as an international public good) is external yet the benefits of reforms are internal. Because of this asymmetry, a philanthropic approach to RPG provision (i.e., encouraging WB reforms) is likely to be even less efficient and equitable than intra-EU RPG provision (e.g., intra-EU management of cross-border externalities).

Section 1 below develops an analytical model that suggests that the sub-optimality in EU-WB relations can be avoided only if EU member states can set the short-term cost of supporting the reforms against the long-term benefits of economic and political stability in the WB.² We will demonstrate that this outcome requires significant change in EU policy towards the region. First, the rules for intra-EU distribution of the costs associated with WB reforms must be made transparent and binding. Secondly, the contractual arrangements between the EU and WB countries must strike a balance between reform conditionality and positive spill-overs from WB reforms. Thirdly, the EU must be prepared to transfer resources proportional to the reform requirements of individual WB countries in order to ensure that the incentives for remaining committed to the reforms are sufficiently high. Section 2 will examine the current framework for EU-WB relations in order to establish the extent to which the existing framework is capable of satisfying these conditions. It will be demonstrated that only some of these conditions are met and, therefore, the current framework is not likely to ensure successful reforms. Finally, we will conclude by summarising the main findings and commenting on the prospects for change in the EU's policy towards WB countries.

² We limit this study to the countries of western Balkans – i.e., Albania, Bosnia and Herzegovina, Croatia, The Federal Republic of Yugoslavia, and The Former Yugoslav Republic of Macedonia. The rationale for this limitation is that other Balkan countries (Bulgaria and Romania) are official candidates, who are linked to the EU via a pre-accession partnership.

1. A credible and efficient framework for RPG provision: a political economy approach

The EU's approach to policy reform in transition countries in general and the WB in particular is characterized by asymmetry. On the one hand, there is a clear emphasis on the need for credible rules that would tie the hands of the policy makers in transition countries. This is considered as a necessary condition for reducing the probability of policy reversals. On the other hand, however, there is a contrasting lack of emphasis on rules that would tie the hands of the EU as a stakeholder in WB reforms. This asymmetry implies that the problem of dynamic inconsistency in policy-making applies to reforming countries only and do not affect the policy design/implementation in the EU.

The main reason for this anomaly is the EU's philanthropic approach to supporting WB reforms. This philanthropic approach assumes that the pace and extent of reforms are matters for WB countries. Therefore, the EU may provide support to accelerate the pace of reform, but it is also entitled to withhold such support unless WB countries demonstrate that they are willing and capable to undertake such reforms. What is ignored here is the possibility that the demand for and supply of reforms may be endogenous outcomes of the strategic interaction between reforming countries and the EU. This strategic interaction unfolds in the presence of positive externalities associated with policy reform. In the presence of such externalities, the reforming countries' demand for reform will be lower than optimum or these countries will have a loose (i.e., ineffective) commitment so that they can deviate from the reform path when necessary. The main reason for this sub-optimal supply of reforms is the expectation of the reforming countries to be compensated for the positive externalities that the reforms would generate. In contrast, positive externalities associated with reforms, unless internalised, induce the EU to demand more reform than is optimal. As a result, a wedge is driven between the higher-than-optimum level of demand for reforms and the lower-than-optimum level of reform supply.

WB reforms generate positive externalities for the EU because political stability and economic recovery of the region (which is a by-product of the reforms) benefit not only the WB countries but also the EU and its member states. The benefits of reform for WB countries are straightforward: reduced capture of public policy by vested interests; reduced distortions in (hence increased efficiency of) the domestic economy; higher levels of growth/employment; reduced risk premiums requested by international portfolio investors; larger FDI inflows, etc. The benefits for the EU and national governments may be less obvious, but they are no less significant: improved access to the reforming

