Center for Global Development

Integration in the Americas: One Idea for Plan B

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Economic policy challenges in the region are changing, and new binding constraints on growth are emerging. The region should now consider new integration models that help address these constraints in pragmatic, politically feasible ways.

Once there was a shared strategy in the Americas to boost growth and spread its gains. In April of 1998, regional leaders launched negotiations in Santiago for the Free Trade Area of the Americas (FTAA), the plan to unite 880 million people in a single market. Now support for the FTAA has effectively collapsed—a victim of the deadlocked Doha Round, globalization fears, ideological differences, regional leadership rivalries, the distractions of financial instability, and the lure of sub-regional approaches.

Should countries of the region care about the demise of their integration strategy?

The following argues that they should, that regional integration matters for growth and income convergence, and that the risks of failing to address extreme regional inequality (both between and within countries) are increasingly evident in political polarization, in weakening support for democracy and for the market model in some countries, in crime and urban violence, and in unsustainable migration pressures.

Moreover, economic policy challenges in the region are changing, and new binding constraints on growth are emerging. The progress made on some of the traditional barriers to investment and growth (weak macroeconomic policy, financial instability, and high formal trade barriers) has often not been matched in other spheres. The region should now consider new integration models that help address these constraints in pragmatic, politically feasible ways.

One possible model, outlined here, is a standards-based regional investment agreement designed to reduce microeconomic and other barriers confronting both domestic and foreign investors.

Why now?

Some may question the urgency of finding a viable path to regional integration after four years of growth in Latin America averaging above 5 percent, buoyed by good macroeconomic and exchange rate policies, more outward orientation, high commodity prices, and rapid domestic credit growth.

True, incomes and consumption have risen in the recent boom, and formal job creation has picked up significantly. But there is a long way to go. An estimated 49 percent of employment in Latin America was still in the informal sector in 2005,[2] and the surging exports which have ignited the recent growth are largely commodities.

It is hard to boost productivity growth and sustain robust formal job creation when so much economic activity is outside the legal system and when so much of the export boom consists of energy, minerals, and food. Crucially, Latin America differs from the most successful emerging market regions in a way that bodes ill for the future: investment as a share of GDP remains discouragingly low (Figure 1). Some countries are exceptions, but in general the microeconomic environment for investment is still exceptionally burdensome (Figure 2), while reform efforts languish (Figure 3).

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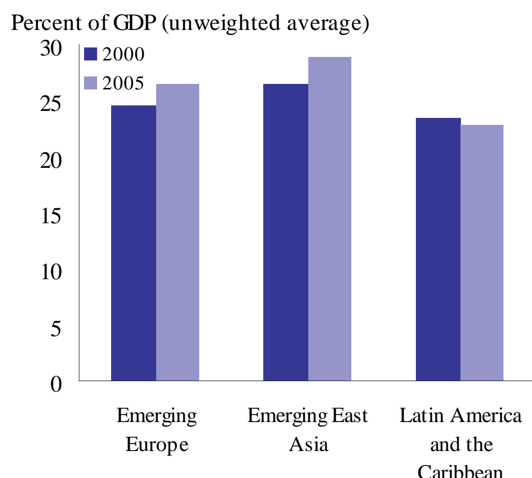
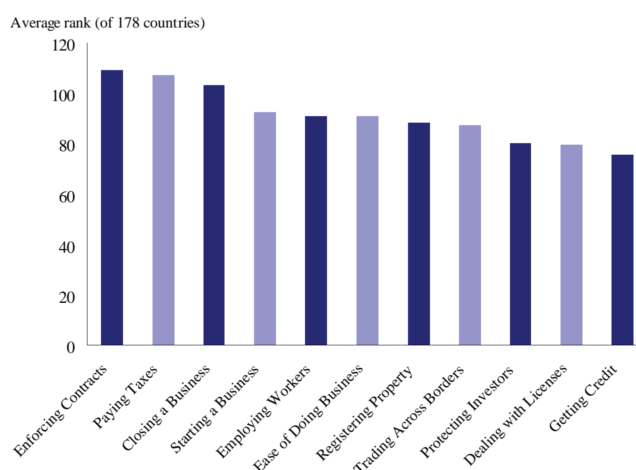
[2] ILO 2006

Figure 1: Gross capital formation, by region, 2000 and 2005



Source: Author's calculations based on data from World Bank 2007a

Figure 2: Business climate indicators for Latin America and Caribbean countries, 2007



Source: World Bank 2007b

Other emerging regions less conflicted about integration

While region-wide progress in this hemisphere has ground to a halt, some of the most successful emerging markets in other parts of the world have forged ahead rapidly with their own integration strategies. More than ten countries in emerging Europe have joined the European Union in this decade and have reaped striking benefits. Emerging East Asia is now knit together in cross-border production sharing chains, which are shaped by foreign investment flows, fed by parts and components trade, and facilitated by governments and regional organizations. Europe has pursued a formal, top-down process, while East Asia has pursued a more bottom-up process led by the private sector.

