odi Briefing Paper

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REGIONAL INTEGRATION AND POVERTY

It is often suggested that regional integration is good for poverty by increasing trade and investment and creating jobs for the poor. At the same time, the number and scope of regional trade agreements is increasing rapidly. However, there is little about whether and how regional integration provisions affect development and poverty in poor countries. The findings of a multi-country research project reveal that while there is a role for regions, expectations relating to poverty effects should be tempered. The trade effects from developing country regional integration are expected to be small because of the low importance of intra-regional trade for most developing countries. While regional integration does tend to raise investment from outside, the bigger countries tend to capture most of the benefits. Capacity constraints further limit the ability of poor countries to benefit fully from trade and investment liberalisation. In addition, regional integration processes affect the incentives to engage in multilateral integration. On the positive side, regional groupings are well placed to address poverty by providing appropriate regional public goods and dealing with liberalisation of sensitive services sectors. Thus the scope of regional integration matters.

Introduction

The number of regional trade agreements (RTAs) notified to the WTO has increased rapidly in recent years, with the EU and Central and Eastern European Countries accounting for a significant proportion. Nearly all developing countries are a member of at least one regional trade agreement, while many are a member of more. For instance, Mexico is a member of seven RTAs; Tanzania is part of four RTAs.

The scope and depth of RTAs is increasing. Some call this the emergence of 'New Regionalism'. 'Old' developing country regions were unstable and failed to live up to their promises. Now RTAs include an increasing number of new issues such as provisions on investment and trade in services. They also include regional cooperation programmes.

The formation of a region may be seen as a tool for development but this is not always the only or even the main reason for countries to come together. The EU's development policy is based to a large extent on supporting the formation of regions amongst developing countries. The European Union is currently initiating negotiations on Economic Partnership Agreements (EPAs) with African Caribbean and Pacific regions under the Cotonou Partnership Agreement before 2008. The EU appears to assume that the question is not whether a region should be formed, but rather what type of region can help to achieve development objectives such as poverty reduction.

However, despite the increase in number and scope of RTAs we do not know enough about the effects of such RTAs on development and whether it is possible to make regions more developmentally friendly. Provisions within RTAs differ so it is likely that different agreements have different effects. Studies do estimate the impact of RTA on trade or on GDP at a regional level, or the impact of all trade on poverty at a national level. They rarely cover the impact of regional provisions on poverty at the country level. This Briefing Paper addresses this issue.

Describing regional provisions

Measuring the degree of integration in regions is necessary before we can measure the impact on poverty. Measurement will need to go beyond merchandise trade and cover other issues such as services trade, investment, social programmes etc.

Glossary of main regions included in the study

- ASEAN Association of South East Asian Nations
- CAN (ANDEAN) Comunidad Andina de Naciones (Andean Community)
- CARICOM Caribbean Community and Common Market
- COMESA Common Market of Eastern and Southern Africa
- MERCOSUR Mercado Común del Sur (Southern Common Market)
- NAFTA North American Free Trade Agreement
- SADC Southern African Development Community
- SAARC South Asian Association for Regional Cooperation

Investment and Merchandise trade

There are interesting differences with respect to investment: for instance, investment provisions in ANDEAN restricted FDI in the 1970s but this changed over the 1980s and 1990s. ASEAN has gradually added more investment provisions over time. NAFTA included quite strong provisions from its inception in 1994. SADC and COMESA contain weak trade and investment provisions. Table 1 measures how regions differ with respect to trade and investment provisions:

- *Over time*, when regions change or add investment-related provisions, and
- *Across regions*, when investment-related provisions differ at one point in time

We expect that a higher value of the index is associated with more FDI (from outside the region). Implementation will vary by country.

Services

Developing country regions have also begun to design provisions addressing trade in services. GATS Article V requires RTAs to be more liberalising than the GATS.