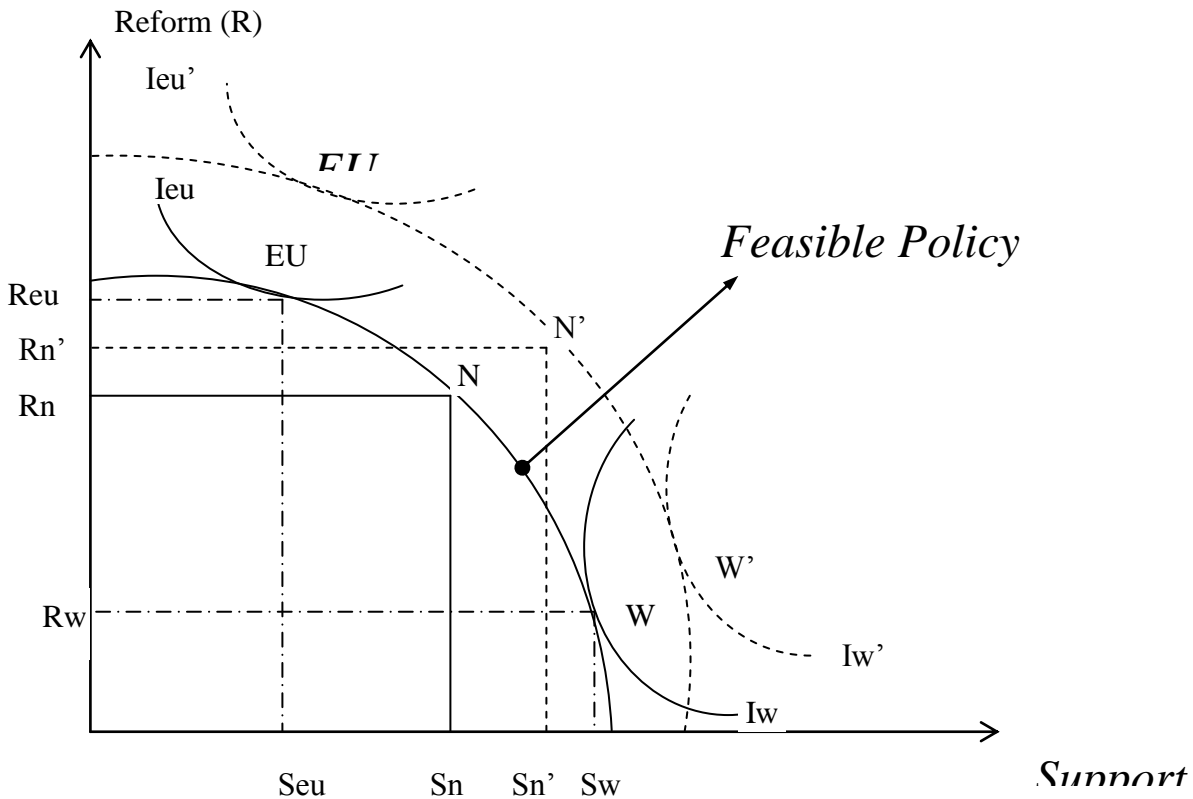
country's market as a result of trade liberalisation; reduced spill-over effects as a result of policy convergence; more transparency in the reforming countries' legal/institutional framework affecting the decisions of the economic agents in EU countries; reduced risk of economic/political instability in a neighbouring region; and reduced risk of negative spill-overs such as illegal migration, drug trafficking and terrorism, etc.

Under these conditions, a reforming WB country would demand that the EU contributes towards the cost of policy reform. The EU, however, would hide behind philanthropy by arguing that the support for reform is voluntary because reform is essentially a matter for the WB country. As a result, the level of reform undertaken by a WB country will tend to be lower than the level preferred by the EU. This gap can be demonstrated with the help of the model in Figure 1, which depicts the interaction between the EU as a 'donor' and a CEEC as a reforming country.³ The model's independent variables are the level of reform to be anchored (R); and domestic political support (S) for reforming WB country. The schedules drawn against these variables are: (i) the feasible policy frontier (FPF) that depicts the optimal combinations of reform and domestic support faced by the WB country; (ii) the indifference curve of the WB country (I_w) depicting the trade-off between reform and domestic support; and (iii) the indifference curve reflecting the same trade-off as perceived by the EU (I_{eu}).

(Insert Figure 1 here)

³ A similar model was first developed by Mosley (1987) to analyse the interaction between international financial institutions and aid recipients. The model has been revised in Ugur and Toviás (2001), to assess the extent to which the EU can anchor policy reform in Mediterranean countries. The difference between the original and revised models is that the latter is dynamic – i.e. it allows for inter-temporal change.

Figure 1: Incongruent preferences for policy reform



The EU prefers a high level of reform whereas the WB government prefers a high level of domestic political support. Consequently, the EU's indifference curve (I_{eu}) is flat, reflecting willingness to give up only a small amount of reform for a given increase in the domestic support for the SEE government. The indifference curve of the reforming government (I_w) is steep, reflecting the latter's willingness to give up a relatively higher level of reform for a given increase in domestic support. Therefore, the feasible combination of reform and support preferred by the EU is R_{eu} and S_{eu} ; whereas the reforming country's preferred combination is R_w and S_w . (For a similar treatment of the IMF conditionality, see Mosley, 1987).