But for both regions, integration, especially its benefits for investment, has played a central role in turbo-charging growth and income convergence (figure 4). Both of these regions offer lessons for this hemisphere, although neither model is easily transferrable. The challenge for the Americas is to find a third way—one that relies less on supranational bureaucracies, uniformity, and aid than does the European Union but takes a more systematic approach to reform than did East Asia.

A regional investment agreement

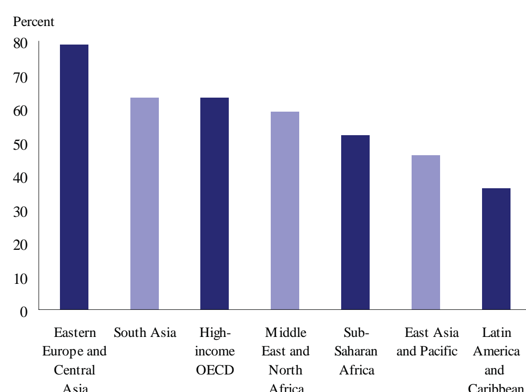
One way to focus directly on the investment problem could be a standards-based regional investment agreement—a collective effort to set standards for improving the quality of regulatory, tax, and legal systems affecting both domestic and foreign investors. Such standards could simplify and expedite systems for starting businesses, paying taxes, obtaining licenses, registering property, dealing with border controls, and accessing credit and infrastructure services.

This approach is now possible because of the enormous leap forward in the world's capacity to evaluate the microeconomic environment for investment using objective, verifiable indicators that are consistent across countries and regularly updated by third-party institutions like the World Bank. In many cases, such indicators are broadly comparable to indicators used to measure formal trade barriers. It therefore has become feasible to set multilateral standards for reducing investment climate barriers in the same way that countries have long set standards for reducing trade barriers in trade agreements Examples of objective investment climate indicators range from the official costs of starting a business (normalized by per capita income), to the number of procedures to obtain licenses, to the number of business tax payments required annually, to the time required for customs clearance, to the strength of creditor rights based on standardized criteria. Countries could use a regional agreement to set common standards or benchmarks based on international norms for an agreed set of indicators.

The gains from such an agreement might be very large indeed. Cross-country studies

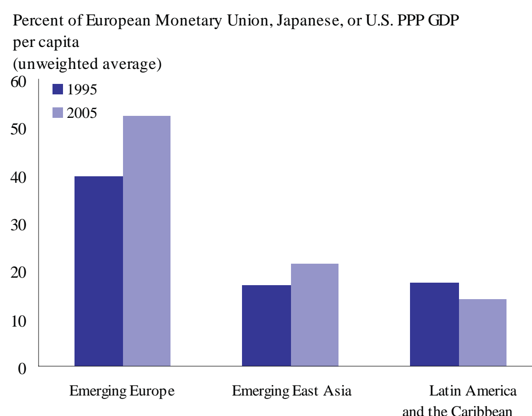
> New databases compiling objective investment climate indicators, consistent across countries, make it feasible to set multilateral standards for reducing investment barriers in much the same way that trade agreements set standards for reducing trade barriers.

Figure 3: Share of countries making at least one positive business climate reform in 2006/7



Source: World Bank 2007b

Figure 4: Income convergence



Source: Author's calculations based on data from World Bank 2007b

suggest that major improvements to regulatory systems in developing countries could boost their per capita growth rates by around 2 percentage points.[3] And, by helping small firms move into the formal sector and grow, an agreement might particularly increase the income of the poor.[4]

Beyond improving the microeconomic environment, such an agreement could also serve as a flexible vehicle to address other frontburner investment climate issues. It could, for example, include confidence-building standards to lock in macroeconomic policy improvements, such as limits on public debt and on business tax burdens. And it could be used to address the increasingly urgent challenges of strengthening standards to protect the environment and labor. By providing a vehicle for regulatory cooperation and consistency, such an agreement could help alleviate intensifying fears of competitive disadvantage in the United States and other countries with relatively strong labor and environmental protections.[5]

Why multilateral?