The Organization of American States argues that regional services agreements differ in three dimensions:

- Coverage describes the four modes of supply (as in GATS: cross-border delivery, consumption abroad, commercial presence, and movement of people) and whether the agreement takes a negative list approach where all services sectors are included subject to exceptions (called non-conforming measures), or a positive list approach specifying the type of access offered to service suppliers in scheduled sectors.
- Liberalising principles include national treatment (no discrimination between foreign and domestic suppliers) and, most favoured nation (no discrimination by source-country).
- Depth of commitments includes transparency (informing members of existing restrictions on services trade), ceiling binding, freeze or standstill on non-conforming measures (no return to less liberalisation), ratcheting, 'list or lose' (non-conforming measures can be maintained only when they are listed in appendices) and future liberalisation.

Table 1 The Regional Integration Index varies across regions and over time

	Investment provisions			Trade provisions		
(date of establishment)	1970s	1980s	1990s	1970s	1980s	1990s
NAFTA (1994)	0	0	3 (1994)	0	0	2 (1994)
MERCOSUR (1991)	0	0	2 (1994)	0	0	3 (1991)
CARICOM (1973)	0	1 (1982)	2 (1997)	1 (1973)	2	3 (1997)
ANDEAN (1969)	-1 (1970)	1 (1987)	2 (1991)	1	1	2 (1993)
ASEAN	0	1 (1987)	2 (1996), 3 (1998)	1	1	1
SADC (1992)	0	0	1 (1992)	0	0	1 (1992)
COMESA (1994)	0	0	1 (1994)	0	0	1 (1994)

Notes: years between parentheses indicate when certain provisions were announced.

Investment Index = 0 if not member of group; = 1 if some investment provisions in region (as in COMESA, SADC); = 2 if advanced investment provisions in region (e.g. improved investor protection in ASEAN) = 3 if complete investment provisions in region (e.g. Chapter XI of NAFTA); = -1 if more restrictive provisions (restrictions on foreign investors in ANDEAN in 70s)

Trade Index = 0 if not member of group; = 1 if some trade provisions (e.g. tariff preferences); = 2 if low external tariff, (close to) zero intra-reg tariffs; = 3 if high external tariff, (close to) zero intra-reg tariffs

Latin American RTAs are most liberalised, followed by ASEAN in Asia while African RTAs have only just started to consider or implement general agreements on services. The picture is complicated as some regions are advanced at a sectoral level or for certain modes. For instance, SADC has included sectoral agreements on infrastructure, while ECOWAS has included provisions on the movement of people (mode 4). It is often not clear how much more liberalised RTAs are compared to GATS, so it is unlikely that signficant effects have been obtained from regional services integration so far. The WTO has hitherto been unable to assess whether regional services agreements are WTO compatible.

Regional integration and poverty: a framework

In order to assess how regional integration (RI) affects poverty, we need a theoretical framework. The starting point is that trade, investment, migration and other provisions can each affect trade, investment and migration. RI can affect poverty at the country level in a number of ways:

- *Route 1:* through the volume (e.g. effects on allocative or dynamic efficiency) and poverty focus (e.g. if regional exports are produced relatively more by the poor, or if regional imports benefit poor consumers relatively more) of trade
- *Route 2:* through the volume and poverty focus of investment
- *Route 3:* through the volume and poverty focus of migration
- *Route 4:* through other routes (regional social and infrastructure programmes, or effective representation of poor people in regional trade negotiations)

There are four basic steps to assess each route:

- *Step 1:* identify relevant regional provisions on trade, investment and migration
- *Step 2:* identify the effect on the volume and poverty focus of trade, investment and migration
- *Step 3:* identify how this change in volume and poverty focus maps onto poverty
- *Step 4:* identify how complementary conditions affect the relationship between the change in volume and poverty focus and poverty

Each of these routes can be assessed using the four steps as building blocks. The trade route is perhaps most well known, so as an example, chart 1 shows the framework for the effects of RI on poverty via investment (route 2). It covers four building blocks. For a country member of a particular RTA we should be asking a number of questions to unravel the effects of RTAs on poverty through investment (or for RTAs of which it is not a member to assess investment diversion effects):

