

# REGIONAL INTEGRATION AND POVERTY

## *MAPPING THE LINKAGES*<sup>1</sup>

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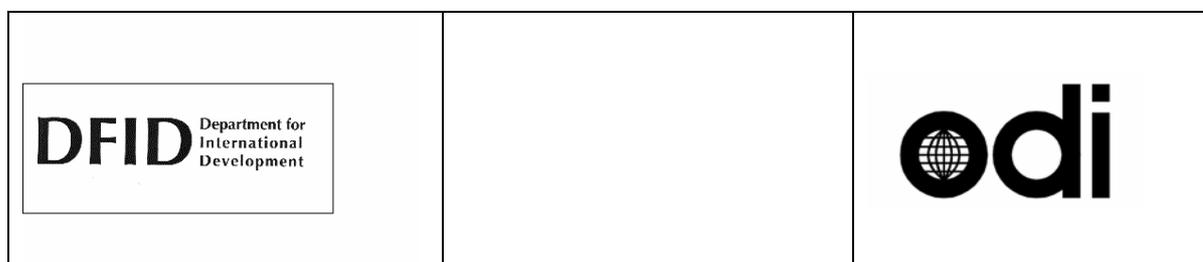
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## Executive summary

This paper brings together the building blocks to examine the effects of regional integration on poverty. It discusses the routes from RI to poverty on the basis of a simple mapping of four sets of links describing how poverty in a country is affected by RI processes:

- RI can affect poverty through increased volume and/or poverty focus of trade
- RI can affect poverty through increased volume and/or poverty focus of investment
- RI can affect poverty through increased volume and/or poverty focus of migration
- RI can affect poverty through other routes

The first set of links between RI and poverty is through trade. Chart ES1 covers a number of building blocks. RTAs include certain provisions that may affect the volume, price and “poverty focus” of trade. This may in turn affect different characteristics of poverty intermediated through complementary conditions including public policies. For a country that is a member of a particular RTA we should be asking a number of questions to unravel the effects of RTAs on poverty through trade. Similar questions could be addressed for a country that is not a member of the RTA, as it may nevertheless be affected, for example through trade diversion effects.

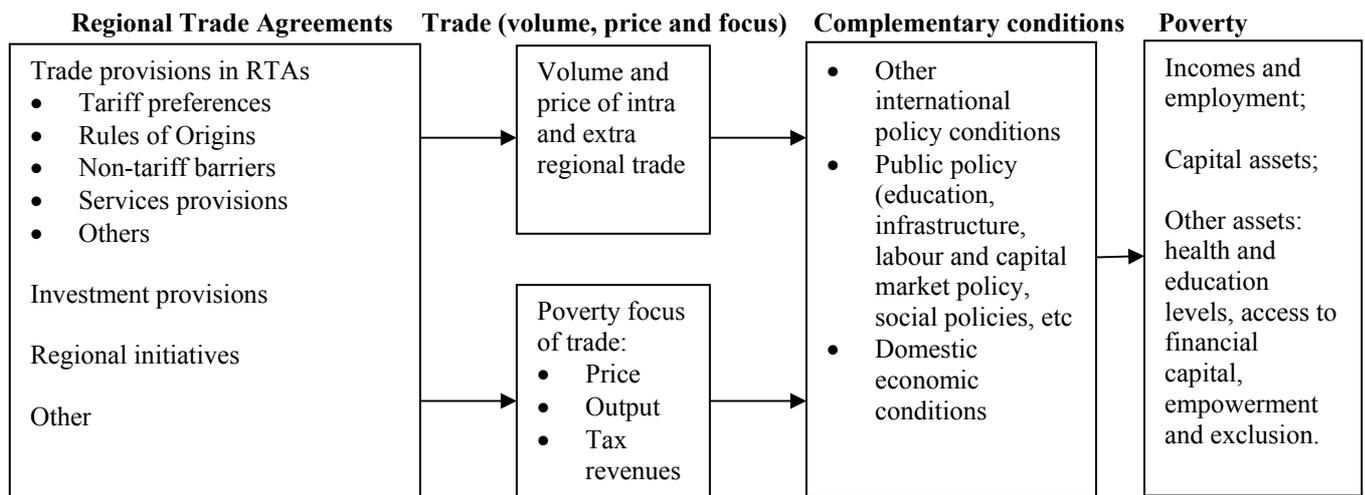
- **Regional Trade Agreement :**
  - What are the goods trade provisions (tariffs, rules of origin, NTB)
  - Are there specific provisions for trade in services
  - What are the investment provisions
  - Are there any other provisions (e.g. on migration, Customs)?
- **Trade (volume, price and focus)**
  - How have provisions in the RTAs affected the volume and price of intra and extra regional exports and imports (and the trade balance) of goods and services
  - How has the RTA affected the poverty focus of trade
    - Does regional liberalisation lower import and domestic prices of products (goods and services) consumed directly by the poor or used in production processes that benefit the poor indirectly.
    - Has the RTA resulted in increased output in each country or have certain countries gained more than others.
    - Does the RTA lead to trade creation or trade diversion, and what are the effects of this on fiscal receipts.
- **Complementary conditions**
  - Does RTA include provisions that are different from other international policies and agreements such as the WTO.
  - Does the country have the capabilities to withstand competition with imports or exports in sectors with comparative advantage in the region.
  - Are public policies (labour, infrastructure, trade facilitation, education) geared towards enhancing import competition and export capabilities.
  - Does the government redistribute income or assets, through taxes, support for incomes, and provision of public goods, temporarily

through safety nets or permanently to compensate (relative) losers of RTAs.

- **Poverty**

- How does trade affect incomes and employment of the poor
- Are there trade impacts on capital assets (equipment, land)
- Other assets: health characteristics, education levels, access to financial capital, empowerment and exclusion.

**Chart ES1 Regional integration and poverty via trade**



The second set of links between RI and poverty is through foreign direct investment. Chart ES2 covers a number of building blocks. RTAs include certain provisions that may affect the volume, and “poverty focus” of investment. This may in turn affect different characteristics of poverty intermediated through complementary conditions including public policies. For a member of a particular RTA we should be asking a number of questions to unravel the effects of RTAs on poverty through investment, in addition to the questions already asked regarding trade effects.

- **Foreign Direct Investment (volume and focus)**

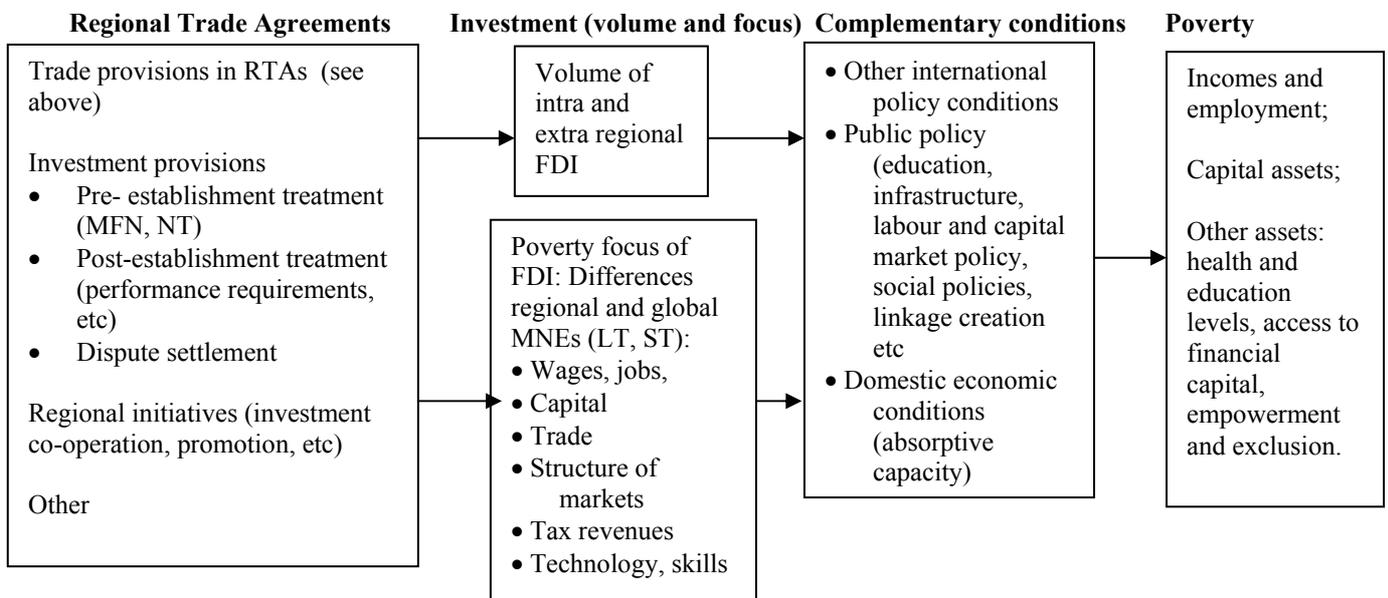
- How have provisions in the RTAs affected the volume of intra and extra regional investment
- How has the RTA affected the poverty focus of investment, i.e. what are differences between global MNEs, regional MNEs and domestic firms with respect to
  - Wages, jobs,
  - Capital
  - Trade
  - Structure of markets
  - Tax revenues
  - Technology, skills

- **Complementary conditions**

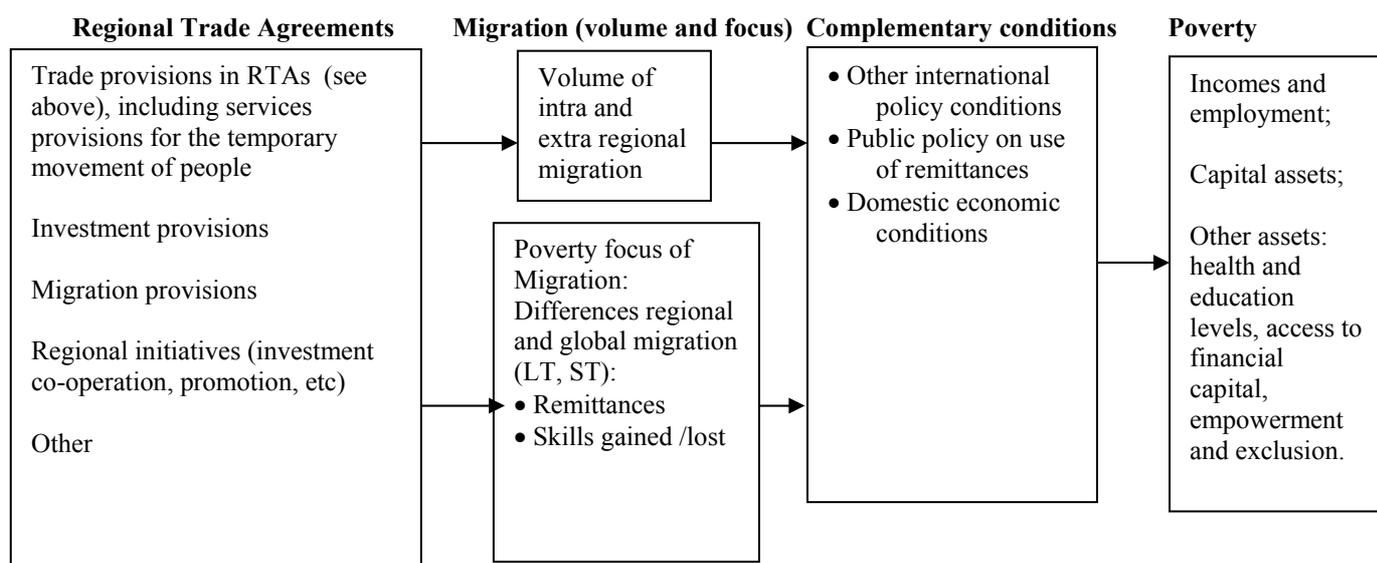
- Does RTA include provisions that are different from other international policies and agreements such as the WTO (e.g. GATS, TRIMS) or bilateral investment treaties

- Does the domestic private sector have the capabilities to withstand competition 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 and employment of the poor
  - How does the investment affect the level, productivity and distribution of capital assets (equipment, land)
  - Does investment affect other assets: health characteristics, education levels, access to financial capital, empowerment and exclusion.

