Now More than Ever:
The Case for a New Integration Strategy for the Americas

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About the Hemispheric Think Tank Working Group in Support of the 2009 Summit of the Americas

This paper was produced as part of the Hemispheric Think Tank Working Group in Support of the 2009 Summit of the Americas, a joint project of the Canadian Foundation for the Americas (FOCAL) and the Inter-American Dialogue (IAD) with the financial support of the Government of Canada provided through the Canadian International Development Agency (CIDA).

The Working Group brought together researchers and policy analysts from the Western Hemisphere’s leading think tanks to engage in intensive debate and dialogue and develop a strong intellectual and policy foundation for preparing and conducting the Summit.

In meetings in Ottawa and Washington, D.C., attended by leading national and multilateral officials, the group explored the critical problems the Summit could address, identified key areas of agreement and disagreement among countries, deeply probed the disagreements, and, where possible, sought to develop pragmatic approaches. These discussions and research have resulted in a series of policy papers that hope to mobilize and raise awareness of the Summit amongst regional governments and civil society.
The sharp deterioration in the global financial and economic environment could erase a significant portion of the economic gains won by Latin America and the Caribbean during the 2003-2007 boom—gains critically important for reducing poverty and building social consensus, support for democracy, and political stability. This grave threat looms over a hemisphere with limited macroeconomic policy options and without the kind of workable framework for economic cooperation and integration that the most successful emerging market regions enjoy. Countries struggling to sustain growth and stability receive little support from shared regional strategies. Regional economic and financial institutions like the Inter-American Development Bank (IDB) are held back by the absence of strategic consensus.

The Fifth Summit of the America in 2009 looms as a challenge and opportunity in this context. The opening paragraph of the current Draft Declaration of Commitment refers to “a renewed spirit of regional cooperation, integration and solidarity” and “advancing collective solutions to the most pressing challenges facing our Hemisphere.” The leaders must find ways to translate these core aspirations into reality.

This paper summarizes the lessons of integration experience so far, outlines key risks, and argues the case for new integration approaches as part of the response to these challenges. Two specific proposals, one on investment and the other on education, are suggested. A central IDB role is proposed for advancing these initiatives.

Integration so far: what it has done and has not done

Latin America and the Caribbean deserve credit for deep cuts in formal tariff barriers, which are now close to rates in competitor regions. Trade liberalization has benefited large and small economies alike. Most countries substantially boosted the share of trade in economic activity and bumped up growth. Probably the largest gains have come from increased foreign direct investment inflows, which responded vigorously to agreements that lock in lower trade barriers and other legal and institutional reforms.

Yet, to the disappointment of many, other important gains eluded countries that opened their markets. Even during the boom, average regional growth stayed well below that of emerging East Asia and Europe. Domestic investment ratios (investment/GDP) and productivity rates for the region are still discouragingly low.¹ Regional transport costs are still high; they are now a more significant impediment to trade than tariff costs.² And progress on the region’s other great economic challenge—reducing extreme inequality—has been slow. In fact, evidence suggests that the region is in the grip of a growth-inequality trap: limits to growth slow declines in inequality, while inequality itself constrains growth by trapping labor in unproductive activity and idling substantial capital.³
For emerging Europe and East Asia, regional integration has been a powerful force for spreading growth to a widening circle of countries and for income convergence across countries. Though the European top-down, formal integration model is very different than the Asian bottom-up private sector driven model, they both have strengthened key aspects of the investment climate. In both cases, investment climate integration has facilitated the integration of production, with gains for both high and low income countries.

With Mexico and some parts of Central America as partial exceptions, this region has not progressed very far in building regional production chains. As a result, competitiveness and efforts to diversify have suffered, while income inequality across countries has shown little tendency to decline.

**Does regional integration deserve a place on the agenda now?**

It could be argued that the global economic downturn and financial strains will inevitably push aside efforts to jumpstart regional integration. Focus has certainly shifted back to macroeconomic management and stabilization. But, in fact, the benefits of regional integration may be more urgently needed than ever.