Each country already has a clear incentive to undertake unilateral investment climate reforms and race to the top. While unilateral reforms make sense (as do unilateral trade reforms), experience demonstrates that multilateral agreements can help drive reform and increase its benefits. They can lock in reform. They can spur countries to mobilize the machinery of government to strengthen implementation. And they can better inform investors of policy progress, given the transparent process of negotiating multilateral agreements.

Why would one country in the region benefit from investment climate reforms in other countries? Fundamentally, for the same reason that Europe decided to move beyond reducing trade barriers to harmonizing systems. Better investment climates boost the supply response to reduced trade barriers. Faster investment-led growth in the neighborhood pulls others along. Growth is not a zero-sum game.

Moreover, there is a reciprocity argument that parallels the rationale for trade agreements. Competitiveness in a globalized economy requires investment strategies that do not stop at the home-country border. Companies pursuing efficient production sharing across borders and economies of scale depend on supportive investment environments in neighboring countries. Each country therefore has an incentive to seek better treatment for its own companies in the region in exchange for offering better conditions at home for foreign (and domestic) investors.

Fostering compliance

Participating countries could consider a gamut of soft to hard options for encouraging compliance with agreement commitments, ranging from promoting transparency via regular country report cards, to conducting peer reviews, to establishing dispute-settlement options for investors and states. Generous transition periods and ample technical assistance could be offered to countries willing to make ambitious commitments and progress.

[3] See, for example, Djankov, McLeish, and Ramalho 2006; Loayza, Oviedo, and Servén 2008.
[4] Birdsall, De La Torre, and Menezes 2008, chapter 5.
[5] Summers 2008

Do businesses worry about microeconomic barriers?

Business surveys suggest they do: the top two cited obstacles to doing business in the region—choosing to remain in the informal sector and resorting to corruption (bribing regulatory and tax officials)—are responses to burdensome and non-transparent regulatory and tax systems.

If all categories of obstacles associated with burdensome regulatory and tax systems are combined, we find that 53 percent of businesses cite these as the main obstacles to doing business.

Table 1: Main obstacles to doing business in Latin America and the Caribbean

	Share of firms citing problem as main obstacle (percent)
Informality*	18.1
Corruption**	11.4
Crime, theft, and disorder	10.9
Political instability	9.9
Access to financing (availability and cost)	9.7
Tax rates	9.1
Electricity	6.9
Skills and education of available workers	6.5
Tax administration	5.1
Labor regulations	4.0
Business licensing and operating permits	3.4
Customs and trade regulations	2.2
Transportation of goods, supplies, and inpu	1.1
Courts	0.9
Access to land	0.8

*Covers the extent of informal and underreported operations (which compete with formal enterprises).

**Covers informal payments associated with customs, taxes, licenses, regulations, and government contracts.

Source: World Bank 2006

The gains from a regional investment agreement might be very large indeed. Resulting reforms would likely boost growth significantly and particularly raise the income of the poor by helping small businesses move into the formal sector.

Initial steps

To launch this effort, interested countries might begin by calling for exploratory discussions to define options for the scope and structure of an agreement that could generate broad support. Such a call might logically come from those countries already focused on investment climate reforms but interested in expanding the benefits. Colombia, Guatemala, Mexico, and Peru, for example, have been named among the top ten global reformers by the World Bank.

The United States would have much to gain from a successful agreement, which could significantly boost the region's contribution to U.S. growth and help level the regional playing field in areas like environmental and labor standards. It could play a critical role by responding positively and quickly to an initiative from interested countries. It could encourage regional institutions to take an active role supporting and convening the discussions, including by engaging the private sector as a vital and logical partner in this effort. And the United States could take the lead in mobilizing aid to help governments build capacity to meet agreed regulatory, tax, and legal standards.

In early 2009, the leaders of the region will gather in Trinidad and Tobago for the Fifth Summit of the Americas. In the likely absence of an agreement to resume FTAA negotiations, leaders at the Summit might support the pursuit of a regional investment agreement among interested countries as one possible new way forward toward integration and income convergence in the hemisphere.

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