Given these divergent preferences, the equilibrium combination of reform and domestic support will be determined by negotiations between the EU and its WB partner. Assuming that the reforming government is sovereign and that negotiations fail, the equilibrium level of reform will be R_w . If

negotiations result in a compromise, the equilibrium may be at any point between W and EU on the FPF – for example at N, with the feasible combination of reform and support given by R_n and S_n . This outcome, however, is unstable because there are incentives for the reforming government to relax the reform effort and increase domestic support by moving towards S once EU support (usually, external loans and/or preferential market access) have been received. This tendency will induce the EU to revise the level of support downward. This reaction, however, will only serve to justify the reforming country's return to S as the side payments offered by the EU are now lower. Overall, the level of reforms undertaken by the WB country will remain lower than the level of reforms preferred by the EU: $R_w < R_{eu}$.

These results are static in the sense that the interaction between the anchor and the reforming government is assumed to be a single-shot game with two pure strategies: cooperation or no-cooperation. It is this static aspect of the model that underlies the current debate on IMF-, World Bank- or EBRD-conditionality as specific forms of anchoring policy reform. Using a similar model, Mosley (1987) finds out that negotiations with the World Bank have generally resulted in a compromise solution such as N. However, N is found to be unstable because the tightness of the World Bank conditionality tended to be non-credible. In other words, the conditionality was relatively more punitive on 'weak' countries in need of World Bank lending, but relatively more lenient on 'strong' countries, which should have relied on structural reforms rather than World Bank lending.

In other studies, it is established that political economy factors in the reforming countries tend to be significant determinants of the solution to such strategic games. For example, IMF (1999) finds out that opposition to reforms from civil servants, staff of state-owned enterprises and other vested interests as well as the lack of social conflict resolution mechanisms tended to weaken reforms and their implementation. These results are observed in both transition economies and other developing countries.

The problem with these studies is that they do not allow for learning - either by donors such as the EU or by reforming governments. If learning were allowed, both parties would find out that they stand to gain by ensuring the credibility of the compromise solution at N. If a complete contract can be devised and if the contract can impose credible sanctions on the defecting party, the feasible policy frontier (FPF) will shift to the right – as depicted by the dotted FPF. This shift will be due to the fact that a credible commitment to reform will force the interest groups in the WB countries to revise their

expectations. For example, vested interests will realise that returns on lobbying against reforms will diminish significantly because of the way in which the contract with the EU ties the hands of the WB government. As a result, resistance against reforms will weaken and the ‘support constraint’ faced by WB government will be relaxed - enabling the latter to achieve higher levels of reform at each level of domestic support. Under this scenario, both parties benefit from what can be described as a ‘credibility bonus’ – an outcome depicted by N' on the new FPF. Compared to the static outcome at N , the dynamic outcome at N' leads to higher levels of WB reform as well as domestic support - as can be seen in these inequalities: $R_{n'} > R_n$ and $S_{n'} > S_n$. This dynamic outcome depends on the extent to which the EU and the WB country choose to co-operate and design credible commitment devices.

It is this optimal outcome that justifies a move away from the philanthropic (hence, discretionary) approach to the provision of RPG. If the EU acknowledges the positive externalities associated with WB reforms and agrees to internalize them (i.e., if the EU agrees to transparent and non-discretionary rules for sharing in the cost of WB reforms), there is a higher probability that WB countries will agree to conclude binding agreements and that these agreements will be implemented. It is true that WB governments will always be motivated to renege on their commitment to reform. However, it is also equally true that the probability of defection cannot be secured by tightening the conditionality of the EU support only. If the EU chooses to rely on tighter conditionality only, the WB governments are likely not to sign any agreement at all. Even if any agreement is signed, the probability of defection by the WB government will be higher than the alternative scenario where the EU reciprocates by a credible commitment to external burden sharing.

The analysis above suggests that the interaction between the reforming WB country and the EU yields two possible results that depend on cooperation or non-cooperation. In the case of non-cooperation, the equilibrium will be the *status quo ex ante*. The reforming country undertakes no reform and the EU remains faced with the risk of instability at its borders. In the cooperative case, the reforming country undertakes the promised reforms and the EU bears part of the reform cost. This cooperative outcome is efficient but may not be feasible unless certain conditions are met.

One factor that determines the feasibility of a credible compromise (i.e., the feasibility of a credible combination of reform and support in Figure 1) is the extent of divergence between the preferences of the reforming WB countries and the EU. The higher the extent of divergence is the more different are the slopes of the indifference curves. Therefore, the equilibriums preferred by the EU and the WB

government (i.e., points EU and W) will tend to be further apart. This divergence reduces the scope for a negotiated agreement and/or increases the incentives to renege should such an agreement be concluded.

This, however, is one of the implications of divergence. Another implication is that the further apart the individual equilibriums are the greater is the scope for gain from policy coordination. This means that the shift in FPF would be larger if agreement could be achieved and the policy reform in WB countries could be locked in. This analytical result is confirmed by theoretical work and simulation exercises on international policy coordination. According to these studies, the gains from coordination between OECD and developing countries are higher than the gains from intra-OECD cooperation (see, for example, Currie and Vines, 1988). In addition, the gains from policy coordination would be higher when trade between the parties is initially restricted by tariff or non-tariff barriers (Helkie et al, 1989).