The reality is that scope for addressing the slowdown through macroeconomic demand management is limited in this region. Room for monetary stimulus is constrained by authorities’ concerns about the effects of exchange rate weakness on inflation and firms’ balance sheets. And, as evident elsewhere, the benefits of monetary easing are diminished in a global environment of severe risk aversion, pervasive de-leveraging and cash hoarding. On the fiscal side, few countries in the region accumulated substantial fiscal savings during the boom and therefore capacity to conduct counter-cyclical policy. While fiscal stimulus may still be the right course for a number of countries, it will be constrained by borrowing capacity and by the need to avoid crowding out a private sector which has also lost much of its access to capital.

In this context, it makes sense to intensify efforts to address supply side constraints to growth. For relatively rapid benefits, for example, the region could step up efforts to fix serious and pervasive problems in the microeconomic climate for investment which restrict willingness to create and expand formal businesses, keep about 40 per cent of economic activity and labor outside the legal system, and discourage innovation. For longer-term gains, countries could redouble efforts to invest in infrastructure, education, energy security, and combating climate change. The question is whether regional cooperation can help advance this agenda.

**Beyond trade and reciprocity: moving to new integration models**

This region has tended to view integration only through the lens of trade agreements based on reciprocity—that is, balancing market-opening concessions. In the current context, there are at least four important limitations to this approach. First, in general, formal trade barriers are no longer among the most significant constraints on growth. Second, the rising backlash against
globalization has weakened the political salability of reciprocal agreements—i.e., losers now tend to speak louder than winners (and are likely to continue to do so until more adjustment assistance is forthcoming for vulnerable workers). Third, trade is widely seen as a force for worsening income inequality (though research suggests that factors like unskilled labor-saving technology are more responsible for income inequality trends). And, fourth, some of the trade-offs needed to balance countries’ concessions and benefits can only be made at the global, not regional, level—agricultural protection and subsidies being a case in point.

In these circumstances, countries are more likely to be interested in pursuing regional integration if it helps them:

1) advance their own reform agendas (rather than the theories of outsiders, whether in Washington or elsewhere),
2) expand the economic gains from these reforms, and
3) augment the resources available for investing in regional public goods.

The future of regional integration in this region may therefore lie in cooperative efforts to set common standards for key policies where there is a shared desire for change in the same direction and to pool resources for mutually beneficial investments.

Two Proposals

The challenge is to define reform agendas and investments of significant shared interest. The following are two examples of proposals that might meet this challenge. The first is an idea for a regional agreement on investment climate standards. The second suggests a new approach to aid for education that draws in new stakeholders and rewards successful ends without dictating the means.

Singling out these two areas is not meant to discount the importance of cooperation on infrastructure, energy, and climate change, all areas where regional approaches are warranted. In addition, in the context of global financial strains, the case for more cooperation on financial stabilization and regulation is obvious. But, at the moment, it would appear that the region may gain more from ensuring a strong voice in G-20 and related multilateral deliberations than from building a separate regional process.

Proposal 1: A Regional Investment Standards Agreement

The microeconomic investment climate: the step-child of the reform agenda

Most of Latin America and the Caribbean have achieved major leaps forward in macroeconomic policy management. Public finances are now more sustainable and monetary authorities have a demonstrated track record on inflation control. But the microeconomic environment for investment, particularly the regulatory and tax environment, remains exceptionally burdensome, and reform efforts lag.5
Based on World Bank business surveys, 53 per cent of regional businesses cite regulatory and tax systems as the main obstacles to doing business. Non-transparent and burdensome systems confront businesses with a harmful choice between remaining in the informal sector and resorting to bribes.

That is particularly bad news for micro, small, and medium-sized firms, which are singled out in the Draft Declaration of Commitment as “fundamental to growth, employment creation, and poverty reduction”. Microeconomic problems fall disproportionately hard on them given their limited political influence and resources. Attacking these problems could help reduce income inequality (which in turn would boost growth) by shrinking informality, aiding newcomers to formal product and capital markets, and boosting the productivity of the poor and near-poor.