**Chart ES2 Regional integration and poverty via investment**



## Chart ES3 Regional integration and poverty via migration



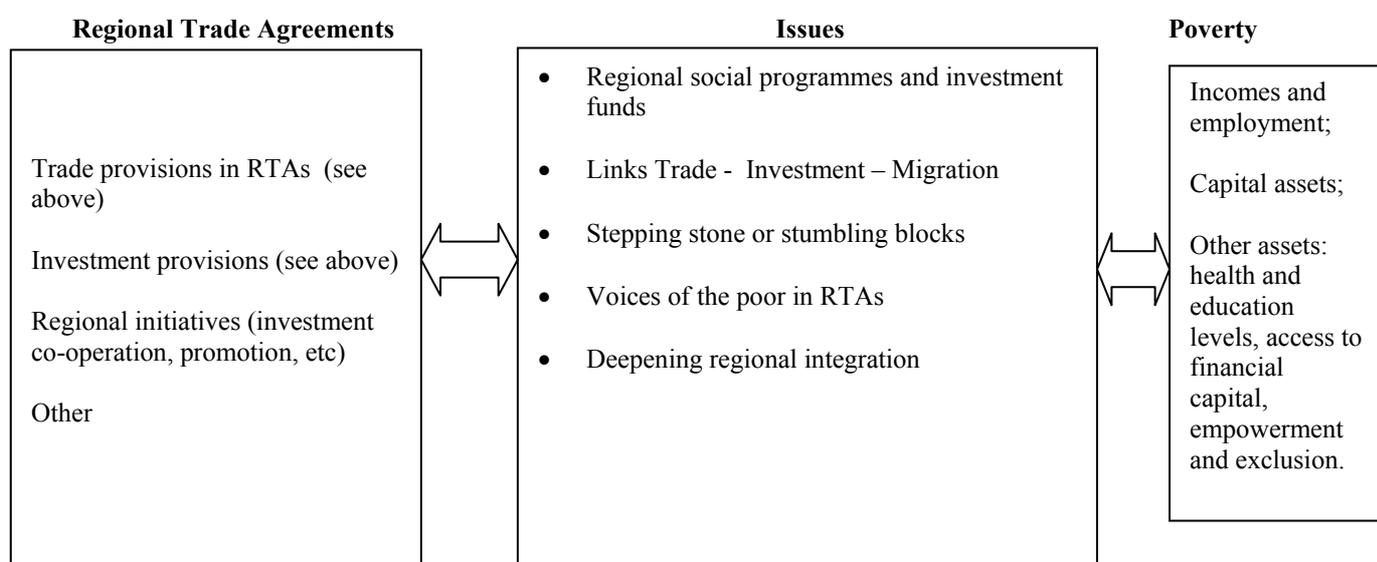
The third set of links between RI and poverty is through migration. Chart ES3 covers a number of building blocks. RTAs include certain provisions that may affect the volume, and “poverty focus” of migration. This may in turn affect different characteristics of poverty intermediated through complementary conditions including public policies that facilitate the use of remittances. For a member of a particular RTA we should be asking a number of questions (in addition to those listed above) to unravel the effects of RTAs on poverty through migration.

- **Provisions relating to labour and migration**
  - How have provisions in the RTAs affected the volume of intra and extra regional migration
  - How has the RTA affected the poverty focus of migration, i.e. what is the difference between global and regional MNEs migration with respect to
    - Skills gained/lost
    - Remittances
  -
- **Complementary conditions**
  - Does RTA include provisions that are different from other international agreements relating to migration (e.g. GATS,)
  - Does the domestic private and public sector have the capabilities to withstand the temporary loss of skills and can they absorb the skills gained in return migrants
  - Are public policies geared towards channelling remittances towards the poor.
- **Poverty**
  - How does migration affect incomes and employment of the poor
  - Capital assets (equipment, land)
  - Other assets: health characteristics, education levels, access to financial capital, empowerment and exclusion.

The fourth set of links can be termed “other” links and relate to non trade and non-FDI issues in RTAs that may affect poverty or trade and FDI issues that affect regional integration processes. These issues included:

- Is the RTA associated with long-run or dynamic effects through competition and scale effects
- Is the RTA associated with convergence or divergence of income levels and how has this affected the regional integration processes
- Does the RTA include regional social programmes and investment funds
- Are there any significant links between an RTA and poverty through migration
- What are the links amongst Trade effects- Investment effects – Migration effects of RTAs
- Can the RTA be seen as a stepping stone or stumbling blocks towards further (multilateral) integration
- Have negotiations on the RTA included effective representation of poor people

**Chart ES4 Regional integration and poverty: non-trade and non-investment routes**



*Further research*

This paper explores the expected (and actual, where evidence is available) effects associated with the above links. Gathering such evidence should make it possible to gain a better understanding of how regional integration affects poverty. For instance, some general empirical findings in the literature include (as testable hypotheses for individual countries/RTAs):

- RTAs boost intra-regional trade through tariff reduction; very strict rules of origin may dampen intra-regional trade or tariff preference take-up. The effect on trade will be greater if initial tariffs are higher, if tariff cuts are bigger, if rules of origin are not strict and if countries can easily comply with rules for using preferences. Regions that include countries with low incomes and trade

in similar and simple products can expect less gain from specialisation (which could affect their motives in deepening regional integration).

- Effects can interact: RoO are more relevant if preferential tariff rates are substantially lower than extra-regional tariffs
- RTAs are likely to lead to increased extra-regional FDI; various RTAs have led to net investment creation. Trade and investment provisions in RTAs can both affect investment, but the precise effects will depend on a range of factors.
- Increased trade and investment is likely to lead to faster economic growth and poverty reduction particularly when economic conditions and appropriate public policies are in place. However, for poorer people many such effects will be indirect as they are less well integrated in the formal international economy. Moreover, investment has a tendency to raise income inequalities if not counteracted by public policies.
- The intra-regional share of trade and investment in the trade and investment is lower for developing regions than for developed regions, so regional integration covers a smaller share of trade and investment. While trade provisions are important for increasing intra-regional trade and hence the intra-regional share (without aiming to divert trade), trade and investment provisions in regions are also likely to raise extra-regional FDI and hence the effect on the intra-regional share of investment is ambiguous.
- The intra-regional share of migration is low as a per cent of total population (e.g. compared to the importance of FDI as per cent of total investment, or trade as per cent of GDP), and while South-South agreements may help to spur migration, it does not deal with South-North migration associated with remittances.
- An important effect of regional integration can be through non-traditional provisions such as services and investment provisions and functional co-operation in energy, infrastructure, regional development banks, regional investment promotion and regional enterprise schemes. However, many regions amongst developing countries, particularly low-income countries, have not a long history in trying to implement a significant amount of new provisions in addition to tariff reductions.
- There are obviously noticeable differences in the amount of provisions in RTAs. Some RTAs with middle to high income countries include investment provisions, and several RTAs include services and migration provisions, while most have implemented (and all have plans) reductions in tariffs. Few regions have deepened and implemented regional integration to encompass significant integration of transport and energy issues. So, especially for RTAs amongst low-income countries, a important question is to what extent they have included and actually implemented provisions and why.

Unfortunately, much of the available evidence is based on multi-country or multi-region studies, deals with averages and fails to identify which provisions in which RTAs have what effect (on trade, FDI, poverty etc.) in which country. While we have documented that trade and investment provisions differ markedly across RTAs and across time, (econometric) studies that examine the effects of regional integration often use simple dummy variables to describe regions. This is problematic for those who want to negotiate the best possible type of regional agreement: in reality no region is the same and some guidance is required on best-practices in provisions in RTAs. For many other links we do not have evidence at all. Further, the

implementation of provisions varies across regions, and some regions have achieved a higher degree of functional co-operation.

This paper suggests two ways in which we will aim to contribute to an improved understanding of the effects of regional integration on poverty (but there are many other ways). The first is to conduct a more detailed study on the effects of specific trade and investment provisions on trade and investment.

Secondly, we will aim to test the mapping structure set out in this paper and as summarised in the first part of this conclusion on the basis of two case studies. There are various countries that would be relevant for this. Due to time constraints it will be possible only to do this for two countries. Bolivia, part of LAIA and ANDEAN (and FTAA due to start in 2005) and associate member of MERCOSUR and featuring in the EU and US GSP systems, and coupled with having one of the worst poverty records in Latin America may be a good first case study to examine the effects of RTAs. A second case study in Africa will be Tanzania. Tanzania is a member of the CBI, EAC (old and new) and SADC and is also part of others such as GSP systems and the Cotonou Agreement, but withdrew from COMESA. At first sight the two countries also differ with respect to implementation. Bolivia has implemented more provisions for a longer time in ANDEAN compared to Tanzania in COMESA. Tanzania seems an example of limited implementation of regional provisions as is common in most African RTAs (except those in the South), while ANDEAN has included investment provisions since the 1970s, zero intra-regional tariffs as well as liberal migration and services provisions. So this selection could be used to shine an empirical light on often made remarks such as: regional integration does not work for low-income countries' development because the theory says benefits are minor, or it does not work because regional integration has not been implemented properly.

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## List of abbreviations

ACP	Africa Caribbean and Pacific countries
AFTA	ASEAN Free Trade Area
AGOA	African Growth and Opportunity Act
AICO	ASEAN Industrial Cooperation scheme
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
CACM	Central American Common Market
CAN (ANDEAN)	Comunidad Andina de Naciones (Andean Community)
CARICOM	Caribbean Community and Common Market
CBI	Confederation of British Industry
CER	Closer Economic Relations
CET	Common External Tariff
COMESA	Common Market of Eastern and Southern Africa
CTH	change in tariff heading
DC	domestic content
EAC	East African Community
EBA	Everything but Arms
EC	European community
EDB Singapore	Economic Development Board
EEC	European Economic Community
EFTA	European Free Trade Association
EU	European Union
FDI	Foreign Direct Investment
FTAA	Free Trade Area of the Americas
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
GULFCOOP	Gulf Cooperation Council
ICSID	Convention of the Settlement of Investment Disputes
IDA Ireland	Industrial Development Agency
ILO	International Labour Organization
IMP	internal market programme
IPA	Investment Promotion Agency
IPS	Inter-Press Service
LAIA	Latin American Integration Association
LT	long term
MC	import content
MERCOSUR	Mercado Común del Sur (Southern Common Market)
MFN	most favoured nation
MNE	multinational enterprises
NAFTA	North American Free Trade Agreement
NT	National Treatment
NTB	non-tariff barriers
OAS	Organization of American States
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
PATCRA	Papua New Guinea Agreement on Trade and Commercial Relations
R&D	Research and Development

RI	Regional Integration
RoO	Rules of Origin
RTA	Regional Trade Agreement
SAARC	South Asian Association for Regional Cooperation
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAPTA	Agreement on SAARC Preferential Trading Arrangement
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
SPS	sanitary and phyto-sanitary
ST	short term
TBT	Technical barriers to trade
TRIMS	Trade-Related Investment Measures
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNECA	United Nations Economic Commission for Africa
VAT	value-added tax
WTO	World Trade Organization

## 1 Introduction

There is a renewed emphasis on fostering regional integration processes in the belief that this is good for development and poverty reduction. Unfortunately, a framework to map regional integration onto poverty does not exist, and so this premise is difficult to assess *ex ante* or even *ex post*. There is however a lot of research that is directly relevant. For some time now, there have been studies that examine the effect of RI on trade (at least as far back as Viner, 1950). More recently researchers have begun to extend this to RI and foreign direct investment. Ethier (1998) suggested that in the “new” regionalism countries seek to form regions in order to attract investment. Researchers have also begun to address the effects of trade and investment on poverty (see e.g. McCulloch *et al*, 2001; McKay *et al*, 2000; ODI, 2002). However, the evidence has never been put together into a single framework to address the links between RI and poverty. The purpose of this review is to provide such a framework. It is hoped that such a mapping exercise will inform those responsible for regional trade policy with respect to the presence of such links and where available with respect to the effects of available policy options on poverty. The resulting mapping should also be useful in identifying a checklist of areas relevant to assess the impact of RI on poverty in individual countries.