Given this trade-off, the **first condition (C1)** for an efficient level of reform (hence RPG provision) can be stated as follows (C1): *The EU must be prepared to bear higher costs in terms of supporting WB reforms, the more divergent the existing WB policies are from those of the EU.* This condition implies two transparent rules for EU-WB relations: (i) the per capita EU support to the WB countries as a group must be higher than the per capita EU support to Central and Eastern European Countries (CEECs), who are more convergent to the EU norm; and (ii) the per capita EU support to an individual WB country relative to other WB countries must be correlated positively with the extent of relative divergence from the EU norm.

Another implication of Figure 1 is that EU support to WB countries must be proportional to the positive externalities to be generated by WB reforms. In other words, the EU's financial aid and market access facilities must be linked to the extent of policy reform to be undertaken. This relationship is also implied by studies on policy coordination, which indicate that coordination tends to fail when those who gain and those who shoulder the burden of adjustment are different sets of actors (see, Currie et al, 1989: 27). Therefore, the **second condition (C2)** for an efficient level of reform (hence RPG provision) can be stated as follows: *the extent of EU support to WB countries must reflect a WB government's reform commitment rather than the bargaining power of that government or the extent to which the EU can afford to be philanthropic.*

The third implication of Figure 1 relates to the difference between the EU and CEEC in terms of the rates at which they discount future gains. Stylised facts about transition and EU-WB relations suggest that the EU (and other donors) tend to emphasise the long-term benefits of the policy reform, whereas WB countries tend to be concerned about short-term benefits of the partnership with the EU – e.g., improved market access, financial aid, foreign direct investment, etc. These signals indicate that WB countries discount the future benefits more heavily than the EU. Under this condition, the long-run, cooperative solution in Figure 1 (i.e., point N') may not be feasible as it assumes equal (in fact, zero) discount rates for both parties.

The existing research on strategic bargaining indicates that bargaining games tend to be inefficient when the buyer's discount rate is higher than the discount rate of the seller (Crampton, 1985: 172-77). When the buyer's future discount rate is higher than that of the seller, the value of the exchange for the buyer is declining faster than the value of the exchange for the seller. Therefore, for the buyer, the exchange must take place sooner rather than later. Otherwise the exchange may not take place at all. Under this condition, bargaining does not lead to an improvement on the *ex ante* outcome that dominates the sequential bargaining. Now, if we think of the WB countries as 'buyers' of EU assistance, we can see that a WB government would insist on a front-loaded package of concessions. Otherwise, it would either refrain from concluding credible agreements with the EU or renege on these agreements as soon as possible. Therefore, the *third condition (C3)* for an efficient level of reform (hence RPG provision) can be stated as follows: *lengthy bargaining on or piecemeal market access and side payments to the WB countries are inefficient and reduce the probability of concluding partnership agreements. Therefore, the EU must come up with offers that are as close as possible to the eventual offers in order to ensure that agreements are concluded.*

The difference between discount rates has significant implications for EU-WB relations for another reason too. Again, stylised facts suggest that there is an evident contrast between the 'institutional thickness' of the EU and the WB countries. Institutional thickness refers to the strength and range of social conflict resolution institutions. Therefore, it has direct implications for inter-temporal preferences. The higher the institutional thickness is, the higher is the inter-temporal preference and, therefore, the lower is the discount rate. This implies that the EU, as the party with lower discount rate, has a longer time horizon than WB countries, which have a higher discount rate. Given this asymmetry, cooperation between the parties hinges heavily on the extent of short-term concessions that the EU can provide. Then, *the fourth conclusion (C4)* can be stated as follows: *locking in the policy*

reform of the WB countries requires substantial concessions from the EU. These concessions will enable WB governments to compensate the adversely affected interest groups in their jurisdictions. In other words, WB countries need to buy support for the policy reform to be locked in. (For the role of compensation in game-theoretic modelling of the Uruguay Round negotiations between the EU and the US, see Kennedy, 1995).

Having derived the analytical conditions that must be satisfied for an efficient burden sharing, in the next section we will assess the EU's market access and financial support commitments towards WB countries in the light of four criteria: (i) 'completeness' of the agreements (i.e., the extent to which implementation is enforceable rather than voluntary); (ii) the link between EU concessions and WB reforms; (iii) burden-sharing rules; and (iv) the size/significance of EU concessions. This assessment will enable us to ascertain the extent to which the EU's approach to WB reforms is philanthropic or guided by efficient/equitable external burden sharing rules.