- *Regional Trade Agreement*: what are the goods trade provisions (e.g. tariff and not-tariff barriers, rules of origin); what are the services provisions; what are investment provisions; other provisions?
- *Foreign Direct Investment (volume and focus)*: how have provisions in the RTAs affected the volume of intra and extra regional investment; how has the RTA affected the poverty focus of investment, i.e. what are differences between global multinational enterprises (MNEs), regional MNEs and domestic firms with respect to: wages, jobs, capital, trade, structure of markets, tax revenues, technology, and skills?
- *Complementary conditions*: does the domestic private sector possess the capabilities to compete with foreign firms to capture productivity spillovers; are public policies (labour, infrastructure, trade and investment facilitation, education, MNE-local firms linkage stimulation) geared towards capturing the productivity spillovers; does the government redistribute income or assets, through taxes, support for incomes, and provision of public goods, temporarily through safety nets or permanently?
- *Poverty*: how does investment affect incomes, employment, capital assets (equipment, land) and other assets (health characteristics, education levels, access to financial capital, empowerment and exclusion) of the poor?

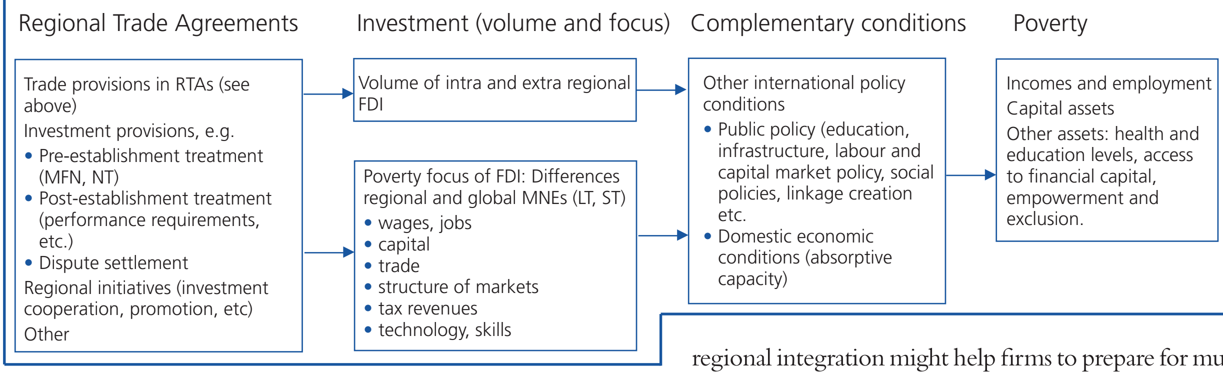
The effects work similarly for trade and migration.

What is known…

There are a number of expected and sometimes actual effects for the above links which should make it possible to gain a better understanding of how regional integration affects poverty:

- RTAs boost intra-regional trade through tariff reductions; many regions are trade creating, but regions such as the EU and EFTA may have been trade diverting.
- Standards and very strict rules of origin (RoO) may decrease intra-regional trade because the region may not have the appropriate processing capacity or tariff preference take-up because it may be costly to obtain relevant certificates. Overlapping membership of more than one region may add to the confusion. Effects can also interact: RoO are likely to be more relevant if intra-regional tariff rates are substantially lower than extra-regional tariffs.
- RTAs are likely to lead to increased FDI from outside the region; various RTAs are net investment creating.
- General and partial equilibrium models find that service liberalisation can bring large benefits to developing countries. Whilst it is more efficient to liberalise most services multilaterally (e.g. to facilitate investment into tourism), sensitive sectors are easier to liberalise regionally (e.g. migration in CARICOM).
- The effects of increased trade and FDI depend on complementary conditions such as provision of education.
- Despite these positive indications, any effect through trade, investment and migration provisions in developing country regions is likely to be small in the aggregate for various reasons.

Chart 1 Regional integration and poverty via investment



This is because the share of intra-regional trade in total trade in developing regions is small (e.g. 15%, table 2) and trade (average of export and imports) is usually not more than 30% of GDP. So regional trade is only around 5% of GDP. In addition, of the 21 percentage point cuts in average weighted tariffs of all developing countries between 1983 and 2003, unilateral reforms accounted for the majority followed by multilateral commitments leaving just 2 percentage points (10% of the 21 percentage points) due to regional agreements.

- Similarly, intra-regional inward FDI is low (table 2), and is 1% in the South Asian Free trade Area (SAFTA); although it is 'only' 25% in SADC, several SADC countries depend for more than 50% of FDI from South Africa. While intra-regional migration as a share can be high in MERCOSUR (26%) or ANDEAN (53%), migration as such is usually (except for small 'migration countries') low and less than 1% of the population.