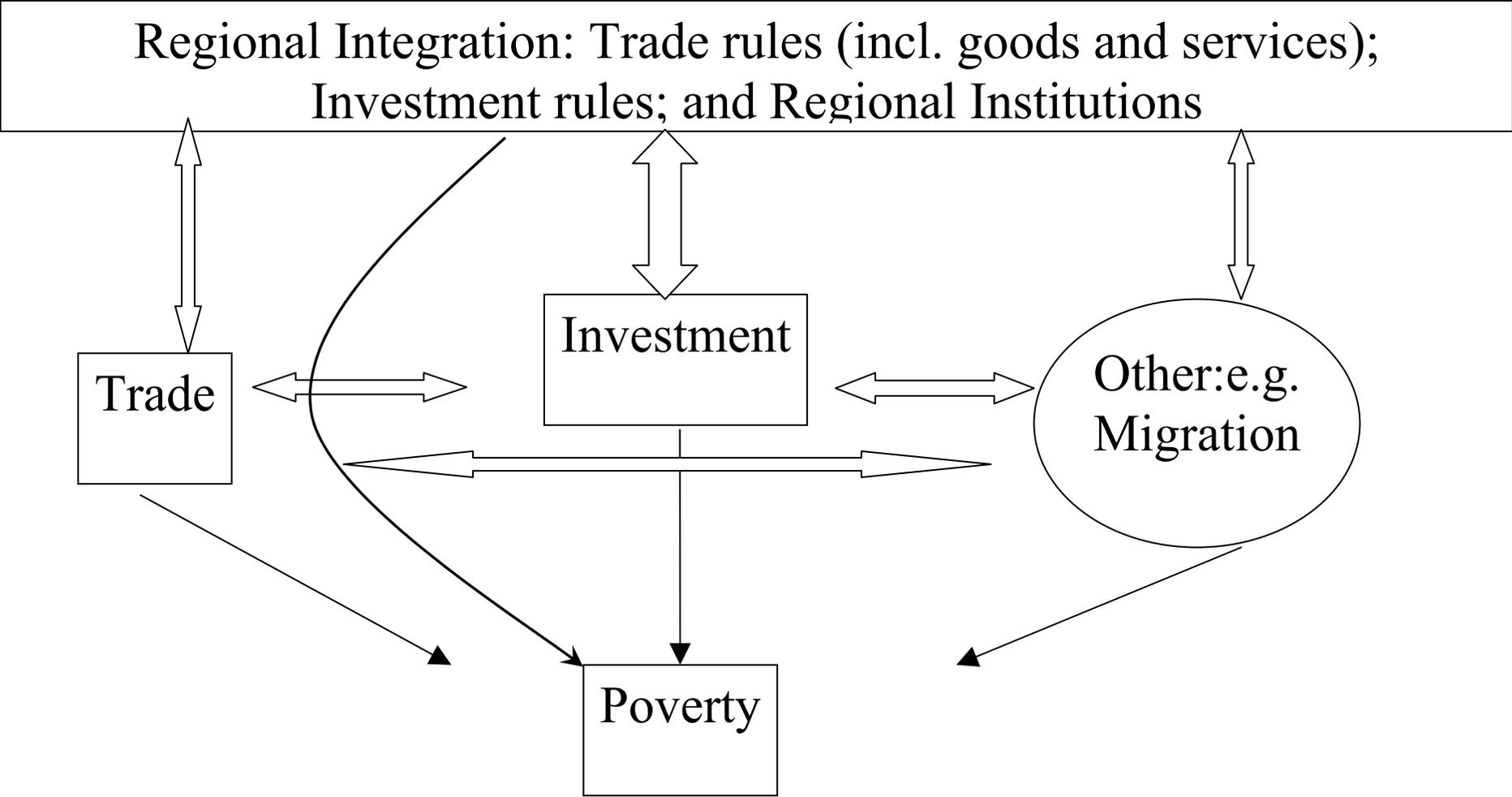
There are many ways in which this paper can be structured. For instance, one could choose to examine various regions by depth of integration (preferential trade agreement, free trade area, customs union, common market and economic union). We have chosen for a relatively simple functional approach by type of integration (chart 1). Provisions in regional integration affects movement of products and factors of production across borders - trade in goods and services and movement of people and capital – which in turn affect poverty through various routes. Regional integration can also affect poverty directly through special initiatives and programmes (although strictly speaking some of this could be seen as movement of capital) and other functional co-operation. The movement of products and factors of production are related and there may be relevant relationships here. Finally, there may be feedback from economic variables back to the regional integration processes.

On this basis, we bring out four mappings describing how poverty in a country is affected by regional integration processes:

- RI can affect poverty through changes in volume and poverty focus of trade
- RI can affect poverty through changes in volume and poverty focus of investment
- RI can affect poverty through changes in volume and poverty focus of migration
- RI can affect poverty through other routes (including migration)

Chart 1

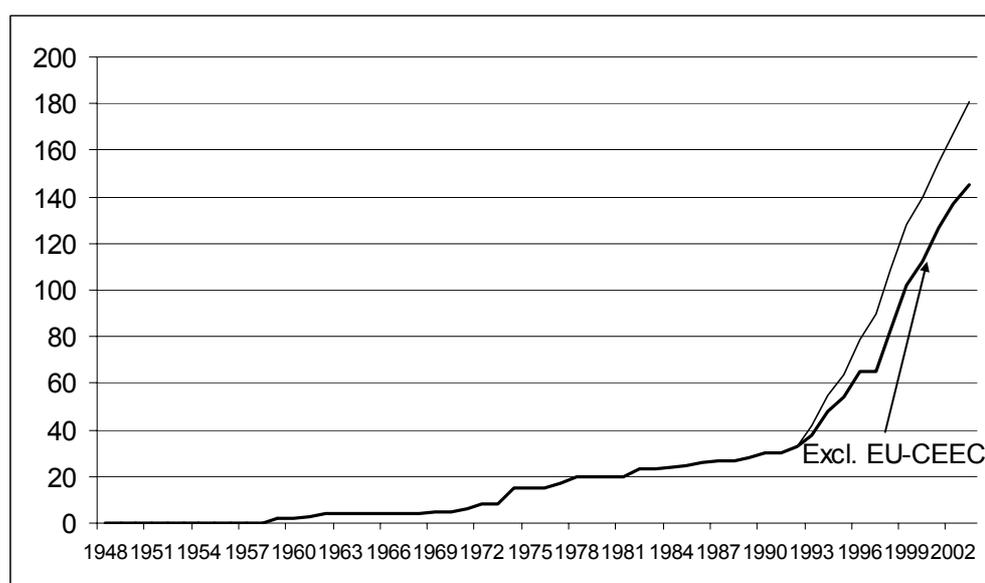
Mapping The Regional Integration Process onto Poverty



There are various reasons that further motivate to examine the subject of RI and poverty at present. First, the number of regional trade agreements notified under the WTO has increased rapidly in recent years (chart 2), with some regions much more advanced than other regions.<sup>2</sup> What effect does this have on development and poverty in developing countries? Secondly, (current) negotiations at the WTO are as usual slow and this has led some countries to focus on regional and bilateral trade negotiations. In the Americas, negotiations for a Free Trade Agreement of the Americas (FTAA) are well underway and were due to finish in 2005, and NAFTA, now ten years old, has inspired a range of other regions; in Asia, ASEAN has recently started discussion with other Asian countries.

Finally, the EC's development policy is based to a large extent on supporting the formation of regions amongst developing countries. The European Community plans to negotiate Regional Economic Partnership Agreements with ACP 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. This survey hopes to shine light on how different types of regions may affect poverty reduction.

**Chart 2 The number of GATT/WTO notified RTAs in force**



Source: WTO

This paper aims to examine the linkages between RI and poverty. Section 2 examines the effects of trade, FDI and migration on poverty. Section 3 will discuss the effects of Regional Integration on trade, foreign direct investment and migration. Section 4 will bring section 2 and 3 together and discuss the major ways in which RI affects poverty. Section 5 concludes.

<sup>2</sup> The EU and CEECs account for a significant number of agreements, between them and amongst them.

## 2 Trade, foreign direct investment, migration and poverty

### 2.1 Trade and poverty

Examination of the relationships among trade, trade policy and poverty shows (Page 2001, Bird 2003 for an extensive discussion and bibliography) that trade can have significant effects on total income and on its distribution, and therefore on poverty. Both the macro-economic and the sectoral and distributional effects have now begun to be studied (and even sometimes exaggerated, Freeman, 2003), resulting a several conjectures. The direct impact on poverty of particular changes in trade can be traced, through price, employment, and fiscal effects to incomes, and then through household analysis, to the income and assets aspects of poverty. If policy such as a regional agreement or its ending (unlike normal trend changes in trade) creates abrupt changes (losses of a whole sector), the effects may be more severe. If opening to trade increases or decreases the vulnerability of an economy to large variance in income, this may have important impacts on poverty as the poor are less able to adjust to changes. More opportunities in trade (through imports or access for exports) are likely to increase national income and may increase efficiency sufficiently to increase growth. Any of these income effects may have direct effects on poverty (the evidence is that it is likely, but not inevitable), and clearly will have effects on the potential to reduce poverty. This, however, depends on government policy response.

If we assume that countries have the objective of reducing poverty and that they have the administrative skills and institutions to redistribute income, then we need look only at the first round effects of a change in trade: if this increases income, then poverty can be reduced. If we take the more reasonable approach in a development context, that countries face problems of skill and institutions in implementing policies, then we must look at where the initial benefits from trade come from: do they reduce the prices of the goods purchased by or produced by the poor? Are any negative changes impossible to reverse through policy? If we assume that even if governments do not have poverty reduction as an objective, other governments (donors or trading partners) have some internationally given 'right' to impose this target on them, then we can look only at the first round effects (and even this requires an assumption that governments cannot redistribute for administrative reasons).

#### *Output and growth effects*

In traditional terms, opening to trade (or to more trade) should raise a country's income (its potential welfare) by permitting it to change the composition of its output to a more efficient structure, that is, permitting it to specialise according to comparative advantage. This produces a one-off increase in total national income, and may, through the effect of an increase in output on investment, cause some further increase in output.<sup>3</sup> This assumes that prices are operating as correct signals (or that

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<sup>3</sup> While there a lot of evidence on trade, trade policy and growth regarding the goods sector, there comparatively less on trade in services. Surveys of recent work (OECD, 2003; Whalley, 2003) also indicate that services trade liberalisation offers benefits. Three sectors offer strong benefits. Efficient financial services contribute to investment and growth, and foreign providers offer potential gains. Efficient transport services can reduce substantially the costs of trade (Fink *et al*, 2000a). Telecom services are an important element in effective communications and dissemination of information. The problem is ensuring competitive provision in relatively small markets; there is a need for safeguards that protect consumers as well as foreign investors (Fink *et al*, 2000b).

they are altered to remove distortions as part of the opening of the economy) so that transmission effects work, and that there are no binding obstacles to growth. If instead the economy (or at least those elements which are opened to trade) is assumed to be operating with other constraints, of inefficiency for example, then greater integration will not necessarily increase output and in a constrained economy the effects are most likely to be negative as the economy has limited ability to compete with imports or expand exports (though there is likely to be a positive effect through cheaper consumer prices). The traditional efficiency gain is problematic faced with increasing evidence that external openness is not necessarily associated with reduced domestic price distortion, but at a minimum it can contribute to reduced price distortion and therefore to some increase in efficiency.

Transmission effects may not function as directly (or as smoothly and fast) as analysis suggests, because the country economy is not fully integrated or because of policy interventions, insulating individuals from either good or bad effects, or postponing or attenuating them.

Trade does not raise all incomes, and may lower some. One obvious example is if a trade policy change is from protecting some sector either through restricting imports or through subsidising exports, towards opening. Total income will normally rise, but it is clear that some in the protected sector will lose, unless there is immediate and perfect mobility out of it. And if some institutions depended on the subsidies, for example marketing arrangements (Winters, 1999 p. 4), then the losers may not be confined to the sector which is liberalised (all who used the marketing boards will lose a service). Normally, it is not the poorest (who are, probably, politically weakest) sectors which are protected, so normally a shift of income away from a protected sector to other sectors is more likely to improve poverty or income distribution, than to worsen them, but this is not certain.

Fields (2001 p. 101) notes that 'it has proved far easier to generate economic growth than to change the Gini Coefficient. In the developing world, GDP per capita grew by 26 percent between 1985 and 1995...while Gini coefficients in the world barely changed over the same period'. What is not clear from this observation is what 'easier' means in this context: growth has been the objective of most developing countries during this period, not inequality, so it may indicate no more than that countries have succeeded more in what they were trying to do than in something which was at most a secondary objective. A detailed analysis of projections of possible growth and/or inequality paths, in an attempt to determine whether the development targets for reducing poverty by 2015 are feasible, found that 'except for the very poorest countries, policies which spread the gains from growth more evenly will lift people out of extreme poverty more effectively than plausible increases in the overall rate of growth' (Hanmer, Wilmshurst 2000 p. 9). And, although the precise elasticities depend on the shape of the inequality curves, in general the more unequal a population, the smaller the effect of growth on poverty.<sup>4</sup>

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<sup>4</sup> Because of differences in the degree of inequality, general conclusions that on average reductions in poverty are closely correlated to increased in average income are not helpful. Gallup, Radelet and Warner 1998, cited in McKay et al 2000 find 'that some cases show less than proportionate growth..., but argue that these are balanced by cases where the poor have done better than average' (p. 28). It is not clear in what sense the fact that the poor in some countries have done well 'balances' the fact that they have done badly in others: it seems more logical to rephrase this as that the effects depend on the

Fields also (2001 p. 190) finds that examples where growth has led to all distinguishable income groups seeing an increase in income (and, for the reverse: all suffering from a fall) are quite common, looking across the experience of the Asian countries, but also some Latin American. But inequality has increased in many of the cases, so that if inequality as well as levels of income is part of the welfare function, the results are not unambiguously good or bad.