2. The EU-WB partnership: a critical assessment

The first step to be taken here is to establish the extent of divergence between the EU and WB countries in terms of structural indicators. This exercise is necessary to contextualise the reform environment. More importantly, however, it will provide some indication about the cost of reform as perceived by the reforming government. Finally, it will also allow for comparison between EU contributions to WB countries Central and Eastern European Countries (CEECs). Structural indicators are given Table 1 (A) below. Table 1(B) compares the indicators of economic performance for WB countries and CEECs – with a view to provide a background against which the need for reform can be analysed. Finally, Table 1 (C) provides some transition reform indicators to highlight the extent of policy divergence between the WB countries and the EU.

Table 1:**(A) Indicators of structural convergence/divergence: EU = 100**

Indicator	WB	CEECs	EU
Road density (km/1000 sq kms)	41.1	105	100.0
Railway density (km/1000 sq kms)	75.6	139.2	100.0
Main telephone per 100 inhabitants	37.9	50.4	100.0
Electricity production per inhabitant	45.6	66.0	100.0
Public expenditure on education (%GNP)	74.0	92.1	100.0
Public expenditure on health (%GDP)	85.6	107.2	100.0

Source: Skayannis (2001: 202).

(B) Indicators of economic performance: WB vs. CEECs

Indicator	WB(*)	CEECs
1998 GDP as % of 1989 GDP	75	107
1998 Productivity as % of 1989	95	145
Gross Domestic Investment (% of GDP in 1998)	18.3	28.3
Unemployment (% in 1999)	30.0	14.0

Source: Worldbank (2000); and EU Commission (2001)

(C) Indicators of transition reforms: WB vs. CEECs

Indicator	WB(*)	CEECs
Total Privatisation Index	3.1	4.0
Enterprise Restructuring Index	2.2	2.9
Price Liberalisation Index	3.0	3.1
Competition Policy Index	1.8	2.8
Financial Reform Index	2.7	3.3
Capital Market Reform Index	1.9	2.9
Legal Effectiveness/Extensiveness Index	2.8	3.5
Average Reform Index (1999)	2.8	3.4

Source: Worldbank (2000)

(*) = Include Romania

The indicators in Table 1 (A) demonstrate clearly that the initial conditions in WB countries are less favourable for reforms compared to those in CEECs. The implications of these indicators for EU policy are obvious: the EU should provide a relatively higher level of support to WB reforms in order to: (i) induce WB governments to embark on reform; and (ii) ensure that the commitment to reforms is maintained. The performance indicators in Table 1(B) have similar implications for EU support to the WB countries. The latter's poor economic performance is a source of relative poverty and political/economic instability. Because of the negative externalities associated with poverty and instability (e.g., migration, social unrest, civil wars, etc.), the EU must bear a relatively higher cost in terms of supporting WB reforms. The higher level of EU support is required to avoid such externalities and cannot be left to the philanthropic discretion of EU member states. Finally, the indicators in Table 1(C) also point in the same direction for a different reason. The WB countries lag behind in terms of policy convergence towards EU norms. The elimination of this divergence generates positive externalities that would benefit not only the WB countries, but also the EU and its member states. Therefore, the EU must provide relatively higher support to WB countries in order to internalise these externalities (i.e., to compensate the WB countries partly for adopting policies that are preferable for the EU).

Most of what is said up to now is not unknown to the providers of assistance to WB countries. For example, the World Bank and the European Bank for Reconstruction and Development (EBRD) reports are full of evidence and conclusions suggesting that: (i) the WB countries started the transition from very weak positions (i.e., weak institutions, fragmented civil society, and high levels of political uncertainty); (ii) the violent conflicts in the region severely disrupted economic activity; and (iii) the commitment to reform has been weak and easily reversible. (World bank, 2000; EBRD, 1999). Similarly, the EU Commission's report on the stabilisation and association of the WB countries states that the region has been highly unstable, that it had to start the transition process from a very weak institutional base, and that it has been very difficult to make progress against the obstacles of inter-ethnic conflict and fragmented economic and political landscape. What is missing in these reports, however, is a clear assessment of what these conditions imply for the support framework that must be put in place in order to: (i) encourage reforms in WB countries; and (ii) ensure the irrevocability of the induced reform process.

The model developed in Section 1 above suggests that the support framework must satisfy a number of conditions. First, The EU must be prepared to bear higher costs in terms of supporting WB reforms, the more divergent the WB country is from the EU. Secondly, the extent of EU support to a WB government must reflect that government's reform commitment rather than its bargaining power or the extent to which the EU can afford to be philanthropic. Thirdly, lengthy bargaining on market access

and side payments to WB countries are inefficient and reduce the probability of concluding partnership agreements. Finally, locking in the WB policy reform requires substantial concessions from the EU.

