POLICY BRIEF #1

The impact of regional integration on poverty in developing countries

What do we know and what have we learnt?

Michael Gasiorek (CARIS) and Antonio Martuscelli (CARIS)

The empirical literature examining the links between regional integration and poverty for developing countries is relatively scant. In this briefing paper we set out a framework of analysis, consider the evidence, and then provide policy recommendations which can be applied in the context of East Africa.[1]

What do we know?

The impact on poverty will depend on three S's:

- The *scope and depth* of liberalisation and therefore on which prices change (which sectors and products experience liberalisation of tariff and non-tariff barriers), whether investment and capital flows are included, and on whether migration between countries is allowed. What is included and implemented will be determined by the political economy within each region.
- The *structure* of the economy and in particular on existing patterns of production and consumption and trade, both geographically within and between countries, and between different social groups within countries.
- The *size of the constraints* faced by the poor. Trade creates both opportunities and challenges. The impact on poverty will depend on the ability of the poor to overcome the constraints to taking advantage of the opportunities, and the constraints to protecting themselves from negative shocks.

…and several factors will impact on how regional integration affects poverty

1. The scope and depth of what is liberalised depends critically on the political economy driving the regional integration process - the combination of power and interests both within and between countries determines the outcomes of negotiations.
2. In turn, the scope and depth of the agreement, as well as its implementation, determine the impact on government revenue and hence poverty reducing public expenditure.
3. Regional integration may lock in policy commitments, leading to more stability, with a positive impact on investment and migration flows.
4. Regional agreements may encourage intra-regional infrastructure projects that are particularly important for land-locked countries/regions.
5. There may be explicit regional social policies designed to impact upon poverty reduction
6. Where regional integration is encouraged and supported by governments and their development partners, there may be associated policies designed to mitigate any negative impacts on poverty.
7. Regional integration is often associated with so-called 'deep integration', going beyond tariff reductions to include policy and standards harmonisation, which is likely to lead to greater impacts on the distribution of income, and on poverty.
8. Regional integration may be an important facilitator of cross-border trade, which is important for many developing countries.
9. The nature of the relationship between the regional process and integration into the world economy will affect the impact on poverty.

[1] For a full discussion of the conceptual framework discussed in this policy brief and its application to the EAC, see Gasiorek et al. (2016), *Regional Integration, Poverty and the EAC: What do we know and what have we learnt?* ECDPM Discussion Paper 202. http://ecdpm.org/publications/regional-integration-poverty-east-african-community/

The impacts depend on the constraints faced by the poor

The poor face many constraints which impact on their *ability to respond to negative shocks*, for example:

- For producers: competition from imports leading to reduction in sales/income
- For workers: competition from imports leading to reduction in employment and/or wages
- Reduction in tariff revenue leading to a decline in expenditure on poverty alleviating measures (health, education, social security)

And on the *ability of the poor to seize opportunities*, for example:

- For consumers: lower prices from cheaper imports; increased employment and/or higher wages in expanding sectors
- For producers: improved access to export markets; cheaper and/or higher quality intermediates; increased investment

The bigger the constraints, the harder it is for the poor to benefit from trade liberalisation, and the harder it is to adjust to negative shocks caused by liberalisation.

The ability of the poor to respond to the constraints will depend on factors such as their location, household status, sector and status of employment, and production and consumption patterns.

What have we learnt?[2]

There will be short-term direct impacts…

… arising from the changes in prices which impact on both consumers and producers, and changes in tariff revenue which impact on government expenditure. This is where the scope and depth of liberalisation matters, and where there is evidence that reducing non-tariff barriers may now be more important than tariff barriers in reducing poverty. This includes trade facilitation, transport costs, health and safety standards, and barriers to services.

Important too is the comparison of pre and post liberalisation tariffs and how this interacts with the structure of production, consumption and trade. This means that even within the same regional agreement there might be differential impacts on poverty for different countries. In the case of Mercosur evidence suggests the effect was pro-poor in Uruguay but negative for Paraguay. Similarly there may be different impacts across sectors and groups within society, such as between the urban and rural sectors. Where tariff revenue is an important share of government revenue, any revenue losses are more likely to have a negative impact on poverty.