#### *Distribution of trade effects*

The most common area in which to look for explanations of how growth affects poverty or income is in composition effects: 'The composition of economic growth and the inequality of a society have a significant effect on the relationship between growth and poverty reduction' (Weiss, 2000), justifying the analysis of poverty in terms of sources of income. While the direction of effects from individual elements of trade or other international integration or from growth to the economic variables is normally clear, or subject to known influences, even if difficult to quantify in particular cases, the interaction of all the effects can only be analysed under strict assumptions about the general equilibrium of an economy, and assuming either no policy or very specific policy changes. As well as the obvious practical difficulties of modelling and analysing economies which are in the process of major structural change (from development, even if there is no change in their integration), the policies themselves will react to the changes, so the analysis becomes undetermined. Here, we will look at the direct, partial effects.

Increased specialisation makes the characteristics of the sectors in which the country has a comparative advantage a particularly important determinant of the direct impact of trade on the economy. In developing countries, this is often initially a primary product, either agricultural or mineral, but later it can become a specialised manufacture or service. If it is a product also consumed (or used as an input) in the country, growing specialisation in its production may lower consumption costs, and increase the return to output in the country, as well as the income from the exports; if it is not directly used in the country, and if the income from production is not distributed appropriately, there will be more pressure on the country's institutions to redistribute the income both to support other development and to increase the income of poor households. Thus the nature of the export helps to determine how important it is to have effective fiscal and social institutions in order to get the optimum effects on poverty.

Trade theory argues that increasing the openness of an economy improves the return to factors which are less scarce in the country than in those to which it opens (it moves their price, and therefore their return, nearer to the other levels). For countries with abundant labour, this is likely to mean an improvement in the distribution towards wages, but for those where natural resources, whether agricultural, mineral, or scenic (in the case of tourism) are the principal advantage, it may instead shift the distribution towards returns to holders of these, that is towards profits and rents. Where the move is towards labour, it is likely (for a developing country) to be towards labour that is unskilled relative to world levels, so that there is 'mixed evidence on the effects of greater openness on relative skilled-unskilled wages'

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policies and the existing distribution of income than to attempt to draw generalisations which do not answer the specific question (see also Dollar, Kraay 2000).

(McKay *et al.*, 2000 p. 19), made more uncertain by different countries' definitions of the boundary.

The labour which gains may not be the lowest skill level by national standards. Producing internationally competitive products requires some habituation of labour, if not what would be defined as training to 'skilled' level. It is, however, likely to increase total employment. This may increase the employment of the less skilled through substitution at various levels of untraded and already traded activities, as the more skilled move into the new traded sectors. Thus where labour is a country's main advantage in international trade, there is likely to be an improvement in the distribution of income at least to the less well off, and probably to some previously unemployed. This is likely to include some defined as poor. But, as discussed above, if a country had protected its manufacturing industry before liberalising and increasing its trade (McKay *et al.*, 2000), then removing this distortion may counterbalance some or all of the potential gains to labour income. The potential opening of trade in services would increase this bias of positive trade effects on labour intensive countries.

The greater specialisation encouraged by trade may make individual producers/households more vulnerable to shocks, and if neither the economic unit (because it is too small or lacks access to capital markets) nor the country (because it is poor or administratively lacking) has a suitable income-protection or insurance scheme, then small producers who decide to specialise may be more vulnerable to income shocks and poverty following an opening to trade. It could be argued that they have made a choice; to go for the more risky, but higher income path of specialisation rather than sticking to a still feasible joint production strategy, but they may also lack information about the nature of more specialised markets. The policy question is whether the implication of this is that there should be less openness to trade to encourage small producers or fewer small producers, to allow the country to have the advantages of greater trade (see Killick *et al.*, 2000). Providing income support may be particularly difficult and costly for a poor developing country. It may be better to shift to larger trading units (it is notable that in all developed countries most trade is by large companies).

But if mobility of labour among different types of work or different sectors is high, then any increase in income will come through more strongly and losses from any falls will be reduced, as people shift from losing to rising sectors. And in practice, especially in poorer households in informal or agricultural activities, many of these separate interests are actually the same people or companies, although it could be said that poorer households would generally be less well integrated in the formal international economy and so shielded from possible benefits from trade. All households are consumers. Many producers of exports use imports. Many people and companies may be involved in the production of a variety of products, including both import substitutes, which may lose, and exports and potential exports which may gain. Therefore it cannot be assumed that all losses correspond to or allow us to identify 'losers' from trade.

#### *What poverty is to be measured?*

There are differences in the concept, in the quantification, and in the approach to analysing poverty. The simplest economic definitions depend on income or capital,

expressed and measured in money terms. Most quantification based on this measures income-type concepts, not capital. The income may include imputed non-monetary income (subsistence, public services). But when the definition is modified to include either additional economic or new non-economic elements, these are normally expressed and measured as forms of asset or capital: health characteristics, education levels, access to financial capital, perhaps plus measures of non-economic assets like empowerment or exclusion. Although much empirical discussion of the impact of trade on poverty finds significant effects from wealth distribution factors, in particular land distribution, capital is not normally found in analysis of trade's effects on poverty.

Current research is emphasising the time dimension of poverty. Adjustments down (reductions in output, employment, and therefore income) can normally be very rapid. New activities, investing in the capital and labour resources, producing and marketing new products, require adjustment time. Fluctuations in income have more effect on those who are poor than on others. Researchers are now trying to distinguish between the chronically poor and the transitorily (perhaps in response to a shock) or even seasonally poor. Trade can increase the probability of some types of shock, but would normally be expected to reduce the size and frequency of shocks (by increasing the range of possible markets and sources of consumption goods).

Definitions which start from either analysis or surveys of what 'the poor' want are also based on income (if only to identify the 'poor' whose wants are to be measured). Such surveys suggest that the poor would add elements like health or education characteristics, but also other, apparently non-economic, needs: 'a sense of insecurity or vulnerability; lack of a sense of voice vis-à-vis other members of their household, community, or government' (Farrington *et al*, 1999). These may be related to income or relative income, but cannot be directly 'purchased' by reallocation of spending as education or health can potentially be. They may suggest a need for institutions as well as income or market redistribution to equalise outcomes.

For both conventional income or capital and power/vulnerability measures, it would be desirable but is normally impossible, for the unit of analysis to be the individual. In most countries, this is the unit on which power and voice in government are based (subject to exclusions like children), and it is the normal base for welfare analysis in economics. The existence of different distributions of power in households is paralleled by different effective access to income (and capital). But there are rarely data on intra-household stocks or flows or relationships, and in practice most analysis of the impact of policy on poverty has tended to go in the opposite direction, of treating households as the unit, and assuming that households take a collective 'livelihood' approach to all the different types of income and expenditure found within the unit. Another approach would carry the emphasis on sources of income to the extreme, to look at 'classes' of those dependent (entirely or predominantly) on particularly types of income, and assume that these can be treated together as having the same interests (a definition of a Marxist approach, Cogneau, Robilliard, 2000, p. 7).<sup>5</sup>

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<sup>5</sup> The 'livelihood' approach is a mixture of capital and income measures (of assets and activities). It is an extended version of the income plus other economic elements approach, based on the total capital available: financial, human, natural, and social (Farrington *et al* 1999). Further additions, like 'clean water and other services which are required to prevent people from falling into poverty' (Farrington *et*

### *Policy responses*

While most effects of trade unambiguously lead (eventually) to an increase in national income, the direct consequences for the distribution of this among households (and within households) are not necessarily the most favourable for reducing poverty, and may have temporary or permanent effects that increase it for some people. Therefore, the principal determinant of the effect of trade on poverty is likely to be not any of the factors determining the initial distribution of effects, but the policies followed (or not followed) by the government to redistribute income or assets, through taxes, support for incomes, and provision of public goods, temporarily through safety nets or permanently. The increase in national income permits increased spending (whether public or through redistribution of income to households) on education and health, seen both as components of welfare in their own right and as contributing to future welfare by increasing productivity. It also permits increased investment, on infrastructure (water provision, transport, basic financial and marketing services) and directly productive activities, and any effects on growth (as discussed under the output effects) will also stimulate increased demand for investment. Over time, the increase in the size of the economy and the increased availability of specialised resources from abroad increase the efficiency of the structure of the economy, by providing the scale necessary for basic commercial and financial services to operate.

If this pattern of short-term losses and long-term gains holds, it raises a basic policy question: whether it is better to try reduce poverty in the short run by increasing or preserving production in the traditional sector (which may be difficult: the possibilities of production increase may be limited, so that productivity and income can only be increased by transferring labour out), and thus increasing or stabilising the income of the poorest in the short run, or to encourage the modern sector in order to accelerate the transfer. The decision requires choosing among different targets (poverty, distribution, total income).

Whether governments can redistribute any addition to national income and whether they will do so will depend initially on the share of any increase going to the government in taxes or easily available to it in taxable sectors, and then fundamentally on its social objectives, political will, and administrative competence. Any increase in income can be captured by appropriate taxation, but for increases in trade there are

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al 1999) can be made, but to be consistent these would need to be based on an analysis of rigidities either in the economy or in public provision of services which would prevent individuals from obtaining these by using the 'income' or capital included in the basic measure, or on rigidities in utility functions. If each of 'a range of livelihood outcomes (health, income, reduced vulnerability, etc.)' is to be considered an end in itself, not a component of aggregate utility or welfare, this would not accept the trade-offs basic to normal utility analysis. It is not clear that they should be considered additional or merely a component of the minimum basket of goods on which poverty lines or other income measures can be based. To the extent that they are based on 'other streams of analysis, relating for instance to households, gender, governance and farming systems', this may imply findings of rigidities, and the emphasis on structures, processes, and institutions is a useful way of conceptualising the rigidities which may require looking at multiple impacts and objectives. As its proponents point out, 'it is essentially an integrating device, helping to form and bring together the perspectives which contribute to a people-centred...approach...[It] does not replace other approaches but builds on them'. It uses detailed quantified analysis for variables for which this is possible. By starting from the population on which effects are to be measured, it also avoids omission of negative indirect effects (if the impact of one effect is to alter that of another) (Ashley 2000 p. 19).

also direct effects. For many poor countries, tariff revenue is a major source of revenue, and administratively one of the easiest and cheapest to collect. Trade taxes are particularly important for small countries (where trade is a high share of total income and output) and for many Least Developed countries (McKay *et al*, 2000 cite an IMF result that for 36 it is 'nearly one third of total tax revenue or around 5% of GDP, p. 22). For this reason, tariff reform is normally assumed to require simultaneous increases (or introduction) of other taxes. The least market distorting practical tax is normally an indirect tax (VAT), but if the government wants to 'distort' incomes in favour of the poor, either an income tax or a discriminatory sales tax, combined with subsidised or free provision of desired social services, will be more appropriate. The important point to note is that unless specific action is taken to alter other taxes, lower tariffs may reduce the share of government revenue, at a time when the risk that the increase in national income may go, under some conditions, more to the high income than to the poor requires the share to increase.

## 2.2 *FDI and poverty*

### *FDI and development*

As discussed in Te Velde (2003) there are many areas in which FDI affects development and table 1 lists seven of these (employment and incomes, capital formation, market access, structure of markets, technology and skills, fiscal revenues, and political cultural and social issues. The table distinguishes between static and dynamic effects and argues that FDI can have positive and negative dynamic effects on development in all of these areas. While FDI was traditionally seen as an additional source of capital, vital for the development of countries with insufficient economic capacity and infrastructure, and where domestic saving rates are low, the view that FDI can also bring new techniques and skills is also important.

The table also shows the areas in which FDI can have an impact. As FDI is associated with direct costs and benefits as well as indirect costs and benefits, a simple quantitative measure (FDI flows, direct employment, wage levels, etc.) is not sufficient as a means of assessing the impact of FDI on development. There are three alternatives. First, there are detailed econometric studies assessing one aspect of the investment, for example, productivity spillover effects. Second, there are cost-benefit analyses, valuing the costs and benefits of all aspects of an investment. Finally, there are qualitative accounts comparing outcomes in similar situations but with alternative policies in place. While the first two approaches are criticised for not being able to construct a 'strategic counterfactual', the qualitative approach may not address cause and effect adequately. Outcomes of all approaches may further depend on the time framework and sector of analysis.

There is a heated discussion about the impact of FDI on development, and at least a significant part derives from the observation that (foreign) multinationals are different from local (non-multinationals) firms. Foreign multinationals tend to be larger, pay higher wages, are more capital and skill intensive and introduce more up-to-date technology (see e.g. Dunning, 1993 and Caves, 1996). Some characteristics of multinationals relate simply to the size of the firm, which itself is often related to higher pay, more training and usage of the latest technologies (Tan and Batra, 1997). However, controlling for factors such as size, foreign ownership is still related to better performance.

### *Output and growth effect*

When discussing the econometric evidence of FDI on growth and productivity, there are different types of econometric studies. Macro and meso studies usually find positive and significant correlations between FDI and GDP per capita or productivity. This may come as no surprise as FDI tends to locate in higher value-added industries. It is often not clear whether productivity increases at the macro level are driven by spillovers to and learning effects in local firms, or only because of a composition effect. It is thus important to understand *whether* and *how* positive spillovers to local firms occur because FDI associated with positive spillovers has long-lasting effects for development whereas FDI without spillovers may have only one-off effects which may disappear when the foreign investors leaves the country.