Now let us examine the current support framework in EU-WB relations in the light of these conditions. The first condition states that the EU's support (understood as market access facilities and financial assistance) must be higher, the more divergent is a WB country from the EU norms. Unfortunately, neither the financial assistance nor market access arrangements satisfy these conditions. Table 2 below demonstrates part of the reason why this is the case with respect to total EU assistance (including PHARE, OBNOVA, Humanitarian aid, etc.). Neither total EU assistance nor per capita assistance over nine years (1991-99) reflects the divergence between the EU and WB countries. Given that Bosnia and Herzegovina is the least convergent country, the highest per capita EU assistance to this country is justified. However, if we compare FYROM and Albania, we can see that Albania is provided with the second highest amount of per capita assistance (256 Euros) despite the fact that it is less divergent than FYROM (Former Yugoslav Republic of Macedonia) who receives 99 Euros per head for the 1991-99 period. The assistance by member states is even less related to the extent of divergence. The least divergent country (Croatia) receives the highest amount of member state assistance. It is not difficult to detect the 'rationale' for this inefficient/inequitable burden sharing: the discretion inherent in the philanthropic approach that enables the member states to decide on who to help irrespective of the extent of reform required.

(Insert Table 2 here)

Table 2: EU Assistance vs Hypothetical ‘Marshall Plan’ Assistance to SEECs

	<i>EU Assistance (91-99, Mn Euros)</i>	<i>EU Assistance (Per Capita, Euros)</i>	<i>Convergence Index</i>	<i>Member State Asst. (Mn Euros)</i>	<i>Hypothetical ‘MP assistance’ (8.8% of 1990 GDP, for 5 yrs)</i>
<i>Albania</i>	871	256	2.25	713	1,587
<i>BiH</i>	2,034	522	1.75	508	1,858
<i>Croatia</i>	347	77	2.68	1,166	8,712
<i>FRY</i>	674	64	<i>n.a.</i>	712	3,509
<i>FYROM</i>	198	99	2.05	178	1,529
<i>SEEC-5</i>	4,124	169	<i>n.a.</i>	2,377	17,195

Source: EU Commission (2001), Kotios (2001: 274), Worldbank (2000)

BiH : Bosnia and Herzegovina
FRY : Former Republic of Yugoslavia
FYROM : Former Yugoslav Republic of Macedonia

Table 2 also provides some evidence as to why EU assistance does not satisfy the fourth condition – namely the condition that the EU should provide substantial transfers. The last column of the table provides hypothetical amounts of assistance, based on the Marshall Plan assistance to Greece as the least ‘convergent’ country during the Marshall Plan. Under the Marshall Plan, over five years, Greece received assistance equivalent to 8.8% of GDP (against a 2.1% for all Marshall Plan assistance recipients). If we follow the same scenario, the total amount of EU aid to five WB countries should have been 4 times the actual EU assistance, and 2.5 times the total EU and member state assistance. In addition, it must also be noted that the EU and member state assistance has been provided over 9 nine years, rather than 5 years. This means that EU and member state assistance is not only lower than the ‘Marshall Plan scenario’ aid, but also its stimulating effect is much more limited.

Another shortcoming of the EU assistance to the WB has been the lack of a single and transparent framework for management. It is true that political instability and violent conflict has complicated the EU’s relations with individual countries. Therefore, the multiplicity of procedures can be justified to some extent. This, however, should not detract attention from the fact that the EU’s response to the transition in the region has been sluggish, piecemeal and detached from the approach to CEEC reforms since early 1990s. As a result, until 2000, EU assistance to the WB countries has been channelled through 5-7 frameworks – depending on the recipient country. The Council regulation 2666/2000 eventually addressed this cumbersome structure by providing a single framework. Yet, the legacy of the fragmented period is still haunting the EU’s aid management (EU Commission, 2001: 18). Now EU aid to all countries except FRY is managed by the CARDS (Community Assistance for Reconstruction and Development) Committee. The management of assistance to FRY, however, is delegated to the European Agency for Reconstruction (EAR). A further complication in EU assistance to the WB is the lack of sufficient co-ordination between the EU and the member states – which is acknowledged even in Commission reports.

The failure of the EU to adopt an efficient/equitable RPG approach is evident in the area of market access too. Until 2000, the EU has established a variety of bilateral trade relations with WB countries. On the one hand, FYROM has had unrestricted duty free access with respect to industrial products – with the exception of iron and steel products. Iron and steel imports from the FYROM are subject to tariff ceilings. On the other hand, concessions to Albania, Bosnia and Herzegovina and Croatia have

been made on the basis of autonomous trade preferences (ATPs). The ATPs for these countries impose tariff ceilings on iron and steel products, whereas textiles and clothing products are subject to tariffs once the tariff-free quota is exceeded. The introduction of tariffs is automatic when the quota for agricultural products is exceeded, but it depends on a demand by the member states in the case of textiles and clothing.