For consumers, the impact will be bigger the more responsive demand is to changes in prices; for producers (both households and firms), impacts depend on how easy it is to respond to changing market access conditions. These in turn depend on the constraints faced by the poor (see box above).

Medium term structural change then has further impacts on poverty…

… as economies adjust to price changes, there will be expansion and contraction of different industries which impacts on employment and wages. These impacts could be positive or negative. For example, concerns about 'de-industrialisation' in Africa focus on structural change leading both to unemployment or underemployment and the move to lower productivity service sector activities.

On the other hand, improved access to export markets can be pro-poor by increasing employment and the wages of unskilled workers. The positive wage effect is conditional on several factors; ease of access to export markets, which in turn may be related to standards; whether firms upgrade to skill-intensive technologies; and may also depend on the presence of foreign direct investment.

Once again the larger the constraints to adjusting to shocks, the more likely it is that liberalisation will either have a negative impact on poverty or that any positive impacts on poverty are reduced. These effects often arise through labour market rigidities making it harder for workers to move to new sectors or regions of employment. Conversely, the larger the constraints to seizing the opportunities from trade liberalisation, the less likely it is that trade liberalisation will alleviate poverty. This could be, for example with respect to transport costs, or from constraints to FDI.

Migration can also lead to reductions in poverty driven by remittance flows but this is not always the case and constraints to mobility can reduce the capacity of the poor to benefit from closer integration. The impact on gender will depend on the female (skilled and unskilled) composition of employment in the affected sectors. If trade liberalisation favours female-intensive sectors then wages and employment may rise. There may be similar within industry effects where trade liberalisation leads to technological upgrading within firms and greater demand for skilled tasks which are more suited to women. On the other hand reduced protection may lead to cuts in education expenditure, which in turn may have a bigger negative impact on girls.

And in the longer-term economic growth is important for reducing poverty…

…and there is substantial evidence on the positive effects of regional integration on productivity, GDP and economic growth. However, evidence suggests these impacts depend on the quality of the physical and institutional infrastructure. The greater the constraints associated with such infrastructure, typically the lower the impact of trade on growth or FDI on growth. As poor, least developed countries are also usually those that lack these infrastructures, it is harder for regional integration to have these positive longer run effects on poverty. Evidence on the impact of migration on growth is more mixed – essentially because outward migration reduces the stock of labour in the home economy and remittances may or may not compensate for this.

2 For a discussion of the empirical evidence on regional integration and poverty linkages see Gasiorek, M and A. Martuscelli (2016), *Regional Integration and Poverty: A review of the transmission channels and the evidence*, CARIS working paper (forthcoming).

A key driver of economic growth is raising firm-level productivity, and these gains can arise from learning in export markets, spillovers from increased foreign direct investment, access to higher quality intermediates, greater competition, economies of scale, or quality upgrading. There is also evidence that FDI and the presence of multinational companies could increase firm productivity, in particular through vertical linkages or horizontal knowledge spillovers. Deeper regional integration is more likely to lead to such spillovers leading to greater productivity gains.

Conclusions and policy recommendations

The impact of regional integration on poverty depends on the scope and depth of liberalisation, the structure of consumption, production and trade, and on the size of the constraints faced by the poor. Policy can directly influence the first and third of these, so for policy to be effective this requires a better understanding of who will be affected, how they will be affected and the constraints they face.

On the scope and depth, policy should focus on:

- Before policy changes are introduced, assessments of the likely winners and losers from the given regional integration process based on the scope and depth of the liberalization
- understanding and removing non-tariff barriers to trade between countries
- developing alternative means of revenue collection and accompanying measures for the losers, where tariff revenue is an important component of government revenue

On the constraints faced by the poor, the existing evidence base is thin and therefore needs to be better understood and measured. Understanding these constraints will improve the ability of policy makers to address the short, medium and long run impacts on poverty. The key constraints are likely to be associated with:

- physical and institutional infrastructure
- access to finance / credit for households and firms
- constraints to geographical and sectoral mobility, and
- labour force participation

ecdpm
US University of Sussex
CUTS International
Funded by:
UKaid from the British people
This material has been funded by UK aid from the UK government; however the views expressed do not necessarily reflect the UK government's official policies.