The stalled race to the top is not the region’s only microeconomic policy problem. There are also growing fears of a race to the bottom. One of the forces arrayed against trade agreements in the United States is the concern that harmful tax and regulatory competition and weaker labor and environmental standards give other countries an unfair competitive advantage over U.S.-based firms and workers. Cooperation to agree on sound common standards would counter this perceived, and in some cases actual, unfairness.

Basic features of an investment standards agreement

The concept. Regional cooperation could play a powerful role in addressing these problems through a collective agreement to set sound and fair standards for improving key microeconomic policies. Such standards could simplify and expedite systems for starting a business, paying taxes, obtaining licenses, registering property, hiring and firing workers, dealing with border controls, and accessing credit and infrastructure services. In this connection, the current Draft Declaration of Commitment notes the intention of leaders to “adopt the necessary reforms to simplify the processes involved in starting and closing a business....” An agreement could also harmonize countries’ standards for limiting carbon emissions as they are developed.

Unlike bilateral investment treaties focused only on foreign investors, this kind of agreement would benefit the home country’s firms, foreign firms investing in the home country, and home country firms investing in the region. There is thus no need for a reciprocal balance of concessions; countries’ self interest and collective interest merge. A better investment climate is an important public good with positive externalities for the region as a whole.

This approach is made possible by the enormous leap forward in the world’s capacity to measure 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. Examples of indicators that already exist range from the official costs of starting a business, to the size of
minimum capital requirements for new companies, to the number of procedures needed to obtain licenses, to the number of business tax payments required annually, to the time required to clear customs, to the quality of creditor protection. Over time, use could be made of new indicators as they are developed in such areas as infrastructure regulatory quality and carbon emissions.

**Norms and principles.** Countries participating in the agreement could collectively set benchmarks or standards for indicators using international norms. To choose norms, they might consider existing best practice in the region, best practice in East Asia and Europe, or best practice in the member countries of the Organisation for Economic Co-operation and Development (OECD).

The aim would not be to impose uniformity on country regulatory and tax systems but rather to promote adherence to a universally applicable set of principles such as:

- **Simplification.** Systems should be as simple as possible in terms of the numbers of steps, documents, and approvals needed.

- **Transparency and use of computerized systems.** Regulations, documents, forms, and procedures should be standardized and published on websites, and applications and approvals should be processed online to limit discretion and scope for corruption.

- **Reduction of direct costs and fees.** Fees charged for procedures and approvals should be kept as low as possible and made transparent.

- **Time limits.** Reasonable limits should be set on the time needed for approvals.

**Benefits.** The World Bank’s annual *Doing Business* reports demonstrate that reforms consistent with these principles are well within the reach of both low- and middle-income countries. The gains may be very large indeed. When Azerbaijan, the world’s top *Doing Business* reformer for 2007/08, halved the time, cost, and number of procedures to start a business, business registrations shot up by 40 per cent in the next six months. Cross-country studies suggest that major and comprehensive improvements in developing country regulatory quality could boost per capita annual growth rates by around 2 per centage points. And a better regulatory environment would likely substantially boost the growth response to lower trade barriers. A regional investment standards agreement would therefore complement and expand the benefits of bilateral and sub-regional trade agreements.

**Participation and compliance.** What kind of countries might participate?: those motivated by one or more of the following considerations. They would likely:
• be focused on shrinking large informal sectors,

• be interested in establishing and expanding regional production chains,

• seek increased inward foreign direct investment, especially in manufacturing and services,

• have domestic businesses interested in more outward investment within the region,

• benefit from an external reform driver to lock in reform,

• seek to forestall a race to the bottom.

To encourage participation, an agreement might contain **incentives** such as:

- **Transition periods and capacity-building assistance.** Participating countries could be allowed generous transition periods and provided ample technical assistance from bilateral donors or development banks to build capacity to meet standards.