The irony of the 'managed' market access concessions is that free access has been granted to products in which CEECs are not competitive. Therefore, the restrictions implied by 'managed' access apply to majority of CEEC exports. For example, 62% of Albania's export is subject to one type of restriction or the other. Similarly, 26-43% of FYROM export is affected by the uncertainty associated with 'managed' access. These shares would be even higher if we included the products subject to 'surveillance'. Therefore, it is not surprising to observe that WB countries have been unable either to increase their exports to the EU. In most case, they have been unable even to reach their quota ceilings. As World Bank (2000) suggests, one of the reasons for this poor performance is the export-discouraging uncertainty and bureaucratic complexity that the 'managed' access has caused.

From 2000 onwards, the EU, in its relations with WB countries, has moved away from unilateral market access concessions towards reciprocal market opening. This is reflected in the Stabilisation and Association Agreements (SAAs) offered to WB countries. The first SAA has been concluded with FYROM in 2001. Unfortunately, this move has not rectified the uncertainty that characterised the 'managed' access provided in the 1990s. Although the EU-FYROM SAA provides for tariff-free access for industrial and processed agricultural products from FYROM, it contains significant exemptions with respect to the latter (Article 27 and Protocol No. 3). Tariff-free entry of processed agricultural products is subject to complex and elaborate technical standards and FYROM exports may be limited by tariff quotas. In addition, there are strict rules of origin which discourages intra-WB trade or trade with CEECs. The rules of origin allow cumulation only for products imported from the EU. This restriction is likely to increase dependency on the EU market and work against the declared objective of encouraging intra-regional trade.

The more damaging aspect of the SAAs is the principle of reciprocity. In return for EU market access concessions, the SAA provides that FYROM would remove all tariff and quantitative restrictions on imports from the EU. The opening of the FYROM market should be completed within a maximum of 10 years. The short-term adjustment costs of this trade liberalisation are likely to exceed the short-term benefits of slightly improved access to the EU market. Even the Worldbank (2000) is of the opinion that the EU could have provided unilateral and free market access. Such preferential treatment is not likely to be blocked by the WTO and may be what the WB countries need to stimulate their economies through increased exports. The CEEC experience has demonstrated clearly that piecemeal market access concessions are not effective in encouraging structural reforms.

Conclusion

We have demonstrated that efficient provision of RPGs is feasible only if the EU can move away from what we described as philanthropic collusion between member states. What is required is not discretionary assistance for the stability of the WB, but a rule-based and transparent arrangement that satisfies four conditions: (i) reform-linked assistance; (ii) minimal discrimination; (iii) front-loaded EU concessions; and (iv) substantial resource transfer to WB countries. When examined in the light of these conditions, the EU's current support to the WB reforms remains essentially philanthropic. Although the EU is the largest donor of financial assistance and has granted preferential access to WB exports, its financial assistance is less than what a 'Marshall Plan' scenario would require and its market access concessions are too 'managed' to stimulate WB exports and economic growth.

Nevertheless, the EU now has a window of opportunity to address the shortcomings of its previous trade and aid policies towards the WB. On the one hand, the armed conflict that shattered the region has come to an end. On the other, the EU has initiated in 2000 the Stabilisation and Association process (SAp), which seeks to promote regional stability and eventual integration of the WB countries. Given these developments, there is less scope or excuse for the EU to maintain the philanthropic approach that has produced two negative outcomes: (i) inadequate EU commitment to the reconstruction of the WB region; and (ii) uncertainty about the success of WB

reforms. The recent developments and the negative consequences of the philanthropic approach provide a fertile ground for the derivation of appropriate lessons. Therefore, it is not surprising to observe that EU policy documents are now reflecting some acceptance of the RPG approach to WB reforms.

For example, the Regional Strategy Paper for 2002-2006 states explicitly that the promotion of peace and stability in the WB region is desirable not only on 'humanitarian' grounds, but also because the conflicts in the region have been detrimental to security and prosperity across Europe. In addition, the conflicts have placed 'a substantial military and financial burden on EU member states.' (EU Commission, 2002a: 4). Translated into the language of RPG provision, this statement suggests that the Commission is now accepting the principle that economic and political instability in the WB region is a 'public bad' for the EU and that the avoidance of 'public bads' is costly. Therefore, the EU, under the SAp framework, has earmarked a total of 4.6 billion Euros to support investment, institution-building and structural reforms in the WB region. In addition, EU support is now organised within multi-annual programmes that will determine the parameters of annual action plans. This is a step in the right direction and should address the shortcomings of the philanthropic approach that prevailed in the 1990s.