Micro-econometric studies can account for the composition effect testing whether local firms can improve their productivity as a result of foreign presence. It must be noted, however, that spillover studies are usually confined to the manufacturing industry. A significant body of evidence (e.g. Haddad and Harrison, 1993; Aitken and Harrison, 1999; Djankov and Hoekman, 2000) finds that the productivity level of foreign firms is higher than in domestic firms (but there are some exceptions, see Matsuoka, 2001, for Thailand) but that the effects on productivity levels and growth in domestic firms are mixed. As a result of foreign firms, domestic firms in the same sector could be better off as (foreign) competition forces them to upgrade technologies (as in the case of Indonesia, see Blomström and Sjöholm, 1999). They could be worse off when foreign firms take the market of existing local firms (as in Venezuela, suggested by Aitken and Harrison, 1999). Or they could not learn at all as the productivity gap is too large to learn anything (as in Mexico, see Blomström, 1986). In Morocco, Venezuela and the Czech Republic, the presence of foreign firms lowers productivity *growth* in domestic firms.

**Table 1 Foreign Direct Investment and host-country development**

Impact Area	<i>Static effects</i>		<i>Dynamic effects</i>		
	Indicators	Differences between foreign and local firms	Potential dynamic benefits of FDI	Potential dynamic costs of FDI	Indicators
<b>Employment and Income</b>	<ul style="list-style-type: none"> <li>• Employment generation inside foreign firms</li> <li>• Wage levels for staff with given characteristics</li> </ul>	Foreign firms are larger and pay higher wages (especially for skilled employees) than local firms.	Provides employment and incomes directly.	May indirectly crowd-out other employment by replacing existing employment or pushing up factor prices; may lead to increased wage inequality.	<ul style="list-style-type: none"> <li>• Long-run employment generation inside firm and in suppliers and buyers</li> <li>• Long-run wage development in foreign firms and spillover effects on wage levels in other firms inside or outside sector</li> </ul>
<b>Physical capital</b>	<ul style="list-style-type: none"> <li>• Fixed capital formation</li> <li>• Financial transfers</li> </ul>	Foreign firms tend to be more capital intensive	Stable source of external finance, improving the balance of payments, and potentially raising fixed capital formation.	May pre-empt investment and opportunities of domestic firms.	<ul style="list-style-type: none"> <li>• Long-run relationship between FDI and domestic capital formation</li> </ul>
<b>Market access</b>	<ul style="list-style-type: none"> <li>• Share of inputs imported</li> <li>• Share of output exported</li> </ul>	Foreign firms tend to be more trade intensive	Firms can gain access to export markets by using global networks of multinationals.	Multinationals can maintain tight controls of export channels.	<ul style="list-style-type: none"> <li>• Long-run relationship between exports and FDI, and between imports and FDI</li> </ul>
<b>Structure of factor and product markets</b>	<ul style="list-style-type: none"> <li>• Concentration in product and factor markets</li> <li>• Profit margins</li> </ul>	Foreign firms can often be found in sectors with 'barriers to entry'.	Entry by foreign firm may lead to more competition. This may reduce product prices.	The entry of foreign firms can lead to further concentration and market power. This may raise prices of own and other products.	<ul style="list-style-type: none"> <li>• Long-run relationship between FDI and profitability</li> </ul>
<b>Technology, skills and management techniques</b>	<ul style="list-style-type: none"> <li>• Skill level of employees</li> <li>• Training budgets</li> <li>• Output per employee</li> <li>• R&amp;D budgets</li> <li>• Types of technologies used</li> </ul>	Foreign firms are more skill intensive, tend to use more up-to-date technologies and train more.	Provides up to date techniques, skilled personnel and advanced management techniques, raising the return to skills offering additional incentives for education. Positive spillover effects on domestic firms through backward and forward linkages, demonstration effects and human resource development.	Spillovers are not automatic or free. Reliance on foreign technology and skills may inhibit development of local capabilities. Increased linkages raise dependency of domestic firms on multinationals.	<ul style="list-style-type: none"> <li>• Intra and extra-sectoral spillover effects on productivity in other firms.</li> <li>• Share of inputs sourced locally</li> <li>• Supplier development</li> <li>• Upgrading and long-run development of technology, training and skill levels in foreign firms</li> </ul>
<b>Fiscal revenues</b>	<ul style="list-style-type: none"> <li>• Fiscal payments</li> <li>• Grants to foreign firms</li> </ul>	Tax holidays or outright grants are sometimes offered to foreign firms	Multinationals can raise fiscal revenues for the domestic government through the payment of taxes in case of new economic activities with more value added.	If multinationals crowd-out domestic firms, fiscal revenues may actually be lower through the use of special tax concessions, eventually leading to an erosion of the tax base. Special tax concessions are an implicit subsidy and in case of lack of transparency can lead to rent-seeking behaviour.	<ul style="list-style-type: none"> <li>• Long-run fiscal payments through foreign firms and through a change in economic activity more generally.</li> </ul>
<b>Political, social and cultural issues</b>			Foreign firms can expose host country to other norms and values, e.g. environmental management, ethics.	Foreign firms may lead to political, social and cultural problems, by imposing unacceptable values (labour and environmental standards) interfering with political regime, and are said to exacerbate existing problems of corruption.	
<b>Poverty</b>	<ul style="list-style-type: none"> <li>• Combination of how above indicators affect the poor</li> <li>• Social investment</li> <li>• Core health, environmental and infrastructure programmes</li> </ul>		If the effects in this column are important, this provides an enabling environment thereby directly and indirectly alleviating poverty.	If the effects in this column are important, this provides a disabling environment thereby directly and indirectly worsening poverty.	<ul style="list-style-type: none"> <li>• Combination of the above indicators</li> <li>• Long-run effect of social investment</li> <li>• Long-run effect of core health, environmental and infrastructure programmes</li> </ul>

Source: building on table in UNCTAD (1999).

### *Distribution of investment effects*

The links between FDI and income inequality are complex. We may distinguish between the effects on wage inequality and on non-wage income inequality. The following general effects play a role:

- *Skill-specific technological change.* In addition to initial efficiency differences, FDI could induce faster productivity growth of labour in both foreign (technology transfer) and domestic firms (spill-over effects). If such productivity growth is skill-biased (for example, information technology), FDI may increase skill-biased technological change (Berman and Machin, 2000).
- *Skill-specific wage bargaining.* Skilled workers are usually in a stronger bargaining position than less-skilled workers because they possess key skills in relatively scarce supply and may have better negotiation skills to negotiate higher wages.
- *Composition effect.* Foreign firms tend to locate in skill-intensive sectors or skill-intensive segments within sectors. If FDI causes a relative expansion of skill-intensive sectors, this will improve the relative position of skilled workers and raise wage inequality (Feenstra and Hanson, 1995).
- *Training and education.* FDI may affect the supply of skills through firm-specific and general training and through contributions to general education. While foreign firms generally train more than their local counterparts, after controlling for other factors that are positively related to training such as size, much training benefits skilled workers.

The above points show that FDI can be expected to increase wage inequality in contrast to prediction by traditional trade theory (in the 2 by 2 skilled/unskilled labour variant of the Heckscher Ohlin model) that FDI reduces wage inequality in developing countries because FDI would allow developing countries to specialise in less-skilled intensive activities. However, because there are many possibly opposing effects, empirical testing is required.

In addition to the effects of FDI on wage inequality, there can be effects on non-wage income. For instance, FDI may increase profits and the return to capital, relative to other types of income such as that of the self-employed and employees. Real wages have decreased over the past two decades in many Latin American countries (Weeks, 1999) implying that capital owners have benefited more from the economic reforms. This could have helped increase income inequality. Other effects on income inequality could be indirect, for instance through the effects on fiscal revenues and expenditures. These could nonetheless be very significant or the main link to inequality for certain types of investment (e.g. natural resource based FDI).

ODI (2002) summaries recent evidence so far. Most evidence on the relationship between inward FDI and wage inequality at the macro level is for developed countries. Blonigen and Slaughter (2001) find that multinational activity was not significantly correlated with skill upgrading within US manufacturing sectors over the period 1977-1994, but Te Velde (2001) finds evidence for a sector bias towards using skilled workers. Figini and Gorg (1999) find that FDI was, up to a point, associated with skill upgrading and increased wage dispersion in Irish manufacturing over the period 1979-1995, while Taylor and Driffield (2000) find significant effects of FDI on wage dispersion in UK manufacturing.

With regards to the evidence for developing countries and Latin America in particular, Feenstra and Hanson (1995) find that inward FDI increased the relative demand for skilled labour in Mexican manufacturing over the period 1975-1998. In some regions (that may be very localised), FDI can account for over 50% of the increase in the labour wage share in the late 1980s. Freeman *et al.*, (2001) find no evidence for a consistent relationship between FDI and wage inequality in a large sample of developing countries.

Te Velde and Morrissey (2002) provide macro evidence for the effects of FDI on wages and wage inequality in five East Asian countries (Korea, Singapore, Hong Kong, Thailand and Philippines). Wage inequality has been low and decreasing in some but not all East Asian countries. Using ILO data for wages and employment by occupation, they did not find strong evidence that FDI reduced wage inequality in five East Asian countries over the period 1985-1998. Controlling for domestic influences (wage setting, supply of skills) they found that FDI has raised wage inequality in Thailand. They also found that FDI raises the wages for both skilled and low-skilled workers. Te Velde (2003) provides further evidence for Latin America arguing that FDI raised wage inequality in Bolivia and Chile, while having no to very small effect in most other Latin American countries. The macro evidence thus shows that FDI does not tend to reduce wage inequality but may increase it.

The empirical evidence on foreign ownership and wages at the micro level shows that:

- foreign-owned firms pay more to their workers than local firms. Wage differentials can be up to 60%, but are often more modest;
- studies that do not control fully for other effects (size, location, industry, etc.) overstate the effect of foreign ownership on wages; and
- studies that distinguish between average wages in two separate skill categories find that wage differentials are greater for non-production (relatively skilled) workers than for production (less skilled) workers.

An issue of current interest is whether FDI can contribute to the objective of reducing poverty, ODI (2002). This will depend on how the gains from FDI are distributed, among sectors, workers and households. Systematic evidence on the effects of FDI on income distribution and poverty in developing countries was discussed before. Because poor people are not directly or less well integrated in the formal international economy, they would least benefit from any positive effects (although they would also least lose out through negative effects). In principle, there is no direct link between FDI and poverty reduction – this does not include ‘socially responsible’ investment which may directly benefit the poor– but there are three possible indirect links.

- If FDI contributes to export growth, productivity growth and finance for the balance of payments, it supports increases in national income that offer the potential to benefit the poor. In this case FDI does not reduce poverty directly, but it helps to create an enabling economic environment.
- If FDI increases employment it may help some to move out of poverty. With the exception of FDI in textiles, a lot of FDI in manufacturing is likely to employ labour that is relatively skilled (in terms of the local market), and would not directly benefit the poor. Well-developed linkages with local suppliers may increase employment of various skill groups.

- Foreign firms may pay higher wages than local firms for workers with similar qualifications. Because of the skill bias of FDI this will not directly affect the poor and is likely to increase inequality of wage incomes, increasing the skilled/unskilled wage differential, and to increase urban/rural income differentials. However, by establishing a higher paid labour force and developing a better skilled workforce there may be dynamic effects.

These effects will depend on the country, sector and time framework of interest.

### *Policy responses*

Most econometric work on the effects of FDI on development tends to ignore economic and policy factors affecting the link between FDI and development. It is often shown that FDI is correlated with growth and productivity, but this masks the fact that different countries with different policies and economic factors tend to derive different benefits and costs of FDI. Whether the positive effects of FDI outweigh the negative effects in Table 1 will depend on the economic and policy factors in the host country as well as the sector and the strategies of multinational affiliates. Recently, researchers have begun to stress the importance of local capabilities (educated and trainable workforce, see, e.g., Borensztein *et al.* (1998), investment in R&D see e.g. te Velde (2001), the ability to conduct an outward oriented trade policy, see e.g. Balasubramanyam *et al.*, 1996) in deriving benefits to the local economy. One implication could be that countries with relatively few local capabilities are less able to derive benefits from FDI. On the other hand, however, researchers have also suggested that countries have more to gain the further they have to catch-up.