- **Streamlined access to multilateral development bank private sector financing.** By meeting these standards, countries would reduce some important risks confronting investors, including the private sector investment arms of multilateral development banks (MDBs). The standards would thus allow MDBs to speed up project analysis and raise estimates of risk-adjusted returns for some projects, making them eligible for investment.

How would compliance be fostered? The simplest and least intrusive approach would be to establish annual national or third-party reporting on country progress. A notch up on the surveillance scale would be a system of peer review, with countries gathering regularly to discuss each other’s progress and perhaps issue assessments. The most ambitious approach would provide investor recourse to arbitration against a country that fails to comply with agreed standards.

**Launching discussions and the IDB role.** To launch this effort, interested countries could begin by calling for exploratory discussions to define options for the scope and structure of an agreement capable of generating broad support. Such a call might logically come from those countries already focused on investment reforms but interested in expanding their benefits. Colombia, the Dominican Republic, Guatemala, Mexico, and Peru, for example, have been named among the top ten global reformers by the World Bank in *Doing Business* reports, while Chile ranks forty in the world in the latest report, the highest in Latin America. The Fifth Summit of the Americas provides an
important opportunity for leaders to encourage discussions among interested countries. The IDB could play a critical role by convening exploratory discussions involving interested governments and business. It could provide essential technical input to identify the kinds of standards that would have the greatest benefit. It could help countries build capacity to meet standards. And its private sector financing arms could offer streamlined access to financing for businesses in participating countries.

Proposal 2: A Partnership for Secondary Education

The challenge. Latin America and the Caribbean have made major gains in primary education. Now the region faces the urgent challenge of expanding access to quality secondary education. The current Draft Declaration of Commitment reaffirms the goal of “achieving a secondary education enrollment rate of at least 75 per cent by the year 2010”. Nowhere does the region’s interest in boosting growth and competitiveness converge more strongly with its goal of increasing socioeconomic mobility.

Countries in the region are among the poorest performing nations on international assessment exams such as the Programme for International Student Assessment (PISA). In both 2000 and 2003, participating countries from the region scored between one and three standard deviations below the international average on the PISA exam.13 Poor quality is compounded by limited access and completion rates. Less than 4.3 million of the 9.5 million youth of age to complete upper secondary school were able to do so in 2004.14

Skill shortages are a serious competitive problem for firms in the region. Foreign firms and others with sufficient resources tend to do their own training to compensate for skill shortages. But this is an expensive solution. Businesses along with private foundations have an interest in reducing training costs by providing incentives to governments to identify and scale up secondary education success stories.

Problems with conventional aid. Donors want to know that their support will produce results. Yet it is not always clear whether aid for building schools, training teachers and buying textbooks will get children into school or ensure that they learn once there. Donors can rarely identify the optimal use of funds in each country from outside. And, even if they can, donor activities without country engagement and ownership do not build effective education delivery systems that carry on after aid disappears.

In addition, the region’s conditional cash transfer programs can generate something of an imbalance in the supply and demand for education in the region. Parents whose monthly payments are conditioned on children’s school attendance now demand more access to education. But the supply, particularly of quality secondary education, has not kept pace.
Proposal for “cash on delivery aid.” The Center for Global Development has developed a design for a new form of results-based aid to help overcome these problems. What follows is a proposal for the region to: (1) set a shared goal for education performance, such as dramatically expanding completion of secondary school, and (2) use a shared incentive mechanism as a powerful means of identifying and scaling up the most effective strategies for achieving the goal as rapidly as possible.

Under the concept of “cash on delivery” (COD) aid, donors commit ex ante to pay a specific amount for a specific measure of progress. In education, for example, donors could promise to pay x amount (say, a few hundred dollars) for each additional child who completes secondary school and takes a standardized competency test.

The proposed process involves six basic steps. Donors and governments agree on a “performance contract” with objectives for education results clearly defined. A credible baseline survey is conducted to determine existing completion rates. The recipient country determines and implements a strategy to improve performance. The country publishes completion numbers and test scores. The donor pays for an independent audit to verify the numbers. Donors pay the government upon a successful audit.