Table 2 The regional share (%) of investment, trade and migration, some examples

	Intra-regional exports as share of total (2003, or last year available)	Intra-regional imports as share of total (2003, or last year available)	Intra-regional investment as share of total outward FDI flows (2000)	Intra-regional immigration as share of total immigration
EU (15)	61.6	61.9	46	Less than 20% for most EU members (0.80% of total population)
NAFTA	56.5	38.1	18	
ASEAN (10)	24.0	23.6	15	
MERCOSUR	11.5	17.0		26% (0.37% of total population)
ANDEAN	10.2	13.9		53% (0.78% of total population)
CARICOM	9.8	16.4		
COMESA	8.6	5.8		
SADC	6.0	6.3	25	

Sources: see Te Velde, Page and Morrissey, 2004; IMF.

- On the other hand, increased trade and investment can lead to faster economic growth and poverty reduction particularly when trade leads not only to increased allocative efficiency but also increased competition and productivity in the long-run. These dynamic effects of regional integration are difficult to measure, but should not be assumed away. There is limited evidence that trade and investment induced by regions boost productivity (e.g. regional exporters pay higher wages than domestic firms in Tanzania) and product variety and availability (e.g. in times of country specific droughts). While such effects are more likely when liberalising multilaterally, to the extent that regional integration drives up productivity, regional integration might help firms to prepare for multilateral liberalisation.

...and what we need to examine

As discussed in the introduction, there are several gaps in our knowledge about the effects of RI on poverty. Two new pieces of evidence have now emerged.

RTAs and investment

Trade and investment provisions differ markedly across RTAs and across time, but (econometric) studies that examine the effects of regional integration tend to use simple dummy variables which do not vary across agreements or time. This is problematic for those who want to negotiate the best possible type of region: in reality no region is the same. It is also problematic for individual countries within the region, as they do not know whether benefits accrue to the country. We estimated a model which explains the level of UK and US FDI in developing countries by a number of factors such as education, infrastructure and market size and identified the effects of specific regional investment-related provisions on FDI (table 3). For the seven RTAs in table 1, it was found that i) membership of a region leads to further FDI inflows from outside, but the type of regional provisions matters, i.e. whether or not regions include certain trade and investment provisions; and ii) that the position of countries within a region matters, i.e. that smaller countries and countries located further away from the largest country in the region benefit less from being part of a region than larger countries and those closer to the core of the region.

Country case studies: Bolivia and Tanzania

Case studies of Bolivia and Tanzania tested the mapping structure set out above, moving beyond effects at regional level to poverty effects at country level. Bolivia is part of ANDEAN, is an associate member of MERCOSUR and other regional groupings and has been included in the EU and US GSP systems. It has also one of worst poverty records in Latin America. Tanzania is a member of regions such as the East African Community (old and new) and SADC and is also part of others such as GSP systems and the Cotonou Agreement, but withdrew from COMESA. While the implementation of regional trade provisions has been slow in Tanzania, it does not appear to have been much slower than comparable countries.

Bolivia. New evidence shows that regional integration has affected the trade composition of Bolivia, geographically towards more trade with ANDEAN and MERCOSUR, and sectorally from minerals towards vegetable fats, food and beverages. However, total trade as % of GDP has not increased, mainly because of supply constraints in Bolivia, so that capacities to trade are important in benefiting from regional integration. This shows the importance of complementary conditions. Lower regional tariffs have led to cheaper imports, but since just

Table 3 Regional integration and FDI in developing countries

	Dependent variable Level of UK and US FDI	
GDP in host country	0.68**	0.67**
Education (average primary, secondary and tertiary)	0.004**	0.004**
Inflation	0.00	0.00
Phone lines per 1000 inhabitants	0.003**	0.003**
Roads (% paved)	0.17**	0.11*
Regional Investment Provisions (index table 1)	0.41**	0.17*
Regional Investment Provisions * ratio of host country GDP to largest GDP in the region		0.80**
No of observations	1521	1521
No of countries	68 for UK 97 for US	68 for UK 97 for US
Time period	1980-2001	1980-2001
R-squared	0.44	0.45

Notes: robust standard errors within parentheses, constant and US fixed effect omitted from tables ** (*) denotes 5% (10%) significance level

8% of the consumption by the poorest part of the population are imported goods (and some of this is not from the region) the impact on poverty through a trade price effect has been weak. To the contrary, data on the pattern of employment across sectors and over time support the idea that regional integration may have hurt domestic producers. This is because a large proportion of imports from ANDEAN and MERCOSUR compete with local producers. On the other hand, while increased exports may not have led to higher wages in manufacturing sectors, it did raise incomes in the mining, hydrocarbon and modern agriculture sectors.