With respect to the effects of policy on the distribution of investment effects, there are potentially ways in which government and business can co-ordinate their actions or form partnerships in order to improve the impact of MNEs on the development of the poorest workers. Such opportunities are most likely to arise when government and business actions interact. The following areas, where the business and development cases are linked, deserve further attention (Te Velde, 2003)

- **Education and Training.** MNEs will train their workers more when workers have a good and appropriate basic education. Governments could therefore consider whether the quantity and quality of basic education is sufficiently geared towards areas of economic expansion and the needs of MNEs. Governments may also consider providing incentives (public-private partnerships in training, subsidies, taxes, standardisation) for more training of less-skilled workers, particularly in larger firms.
- **Health.** A healthy workforce is in the (business) interest of the MNE and a healthy population is a government priority. In the case of epidemics, MNEs and less-wealthy governments may join to fight the disease as witnessed in Southern Africa. Neither partner could fight the epidemic on its own. The government may have limited funds, while the provision of health care for (future) employees can make economic sense.
- **Supplier development.** MNEs will source locally when local quality suppliers are present. There may be a role for the government to provide an enabling environment for private sector development and to actively support linkages

between MNEs and local firms in a market-led way. This would involve matching local suppliers with MNEs and upgrading the basic capabilities of local firms. Well-developed Investment Promotion Agencies (IDA Ireland and Singapore EDB) already perform such tasks through national linkage-support programmes. MNEs may then develop their suppliers further. An example of supplier development in Latin America related to the Intel plant which has more than 100 suppliers. The Costa Rican government is helping local suppliers to become more competitive (see Larrain *et al*, 2000). Public support for linkage creation is discussed in Te Velde (2002).

- **Infrastructure.** It may be in the interest of both the MNE and local communities to provide local infrastructure. A combination of MNE activities and government funds may maximise the benefits to the development of infrastructure in host countries.

### **Box 1 Partnerships and livelihoods of poor people.**

**Partnerships.** Recently, partnerships between firms, government and civil society have emerged to improve the impact of FDI (see, for example, the 230 partnerships put forward to the World Summit in Johannesburg in August 2002). Each of the partners can bring something to the table. In the case of businesses, this does not simply imply cash for compensation of oil leaks (alone), but thinking about what core competencies (finance capacities, marketing networks, etc.) a business employs in order to reduce poverty and improve local livelihoods. A variant of the partnership approach has been taken by Inti Raymi in Bolivia. This approach has moved beyond simple compensation by establishing a foundation helping livelihoods of poorer people surrounding the investment. This has also leveraged in other support for co-operation. However, in general, there is relatively little evidence so far about what type of partnerships can make a difference for the poor in what type of settings.

## 2.3 *Migration and poverty*

### *Output and growth effects*

The literature on migration is emerging and this paper will only briefly deal with migration. The static gains of migration can be shown on the basis of a variation of the 2 by 2 Heckscher Ohlin model. If both trade in goods and capital flows are not permitted, labour flows would also achieve factor price equalisation in a situation where labour is optimally allocated. Simulations using general equilibrium models, based on many assumptions, provide estimates of the static gains of migration. If developed countries permitted movement of labour up to 3 percent of the total labour force, world incomes would rise by \$156 billion (Winters, 2002). Developing countries would be the main gainers and the net welfare for the home region Africa would be \$14 billion. While clearly most of such gains are related to developed – developing migration there may also be some (but obviously lower) benefits for developing country regions.

But there are static and dynamic effects. It is useful to distinguish between effects on labour sending countries and labour receiving countries (World Bank, 2003). The benefits of the sending country are threefold. Labour emigration reduces unemployment and raises wages. Once emigrated workers send remittances back

home which are an important source of external capital flows for developing countries. Table 2 shows that remittances to developing countries amount to \$80 billion, about half more than aid flows. For Sub Saharan Africa remittances are about a third of FDI flows. The emigrated worker can acquire skills abroad, which can be useful once the worker returns. Obviously, the emigrated work will initially translate into a loss of human capital in the sending country, or a brain drain cost. The receiving country will initially gain by importing labour that can be put to work in areas of labour shortages.

**Table 2 Worker remittances to developing world (2002)**

	\$ bn	% GDP
Total	80	1.3
East Asia and Pacific	11	0.6
Europe and Central Asia	10	1.0
Latin America and Caribbean	25	1.5
Middle East and North Africa	14	2.2
South Asia	16	2.5
Sub-Saharan Africa	4	1.3

*Source:* World Bank (2003)

#### *Distribution of migration effects*

North-South migration is usually done by skilled workers, while there appears to be some evidence that the poor migrate less (e.g. a poverty constraint, see Clark *et al.*, 2003, and Hatton and Williamson, 2001). This may relate to the migration of medium to high skilled workers in education, IT and health to developed countries. However, this may be less so for South-South migration, see e.g. migration to the South African mines. Thus (North-South) migration is likely to benefit the relatively skilled workers directly. However, indirectly remittances may also benefit poorest countries and workers (they are often used for small scale investment and start-up of microenterprises. The type of migration may also affect income inequality. If migration is in those skill groups that are relatively unskilled for the receiving country, this may increase inequality, but if immigration is in skilled categories this may lead to an increased supply of relative skills and hence reduced inequality. Migration, especially in Africa, can also negatively affect development and the poor through the spread of HIV/AIDS.

#### *Policy responses*

There are various types of responses to migration. There are different appropriate responses depending on whether it relates to temporary or long-term migration. The sending country may want to limit permanent emigration in favour of temporary emigration and maximise the productive use of remittances. The receiving country may also want to react to the labour market consequences, especially when income inequality is increasing.

### 3 Regional Integration, trade, foreign direct investment and migration

As discussed in the introduction, there has been a remarkable proliferation of RTAs in the second half of the 20<sup>th</sup> Century, with more than 100 different agreements ratified. The first wave of regionalism in the 1950s to 1970s did not include many provisions beyond trade in goods. The second wave started in the 1990s (Baldwin, 1997; Ethier, 1998). The 1990s wave is often referred to as ‘the new regionalism’ as it has a number of distinctive characteristics. First, whilst the old regionalism of the 1950s/1960s typically involved RTAs that were ‘North-North’ or ‘South-South’, the new regionalism has been typified by several ‘North-South’ arrangements like NAFTA, Asia-Pacific Economic Cooperation (APEC) and EU with North African and Latin American countries. Second, many recent arrangements have been intercontinental. Third there are increasingly cases of multiple membership. Finally, many recent agreements have aspired to deep integration with commitments to harmonisation of regulatory measures, freeing up of factor movements with provisions for services and investment.

There are various ways in which RTAs or regional integration efforts affect national economies. We can distinguish between competition and scale effects, and trade and location effects. Competition and scale effects arise because national economies become more closely integrated, with a larger market permitting the economies of scale to be achieved and bringing producers in closer contact thus leading to efficiency gains. Trade and location effects arise when the RI changes the pattern of trade and location of production.

Most direct effects of RI work through trade on member and non-members (3.1), FDI (3.2) and migration (3.3) which we discuss below. Other effects of RI may be harder to capture, such as dynamic efficiency gains, and can be indirect. We return to these issues section 4.

#### 3.1 Regional Integration and Trade

The literature on Regional Integration and trade is an old one and dates back at least to Viner (1950). The theoretical literature was often concerned with whether regional integration was welfare enhancing. We do not attempt to discuss this theoretical literature in depth, but a brief review, with an emphasis on empirics, is needed for the framework to analyse RI and poverty.

Viner (1950) suggested that the effects of regional integration on trade can be either *trade creating* when trade replaces domestic production, or *trade diverting* when partner country production replaces trade from the rest of the world. This implies that RI can lead to further trade, but this is not always welfare enhancing. Reflecting this, RI is not always revenue enhancing, and could in fact reduce national welfare in the case of trade diverting and loss of tax revenues.

##### 3.1.1 Trade in goods

In the past decade there have been various attempts to address the relationship between RI and trade. Some studies distinguish between the effects on intra-regional and extra-regional trade. One example, Frankel (1997) found that the Regional

Integration raised intra-regional trade by 65 per cent in the EC and 150% in Mercosur and Andean. Table 3 contains selected studies on the effect of RTAs on trade, in particular on intra-regional trade. Frankel and Rose show that RTAs have a big average effect on intra-regional trade. Soloaga and Winters (2001) show that the effects can differ amongst RTAs, with some positive and others negative effects. They show that the new wave of regionalism in the 1990s (new blocks and revamping of old blocks) has not led to further intra-regional trade. Further, they show that only the EU and EFTA may have led to trade diversion and the other blocks to trade creation.

**Table 3 Regional trade agreements and merchandise trade: selected studies**

Study	Type of equation		RTAs include	Effect RTA on trade
Frankel and Rose (2001)	Gravity equation explaining log of bilateral trade volumes using control variables such as distance, language, currency boards, income and others	Indirect using dummies	Dummy for the EEC/EC; the Canada-US FTA; EFTA; the Australia/New Zealand closer economic relationship; the Israeli/US FTA; ASEAN; CACM; PATCRA; CARICOM; SPARTECA; and the Cartagena Agreement,	1.1 (0.10) (Table 1)
Soloaga and Winters (2001)	Gravity equation explaining log of bilateral import values using control variables such as distance, language, income and others	Dummies for RTA trade amongst member states, region imports and region exports	EU EFTA ASEAN Mercosur CACM LAIA ANDEAN GULFCOOP	Negative and significant dummies for EU, EFTA, ASEAN. Positive and significant dummies for GULFCOOP, NAFTA, CACM, LAIA, ANDEAN, MERCOSUR. However, no significant difference in dummies before and after new wave of regionalism. Trade diversion in EU and EFTA. Table 3.
Estevadordal and Robertson (2002)	Gravity equation explaining log of bilateral import values using control variables such as distance, language, income and others	Preferential Tariffs (one aspect of RTA)	LAIA NAFTA And US-Latin America and EU-Latin America under GSP	Tariff elasticity significant between -0.8 and -1.7 (table 2)

While RTAs are thus likely to boost intra-regional trade (possibly more than diverting trade), this does not imply that all RTAs will have the same effect. For one, the effect will depend on economic conditions and initial structures. If countries are similar and produce simple final product (typically Sub Saharan Africa, where various applications of gravity models show that trade is already above potential), free trade amongst them is unlikely to provide a major boost to intra-regional trade (which could affect their motives in deepening regional integration). If countries have very different factor endowments with a high income, the possibility of specialisation in a region is much greater, including the possibility of significant intra-industry trade (see e.g. Krugman, 1989). Secondly, there are many ways in which an RTA can affect intra and extra regional trade through different trade provisions. The previous studies account for this simply by including a dummy, but a more detailed account would examine how trade rules within RTAs, such as tariff liberalisation and rules of origin, would affect trade. A deeper cut and a higher initial tariff would be more conducive to further intra-regional trade than a small cut in a low initial tariff.

### Regional Tariff Preferences

The key market access negotiations within RTAs focus on tariff reduction, particularly to what degree parties to RTAs grant each other regional trade preferences. Tariff preferences can be set at a fixed level or a percentage deviation from most-favoured nation (MFN) tariffs. Table 4 shows differences between MFN and regional tariffs. Unilateral and multilateral tariff reductions will erode the absolute level of regional trade preferences.

**Table 4 MFN tariffs and regional preferential rates: selected examples.**

	<i>Average applied MFN</i>	<i>Average applied regional</i>	<i>Absolute preferential tariff reduction (as percent of price)</i>
<b>SAPTA (1996) / SAARC</b>			
Bangladesh	17.5	15.8	1.4
India	33.5	24.1	7.0
Nepal	20.7	18.1	2.2
Pakistan	21.7	19	2.2
Sri Lanka	21.9	15.3	5.4
South Asia	26.4	20.3	4.8
<b>AFTA (2001) / ASEAN</b>			
Brunei	2.6	1.0	1.6
Indonesia	7.2 (2002)	4.4	2.6
Laos		5.0	
Malaysia	7.3	2.4	4.6
Myanmar	5.6 (1996)	3.3	2.2
Philippines	7.3	4.8	2.3
Singapore	0	0	0.0
Thailand	16.8 (1999)	7.4	8.0
Vietnam	16.0	3.0	11.2
ASEAN-region		3.5	
<b>MERCOSUR (2001)</b>			
Argentina	12.7	0.4 (1996)	10.9
Brazil	14.6	0.0 (1996)	12.7
Paraguay	13.2 (2000)	0.8 (1996)	11.0
Uruguay	13.8	0.9 (1996)	11.3
<b>NAFTA</b>			
Canada	7.7	1	6.2
Mexico	16.5	1	13.3
US	5.5	1	4.3
<b>ANDEAN (2001) / CAN</b>			
Bolivia	9.6	0	8.8
Colombia	11.6	0	10.4
Ecuador	11.2	0	10.1
Peru	11.6	0	10.4
Venezuela	11.9	0	10.6

Sources: WTO, IPS (2000), own calculations.

Estevadeordal and Robertson (2002) review existing and provide new empirical work showing that preferential tariffs do have a large and significant effect on bilateral trade, see also table 3.