Payments are thus made only after measurable progress, only for as much as is verifiably achieved, and without prescribing the policy or means to achieve progress. The country can choose to use the new funds for any purpose: to build schools, train teachers, partner with the private sector on education, pay for conditional cash transfers, or for that matter build roads or implement early nutrition programs. This innovative approach would place full decision-making about the use of funds in the hands of country governments, letting them determine the best way to achieve the outcome that recipient and donor both want: a quality education for all. The Center has developed a specific COD aid proposal for the region that quantifies the costs of incentives under two different scenarios for expanding secondary education. One scenario would offer incentives totaling $1.2 billion to add 2.4 million children across the region to the ranks of those completing lower secondary school (which would achieve 100 per cent lower secondary completion rates). The other would offer $1.3 billion in incentives to add 2.6 million children to those completing upper secondary school.

A public-private partnership: the IDB role. Two basic features of this proposal argue for a partnership between the region’s private sector, bilateral donors, and one or more multilateral development banks. First, the aid payments are in the form of grants, which are in scarce supply from multilateral development banks. Second, the private sector and bilateral donors are not likely to be interested in the expensive proposition of developing the capacity to monitor and measure results, an essential element of this approach. Thus, it would make sense to create a partnership between grant-making donors and an
institution like the IDB with the staff and know-how to create the results verification framework.

To mobilize scarce grant financing, a fund could be created for the purpose of pooling resources from a variety of sources—development banks, bilateral donors, private philanthropic foundations, interested multinationals, and other businesses. The IDB could administer this fund. It could also be responsible for contracting with interested governments, verifying results, and making payments out of the fund. The IDB would gain through the augmentation of the grant resources available for this purpose, and donors would gain by availing themselves of IDB expertise and implementation capacity. The region would gain from an approach which brings together a range of stakeholders in a common effort to boost incentives for the production of a public good central for growth and greater income equality.

Summary and Conclusion

This paper makes the case for new models in the Americas for economic cooperation and integration on three grounds:

1) the global downturn makes better policies and greater investment to promote growth and reduce inequality more urgent ever;
2) formal trade barriers are no longer the most significant barriers to growth in the region; and
3) the politics of the traditional model for trade agreements, reciprocal exchanges of concessions, no longer work well in many countries.

Instead the paper argues for approaches designed to help countries do what they already want to do and produce public goods valued across the region. These can come in the form of coordinated shifts in policy where the benefits to individual countries are enhanced by collective action, or they can come through pooled investments in human capital, infrastructure, energy security, or fighting climate change.

Two specific proposals are advanced. The first is a new kind of regional standards agreement that helps countries address a common and serious supply-side problem, the poor microeconomic climate for investment that particularly burdens businesses at the bottom of the pyramid. The second unites the broad range of public and private regional actors with an interest in expanding access to quality secondary education in a new efficient, results-based aid mechanism to reward and scale up success stories. In both cases, the IDB could play critical roles in launching and implementing these efforts. And the Fifth Summit of the Americas presents a critical opportunity for leaders to advance such initiatives as part of a new way forward for hemispheric cooperation and integration.
Endnotes

1 Lee 2008a.
2 Mesquita et al. 2008.
3 See, for example, Birdsall, de la Torre, and Menezes 2008, IDB 1999, and Perry 2008.
4 Lee 2008a.
5 Lee 2008b.
6 Lee 2008b.
7 Birdsall, de la Torre, Menezes 2008.
8 Summers 2008.
9 See Prieto 2008. Recent criticism of the World Bank’s Doing Business indicators has focused on measurement issues, differences of view on regulatory benefits, particularly for labor markets, and the need to avoid downplaying the significance of other investment climate factors like macroeconomic and political stability. These are important issues, but the indicators remain useful for the purpose of setting common microeconomic standards, especially as the World Bank strengthens measurement.
10 World Bank 2008a.
11 See, for example, Djankov et al. 2006 and Loayza et al. 2008.
15 Birdsall and Vyborny 2008.
References


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March 2009

Publications Mail Agreement: 40012931

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