Tanzania. Regional integration has increased trade in Tanzania. Regional trade has a better poverty focus than other trade, i.e. it comprises products that involve the poor more directly. RI may not have affected FDI, but conversely FDI may actually have affected regional integration processes: Tanzania is part of SADC, not COMESA, and has important commercial links with South Africa. The effects of RI on poverty through trade and investment have been limited. This is not necessarily because of limited progress in the regional integration process, but rather due to capacity constraints particularly in areas where the poor live. On the other hand, the East African Development Bank has provided regional public goods including socio-economic projects and environmental projects related to Lake Victoria. These projects help to reduce poverty, but while the initiatives are significant they remain limited in scope. Whilst it is too early to evaluate fully such initiatives, it is an encouraging sign that regional integration can benefit the country through non-trade/investment/migration routes.

Concluding remarks

Regional integration can affect poverty in a variety of ways. The effects through merchandise trade are likely to remain limited for some time in regions amongst poor countries with similar production structures, so expectations with respect to poverty effects should be tempered. While there may well be dynamic effects and these can be more important than static effects, the evidence of this remains limited, and it needs to be shown whether dynamic effects from regional integration support dynamic effects from multilateral integration.

The effects of regional integration on investment (from outside the region) are positive, but the benefits are likely to be distributed unequally across the region. The poverty effects through trade and investment do not only depend on the depth of the integration process, but more likely on the complementary condition that countries put in place. Supply constraints are the reason that Tanzania has been unable to expand its exports of agricultural products more quickly and that Bolivia has not been able to increase the trade to GDP ratio.

Thus while we remain cautious about the first three routes to how poverty could be affected (trade, investment and migration), there might be important effects in the fourth route. Regional integration can affect poverty by including regional socio-economic projects and other types of integration, e.g. in providing infrastructure or regional public goods more generally. In this sense, the type and scope of the regional integration process may matter a lot for poverty reduction. Several regions have widened the scope beyond trade and investment. SADC, for instance, has created a Southern Africa Transport and Communications Commission to implement its transport protocol.

A final note of caution relates to negotiating capacities and incentives to engage in multilateral liberalisation. Regional integration processes affect the incentives to engage in multilateral integration (particularly N-S, but also S-S). When some countries have acquired tariff preferences they would like to keep these, and perhaps understandably may prevent further multilateral liberalisation which would erode the preference margin. More attention should therefore focus on what areas fall within the competences of regions (e.g. regional public goods) and how to ensure a country commits to and benefits from regional integration in a way that does not impede multilateral trade liberalisation later. Regional integration processes, just as other integration processes, require government capacities. Normally, national policy is more important than any trade policy in development, so countries should avoid being diverted excessively to trade, especially to a small portion of total trade, as in most developing country regions. Thus there needs to be a better understanding of which type of negotiating capacities are useful for both regional and multilateral negotiations (e.g. national baselines of services liberalisation as proposed by COMESA) and which are not (e.g. time spent in meetings).

Project background papers:
www.odi.org.uk/iedg/projects/ec_prep.html
Velde, D.W. te, S. Page and O. Morrissey (2004), 'Regional Integration and Poverty: mapping the linkages'
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Velde, D.W. te and D. Bezemer (2004), 'Regional Integration and Foreign Direct Investment'
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For further information contact the principal author Dirk Willem te Velde (d.tevelde@odi.org.uk).

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Overseas Development Institute, 111 Westminster Bridge Road, London SE1 7JD
Telephone: +44 (0)20 7922 0300 Fax: +44 (0)20 7922 0399 Email: publications@odi.org.uk