### *Rules of Origin*

Rules of origin constitute another trade rule that can affect location decisions. Rules of origin differentiate trade regimes, to ensure that goods that enter a country receive the correct import treatment. Proof that the imported product was produced in a party to the regional agreement would be sufficient to obtain preferential treatment as applied in the region. However, this may become complicated if products are partly produced and processed in a member of the region and partly outside the region. Rules of origin provisions govern when such products can benefit from preferential treatment and when products will be treated as originating from outside the region.

There are three main methods that determine where a substantial transformation takes place (WTO official document WT/REG/W/45, 2002). First, the *change in tariff heading* (CTH) method origin is granted when a processed good falls under a different tariff classification (e.g. Harmonised system usually at 4-digit level) from the imported good used for processing. Secondly, the *percentage criterion method* determines that a substantial transformation has taken place on the basis of a minimum percentage of the total value that must have been added in the exporting country (domestic content or DC) or a maximum percentage of value due to imports (import content or MC). Thirdly, the *technical test method* stipulates certain production or sourcing requirements in processing operations. There are advantages and disadvantages for different parties to an agreement for all three rules, which is why regions often decide to adopt more than one rule, especially if there is a dominant country, as in NAFTA or SADC.

Rules of origin can include provisions for cumulation. Such provisions describe the conditions under which imported inputs can be regarded as domestic content in the exporting country so that final products will more often benefit from preferential tariffs. Some RTAs allow for bilateral cumulation, where inputs from importers and exporters are regarded as domestic content. Diagonal cumulation allows that inputs from non-parties are regarded as domestic under certain conditions. Full cumulation allows that all processing in the whole RTA area will be regarded as domestic. This would be more generous than bilateral cumulation when domestic content of the exporting country is low, but the regional content is high.

Other concepts discussed in more detail elsewhere include tolerance and absorption levels (see WTO official document WT/REG/W/45, 2002, and Estevadeordal and Suominen, 2003). The *tolerance* rule allows a certain percentage of inputs not originating in the exporting country to be used without affecting the origin of the final product. This can make it easier for products with non-originating inputs to qualify for preferences. The *absorption* rule allows parts or materials that under relevant rules of origin are regarded as not originating can be treated domestic in any further processing operation.

Empirical evidence on the effects of rules of origin on trade is scarce. The evidence that has attempted to address the issue shows that RoO can prevent growth in (intra-regional) trade flows and divert resources from their most efficient source, i.e. RoO

can be so stringent that importers do not use tariff preferences which they would be due. Estevadeordal and Suominen (2003) summarise evidence that utilisation rates of preferential trade agreements can be low.

### *Non Tariff Barriers*

There are non-tariff barriers to trade ranging from administrative requirements like customs control procedures to labour and environmental standards and these can have effects on investment. Technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures can also affect trade. For instance, Barrell and Te Velde (2002) examined the Single Market Programme in the EU which began in 1986 with the removal of technical barriers to trade and the harmonisation of standards and showed that this has affected trade in varying degrees.

A barrier, which is not normally included in “NTBs”, is the use of anti-dumping which is consistent with WTO provisions. Not only developed countries, but increasingly also developing countries use these provisions. Well known are the voluntary export restraints and (threats of) using quotas and anti-dumping by the EU in part motivating the Japanese to set up operations inside the EU.

### *3.1.2 Trade in Services*

Little is known about the effects of RTAs on trade in services. At the multilateral level, the GATS governs liberalisation in trade in services. However, developing countries have also begun to design provisions in RTAs addressing trade in services. Some argue that the inclusion of such new provisions is part of the new regionalism (Dee and Gali, 2003). GATS Article V requires RTAs to be more liberalizing than the GATS. RTAs should have substantial sectoral coverage and provide for the “absence or elimination of substantially all discrimination” through elimination of existing discriminatory measures and/or through the prohibition of new or more discriminatory measures either at the entry into force of the agreement or on the basis of a reasonable time-frame. The substantial sectoral coverage in services refers to the number of sectors, volume of trade affected and modes of supply. No mode of supply should be excluded beforehand.<sup>6</sup>

Stephenson and Prieto (2002) define the components often found in regional (Western Hemispheric) service agreements on the basis of three elements: coverage, liberalising principles and depth of commitments.

- *Coverage* describes the four modes of supply (as in GATS: cross-border delivery, consumption abroad, commercial presence, and movement of

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<sup>6</sup> There are four modes covering cross-border supply and returns to cross-border movement of factors in multilateral and regional agreements on services.

- Mode 1. Cross-border supply: when a service crosses a national border. An example is the purchase of insurance or software by a consumer from a producer abroad.
- Mode 2. Consumption abroad: when a consumer travels abroad to consume from the service supplier, such as in tourism, education, or health services.
- Mode 3. Commercial presence: when a foreign owned company sells services (e.g. foreign branches of banks).
- Mode 4. Temporary movement of natural persons: when independent service providers or employees of a multinational firm temporarily move to another country.

people), and whether the agreements 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 the fundamental principles of National Treatment (NT – no discrimination between foreign and domestic suppliers), Most Favoured Nation (MFN – no discriminations amongst source of foreign suppliers), Local presence requirement (is a local presence required to supply the service), quantitative non-discriminatory restrictions (e.g. on number of TV frequencies).
- *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 loose (non-conforming measures can be maintained only when they are listed in appendices) and future liberalisation.

Table 5 below compares RTAs in the area of services recently concluded by countries in the Western Hemisphere and ASEAN (see Te Velde *et al.*, 2004, for further details, particularly on services provisions in RTAs between the EU and developing countries). The following points emerge

- Western Hemispheric RTAs are based on a negative list approach, except for MERCOSUR. ASEAN is based on a positive list approach.
- RTAs offer MFN, with the exception of CARICOM;
- ANDEAN, NAFTA and CARICOM require transparency, while ASEAN and MERCOSUR do not have such provisions. Transparency is required when changing measures related to trade in services.
- Many (NAFTA) of the above agreements have separate rules governing investment in services (mode 3 of services), though MERCOSUR regards investment in services as mode 3 of services supplies.
- ASEAN does not have a special chapter on monopoly practices, while ANDEAN, NAFTA and MERCOSUR do. CARICOM has a separate agreement on competition
- MERCOSUR and NAFTA (and CARICOM) *require* member states to encourage recognising titles of other member states, while in ASEAN titles *may* be recognised.
- NAFTA includes provisions on government procurement of services. MERCOSUR has negotiations ongoing.
- Treatment of mode 4 (temporary movement of people) varies considerably. In MERCOSUR it depends on the scheduled commitments, and in NAFTA there are limited provisions related to business services providers only. CARICOM is more advanced, allowing movement of people based on foreign establishments, and (when ratified) free movement of “skilled nationals”.
- ASEAN and MERCOSUR do not have rules regarding non-conforming measures, while ANDEAN, CARICOM and NAFTA are not allowed to schedule any new non-conforming measures.
- Most RTAs are quite ambitious, aiming to reduce all restrictions on trade in services within the coming two decades.

**Table 5 Services components in selected RTAs**

	ASEAN (Framework agreements on services, 1995)	ANDEAN (1998)	MERCOSUR (1994, to be ratified)	NAFTA (1994)	CARICOM (1997, to be ratified)
Sectoral coverage	According to schedules	Universal	According to schedules, all sectors by 2010	Universal	Not determined
Negotiating modality	Gradual, positive list	Negative list	Gradual, positive list	Negative list	Negative list
Most favoured nation	Subject to sectoral exemptions	Unconditional	Subject to sectoral exemptions	Unconditional	No
National Treatment	scheduled sectors subject to bound commitments	General obligation	scheduled sectors subject to bound commitments	General obligation	Yes
Transparency	Not included	Each Party will promptly publish all measures of general application	Each Party shall publish all measures	Procedures to be established to notify restrictions	No, but when ratified the protocol requires notification of existing restrictions and provisions on services providers
Treatment of investment	Commercial presence covered by specific sectoral commitments; separate investment disciplines	Right of establishment guaranteed for service providers; separate investment disciplines.	Commercial presence covered by specific sectoral commitments; separate investment disciplines	No local presence required, investment rules in separate chapter	While no national treatment is provided, it does establish that members shall not introduce in their territories any new restrictions relating to the right of establishment of nationals of other members states.
Safeguards	Provisions exist for Emergency Safeguard Measures and Restrictions to Safeguard the Balance of Payments	Provisions exist for Restrictions to Safeguard the Balance of Payments	Provisions exist for Emergency Safeguard Measures and Restrictions to Safeguard the Balance of Payments	No provision for safeguard action in services, but provisions in case of balance of payment difficulties (different for tare in financial services)	Provisions to safeguard the Balance of Payments
Monopoly practices	No	Disciplines to be developed for monopoly practices and exclusive service suppliers	Disciplines to be developed for monopoly practices and exclusive service suppliers	Yes, for monopolies and state enterprises	Monopolies not specified, but Agreement on competition
Recognition of titles	Each Member State may recognize the education or experience obtained, requirements met, or licenses or certifications granted in another Member State.	Each Party shall recognize the licenses, certifications, titles of professions, and diplomas, accorded by other Member Country, in which activity of services requires of such instruments, according to the established criteria in a Decision dealing with the matter.	Each state shall be encouraged its competent authorities to develop together with those of the other Parties mutually acceptable standards or criteria regarding the exercise of professional activities related to trade in services	Annex on professional services which requires members to encourage the relevant bodies in their respective territories to develop mutually acceptable standards and criteria for the licensing and certification of professional service providers, to provide recommendations on mutual recognition to the parties and to develop procedures for the temporary licensing of professional service providers of another party	Provision to establish common standards and measures for accreditation or, when necessary, for the mutual recognition of diplomas, certificates and other evidence of qualifications of nationals of CARICOM members
RoO	Benefits are denied to a service supplier who is a natural person of a non-Member State	Benefits of the protocol can be denied to a service provider from another member party, given notification and consultation, when this party demonstrates that the services provided by a person or country not part of Mercosur.	Benefits of the protocol can be denied to a service provider from another member party	Subject to prior notification a Party may deny the benefits to a service provider of another Party	It seems possible to deny benefits of the protocol to a service provider from member an non-member parties.
Government procurement	No	Government Procurement disciplines to be applied to services, once developed	To be developed, but to be applied to services	Includes government procurement of services in separate chapter on government procurement	Not mentioned

Movement of natural persons	No	Freedom of Temporary movement guaranteed.	No, depends on scheduled commitments	Commitment regarding temporary movement of business services providers	Temporary movement of persons as services providers in connection with foreign establishment, incl. (family of) management, supervisions and technical staff; CARICOM skilled nationals act to be ratified before 2005 by all members.
Dispute settlement	A specific dispute settlement mechanism may be established	Provisions provide for procedures in the case of rules of origin dispute, including consultation	Disputes are to be settled according to the dispute mechanisms of MERCOSUR	Access to investor-state dispute mechanisms under chapter 11 on investment, see e.g. financial services chapter	No mentioning of this in the chapter on services
Exceptions	No	Yes	Yes	Yes	Yes
Restricting Non-conforming measures	No	No party will increase the number of existing non-conforming measures	No	Parties need to make reference to law when scheduling commitments.	Members will not introduce any new restrictions on the provision of services in the Community (standstill)
Special provisions	Financial services, basic telecommunication, maritime transport, movement of natural persons, and audio-visual	Financial services, basic telecommunications, and professional services will be elaborated in a near future	Financial services, basic telecommunications, maritime transport, movement of natural persons, and audio-visual	Financial services, air services, land transport, telecommunications, professional services, Temporary Entry for Business Persons	Professional services, air transport
Future liberalisation of trade in services	Gradual liberalisation through exchange of lists commitments.	Progressive liberalization of a list of commitments through negotiations within a period of 5 years (by 2005).	Progressive liberalization of a list of commitments through negotiations within a period of 10 years (by 2007).	To remove restrictions but allow for exceptions and reservations.	To achieve a complete elimination of the identified restrictions to the movement of people and capital throughout the region by 2005

Sources: OAS website and RTA chapters/protocol related to services

Nikomboriak and Stephenson (2001) discuss differences amongst RTAs. In particular they highlight the different approaches taken in ASEAN and those in the Western Hemisphere. The latter are based (mostly) on a negative list approach with commitments being “GATS-plus”. ASEAN on the other hand is based on a positive list approach and so far with similar commitments as in GATS. RTAs clearly differ with respect to services agreements for various reasons. It appears that Latin American RTAs are most liberalised, followed by ASEAN in Asia while African RTAs have only just started to consider or implement provisions on services. The table below shows services provisions in African RTAs. For many African RTAs the question is not what is the effect of services provisions in RTAs, but how much has actually been implemented.