There are some developments in the area of trade policy too. Following the declaration of the SAp, the EU has committed itself to integrate the WB countries in a gradual process. One positive implication of this commitment is that WB governments are now better placed to ensure 'national ownership' of the reforms. Another implication is that the Autonomous Trade Preferences (ATPs) that allowed the EU a high degree of discretion will be replaced by Stabilisation and Association Agreements (SAAs). SAAs can be superior to ATPs if they put an end to selective market opening and grant regional rules of origin. Unfortunately, the SAA with FYROM indicates that the EU is still not prepared to relinquish the philanthropic approach to trade policy yet. Given that the share of WB countries in the EU market is less than one percent, the EU's failure to grant unilateral free access is an indication that the move towards adopting an RPG approach is limited at best and disappointing under normal conditions.

REFERENCES

Crampton, P. C., 'Sequential bargaining mechanisms', in A. E. Roth (ed.), *Game-theoretic Models of Bargaining*, Cambridge, Cambridge University Press, pp. 149-179, 1985.

Currie, D. A. and D. Vines, *Macroeconomic interactions between North and South*, Cambridge, Cambridge University Press, 1988.

Currie, D. A., G. Holtham and A. Hughes Halett, 'The theory and practice of international policy co-ordination: does co-ordination pay?' in R. C. Bryant et al (eds.), *Macroeconomic policies in an interdependent world*, Washington, DC, IMF, pp. 14-46, 1989.

Dollar, D. and J. Svensson, 'What explains the success and failure of structural adjustment programmes', *Economic Journal*, vol. 100 (October), pp. 894-917, 2000.

EBRD, *Transition Report: Ten Years of Transition*, London, EBRD, 1999.

EU Commission, *CARDS Assistance Programme to the Western Balkans: Regional Strategy Paper, 2002-2006*, DG External Relations, Directorate Western Balkans, Brussels, 2001.

EU Commission, *Commission Report on the Stabilisation and Association Process for South Eastern Europe*, COM(2002)/163 final, 2002.

EU Commission, *CARDS Assistance Programme to the Western Balkans: Regional Strategy Paper, 2002-2006*, prepared by the External Relations DG, Brussels, 2002a.

EU Council, 'Regulation 2666/2000 on Assistance to Albania, Bosnia and Herzegovina, Croatia, FRY and FYROM', OJ No. L306, 7.12.2000, p. 1, 2000.

EU-FYROM, *Stabilisation and Association Agreement*, Interinstitutional File no. 2001/0049, ACV, Brussels, 2001.

Ferroni, M., *Regional Public Goods in Official development Assistance*, Occasional Paper no. 11, Inter-American Development Bank, Washington, 2001.

Helkie, W. et al, 'Protectionism and the US trade deficit: an empirical analysis', Centre for Economic Policy Research (CEPR) Discussion Paper no. 286, London, CEPR, 1989.

Hurwicz, L., 'The design of mechanisms for resource allocation', *American Economic Review: Papers and Proceedings*, vol. 63, pp. 1-30, 1973.

IMF, 'External evaluation of ESAF' in Bredenkamp, H. and S. Schadler (eds.) *Economic Adjustment and Reform in Low-Income Countries*, Washington, D.C., IMF, 1999.

IMF, *Conditionality in Fund-Supported Programs – Policy Issues*, Washington, D.C., IMF, 2001.

Kaul, I., I. Grunberg and M. A. Stern (eds.), *Global Public Goods: International Cooperation in the 21st Century* (New York: UNDP).

Kennedy, P. L., *Game Theory in Multilateral Trade Negotiations: An Application to the Uruguay Round* (Kiel: Wissenschaftsverlag), 1995.

Kotios, A., ‘European policies for the reconstruction and development of the Balkans’, in G. Petrakos and S. Totev (eds.), *The Development of the Balkan Region*, Aldershot, Ashgate, pp. 235 –280, 2001.

Mosley, P., ‘Conditionality as bargaining process: structural-adjustment lending, 1980-86’, *Essays in International Finance*, no. 168 (October 1987), Princeton University International Finance Section, 1987.

Sakayannis, P., ‘Infrastructure comparisons in transition countries: A new north-south divide?’, in G. Petrakos and S. Totev (eds.), *The Development of the Balkan Region*, Aldershot, Ashgate, pp. 175-218, 2001.

Sandler, T., ‘Global and regional public goods: A prognosis for collective action’, *Fiscal Studies*, vol. 19, no. 3, pp. 221-247, 1998.

Ugur, M. and A. Tovias, ‘Can the EU Anchor Policy Reform? The Case of the EuroMed Partnership’ (Paper submitted to METU Conference, Middle East Technical University, Ankara, September 2001). (Manuscript), 2001.

World Bank, *The Road to Stability and Prosperity in South Eastern Europe*, <http://www.seerecon.org>, 2000.