**Table 6 Coverage of services in selected African RTAs**

<i>Region</i>	<i>Coverage of services</i>
ECOWAS	Article 27 of 1975 Treaty on Community Citizenship Protocol on Free Movement of Persons and the Right of Residence and Establishment (1979) 1992 revised ECOWAS treaty affirmed right of entry, residence and settlement
SADC	Sectoral protocols (1996) on <ul style="list-style-type: none"> <li>• Energy</li> <li>• Tourism</li> <li>• Transport, communications and meteorology</li> </ul> SADC Draft Annex on Trade in services under discussion
EAC	Chapter 15 of 2001 EAC Treaty on co-operation in infrastructure and services
COMESA	Chapter 11 of 1993 COMESA Treaty on cooperation in the development of transport and communications Chapter 28, article 164, is on free movement of persons, labour, services, right of establishment and residence

An important question is whether RTAs in services can provide a boost to (intra-regional) trade in services as has been the case for trade in goods, and if so, what strategies, or what elements, help to achieve this? The first part of the question depends on whether an RTA can provide a credible margin of preference for regional services providers on the one hand, and the extent of commitments on the other hand. The Latin American RTAs seem to have achieved a credible margin of preference over GATS, by including more transparency and stability for services providers through a negative list approach and a list of non-conforming measures, and has also included more liberal schedules. So in principle RTAs will be able to provide a credible margin. However not all regions actually do this. The second part of the above question in terms of optimal strategy is difficult to answer, as there is little evidence whether developing country RTAs (do not) boost trade in services, let alone on what type of RTAs are most effective.

### *3.2 Regional Integration and foreign direct investment<sup>7</sup>*

There are various ways through which RTAs can influence FDI and vice versa. We can distinguish between investment rules (3.2.1), trade rules (3.2.2) and other links (3.2.3).

#### *3.2.1 Investment rules*

Investment rules are rules governing cross-border investment in the region and usually consist of rules on treatment and protection of FDI contributing to the “investment climate”. Investment rules do exist in a handful of RTAs<sup>8</sup> although they are not as common as trade rules, particularly amongst the poorer developing countries. Some regions include voluntary principles (e.g. APEC voluntary principles) while other regions include rules with effective dispute settlement procedures. We discuss a number of investment provisions in regional treaties (scope, standard of treatment, performance requirement, expropriation and dispute settlement mechanisms) and their expected effects on the volume of FDI.

##### *Scope*

The scope of investment treaties deals with the definition of investments and investors and the extent to which the treaty applies to member and non-members. Sometimes investment in general is included, while other agreements include FDI only. Provisions in some RTAs apply also to non-member states when they invest in the region from another location in the region (e.g. performance requirements in NAFTA). The scope also can also be used to determine whether investment rules apply to listed sectors only (positive approach) or to all sectors in principles with listed exceptions (negative approach).

##### *Standard of treatment*

While many RTAs would include fair and equitable treatment, more contentious are whether investment rules provide national treatment or MFN treatment to post-establishment operations or to pre-establishment issues. Most liberal are those RTAs that include national treatment to members with respect to pre-establishment, subject

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<sup>7</sup> See background paper by Te Velde and Fahnbulleh (2003)

<sup>8</sup> Investment rules also appear in bilateral trade arrangements (e.g. Singapore-Japan), but more often appear in bilateral investment treaties .

to exceptions, as investors would have the right to establish a subsidiary anywhere within the region, and would be treated the same as national investors. The fewer the restrictions on establishment the easier it is to invest and so the more investment would be possible (though actual investment attraction depends on there being profitable economic opportunities). Such enhanced market access can be important and regional arrangement may include this and may thus be more liberal than is provided for in most multilateral and bilateral (except perhaps the US) investment treaties (see [www.unctad.org](http://www.unctad.org) for coverage and number of bilateral investment treaties. National treatment of foreign firms post-establishment usually refers to issues such as (abolition of) performance requirements.

#### *Performance requirements*

The more elaborate RTAs can include a section on performance requirements and the extent to which they cannot be applied to new and/or existing investment. Performance requirements are requirements imposed on the operations of MNEs and traditionally include export and domestic content (local sourcing) rules related to foreign goods producers. However, they can include more extensive requirements (e.g. employment) or deal with the service sectors in addition to the goods sector (e.g. NAFTA).

Performance requirements affect investment in a number of ways. First, by imposing requirements it may require foreign investors to use inefficient inputs or inefficient production processes. If this is severe this can lower the volume (and profitability) of investment. The potential benefit of performance requirements would be less costly for countries or regions that have built up a minimum supply capacity. It may be difficult to identify the effects of performance requirements on locational decisions in practice. Few sectors are covered by performance requirements. The automobile assembly sector is one sector that is often affected, and a sector where local content requirements can be effective because it depends on component parts. Sectors that are less dependent on inputs from outside the company would be affected less. Secondly, performance requirements may influence the type of investment, because performance requirements could affect quality of inputs used (and hence the profitability of investment).

#### *Expropriation and nationalisation*

Expropriation is a potential threat to interests of foreign investors if governments decide to nationalise subsidiaries of MNEs – though this seemed more likely to occur in the past in Latin America and Africa<sup>9</sup>. International law and regulations normally allow expropriation only when it is in the public interest, on a non-discriminatory basis and against adequate compensation. RTAs can contain such provisions that allow expropriation of property by the state on a non-discriminatory basis (national treatment and MFN). These provisions would add some comfort and diminish the non-commercial risks of an investment. Without other good reasons to invest, such provisions would not attract FDI on its own, but they could help to establish a favourable investment climate when offered as a package with other conditions.

#### *Dispute settlements*

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<sup>9</sup> Some cases take considerable time to resolve. For instance, in January 2003, Nestle settled an expropriation claim with the Ethiopian government dating back to the Ethiopian nationalisation programme of 1975.

Investment rules, including those on expropriation, are likely to be more effective when backed by some dispute settlement mechanism. There are various procedures, ranging from state-to-state to (foreign) investor-state dispute settlement procedures. In the event of an investment dispute, the more advanced regions allow for a consultation process leading to a panel review either between states or between investors and states. In some cases there are regional courts of justice, and in many cases disputes can be reviewed in the host-country or some independent arbitrator (when countries are a member) such as the Convention of the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL). There is much debate about the ultimate effect of such settlements on development but it is likely that investors see some comfort in having them as they may reduce non-commercial risks. The presence of (access to) dispute settlement procedures may also form the basis for home countries offering investment guarantees against political risks in the context of bilateral treaties.

There is a heated discussion on how investment rules (bilateral, regional and multilateral) affect investment decisions. Generally a predictable investment climate can be in the interest of investors when they were previously disadvantaged. It is not clear whether this would lead to *additional* FDI or simply more comfort for the investor. It is however clear that surveys reveal that investors want a predictable investment climate (e.g. CBI position paper for WTO negotiations, EU survey of MNEs – EC, 2000), although not necessarily at the cost of other policy liberalisation (e.g. further trade liberalisation). The predictability of the investment climate may be enhanced when domestic policies are enshrined or locked into regional treaties. However, it remains unclear under what circumstances which investment rules would lead to additional FDI. Much will also depend on existing treatment. If treatment of existing investors in practice is already good or better than of domestic investors, new (regional) rules may add little to generating new investment or a better investment climate, other than offering a little more long-run security. There seems to be no empirical evidence that addresses the effects of individual investment provisions on FDI, so this is an area of further research.

### 3.2.2 Trade rules

There are three types of regional trade rules that may affect investment: regional tariff preferences, rules of origin and non-tariff barriers (which are not taken to include rules of origin). We discuss these with respect to the effects on intra and extra-regional FDI.

#### *Regional Tariff Preferences*

The elimination of intra-regional tariffs will affect trade vis-à-vis the level of sales by multinational subsidiaries depending on the importance of transport (incl. tariff) costs and plant-level and firm-level costs to set-up multinational subsidiaries (Markusen and Venables, 1997, Brainard, 1997, Carr *et al.*, 1998). Hence, the type and motive of investment plays an important role and to reflect this, the analysis will need to distinguish between intra-regional and extra-regional FDI and between horizontal (market-seeking: subsidiaries selling similar products) and vertical (efficiency and

natural resource seeking: subsidiaries exploiting efficiencies or wanting control over input markets) FDI.<sup>10</sup>

Regional tariff preferences are likely to lower *horizontal* (tariff-jumping) intra-regional FDI because it may now become cheaper to serve the partner country by trade rather than to establish a subsidiary and incur plant-level costs more than once and firm-level costs only once. Of course when firm-level and plant-level fixed costs are zero, there would be no trade and no concentrated production facility or FDI – just national production. However, on the other hand, regional tariff preferences encourage *vertically-motivated* intra-regional FDI, because lower trade costs will provide incentives to establish international production networks and establish an efficiency seeking subsidiary in a partner country which can process imports for re-exports. An example includes the increase in US – owned production in Mexico partly as a response to NAFTA (not through “maquiladoras” which were in operation before NAFTA, see e.g. Gruben and Kiser, 2001), although domestic Mexican regulation has also played a role.

Extra-regional FDI can also be affected by declining regional tariff preferences in different ways. First, by lowering tariffs amongst parties to the RTA, it may become profitable for an extra-regional investor to avail of an effectively larger market (horizontal market seeking FDI) from one or more locations in the region (export platforms). If individual countries of a region were previously served by trade, this may then raise inward FDI (export platforms or beachhead locations, see also Ethier, 1998). However, if the member countries of a region were already served through sales of a multinational subsidiary, concentration of production may occur in one of a few countries in the region, with ambiguous or negative effects for the volume of extra-regional FDI in each country. The combination of lower internal tariffs and significant plant fixed costs would lead to a consolidation of several plants in several members of the region into one plant, which is being used by the parent to serve the region as a whole. This may also induce FDI inflows to the most cost-efficient location (usually nearest to the largest market), possibly at the cost of FDI to other members in the same region. This could be the case for market seeking multinationals. An example could be Unilever, which has traditionally invested in many developing countries including Bolivia, Argentina and Brazil. When confronted with lower trade (incl. tariffs) costs between Bolivia, Argentina and Brazil they may decide to

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<sup>10</sup> In the past decades, trade economists have begun to broaden the trade theory and the ‘new trade theory’ now embraces increasing returns, imperfect competition and product differentiation in addition to the traditional comparative advantage paradigm. Recently, multinationals have been incorporated and made endogenous. The first attempts were by Helpman (1984) who integrated vertical multinationals and Markusen (1984) who integrated horizontal multinationals into the trade theory. Horizontal multinationals are multi-plant firms selling similar products in different locations. Vertical multinationals separate production geographically into different plants to intra-industry trade (in practice multinationals include both horizontal and vertical features). Markusen (1997) presents a unified approach to vertical and horizontal multinationals. Horizontal MNEs dominate if nations are similar in size and relative endowments and if transport costs are high. Vertical MNEs appear with headquarters in the skilled labour abundant country, provided that transport costs are high enough. National firms dominate if both trade costs are small and the home market is large enough: in this situation it makes sense to incur the fixed costs of setting up only one plant, from where to export. Within this framework it can be shown that trade and investment liberalisation are not substitutes and the two taken together may lead to a reversal in the direction of trade. Carr *et al.* (1998) provides a good empirical test of the framework, clearly showing the complexity and non-linearities affecting FDI and hence the relationship between trade and FDI.

rationalise production in fewer countries to exploit economies of scale or some other locational advantage (a process of rationalisation has recently taken place). The effects of regional trade preferences for extra-regional vertical (or efficiency-seeking) FDI is likely to be small, though lower regional preferences may lower costs and raise efficiency in the vertically motivated subsidiary when it uses inputs from more than one country in the region (e.g. possibility of regional enterprises in the ASEAN, ANDEAN or SAARC context).

There are various effects of regional tariff preferences on inward FDI. However, in the context of developing country regions, where most inward FDI is inter-regional even more so than in developed country regions<sup>11</sup>, the market size argument would be the most important, and apart from other factors regional tariff preferences would tend to raise inward FDI. It must be noted however that the strength of this argument depends on the difference between tariffs applied regionally and tariffs applied to others (MFN). With large regional markets, but low tariff preferences the effects is likely to be low. Table 4 provides data on this for selected countries.

### *Rules of Origin*

Rules of origin constitute another trade rule that can affect location decisions. The effects of rules of origin (RoO) on investment can vary depending on the type of investment as well as the interaction with regional tariff preferences. The RoO can encourage the use of intra-regional inputs diverting away from extra-regional inputs even if these were more efficient. However, a stricter and more costly RoO would stifle intra-regional trade favouring extra-regional imports (which are likely to be levied the MFN tariff). The higher the difference between MFN tariffs and regional tariff, the higher the incentive to comply with the RoO by importing regionally using good certificates. This has effects for intra and extra regional FDI. For instance, it may encourage extra-regional FDI by setting up subsidiaries in the region to satisfy the RoO, possibly diverting investment made outside the region towards the RTA. Regional rules of origin applied to Mexico (NAFTA) would require many maquiladoras, such as Japanese and South Korean electronics manufacturers, to switch away from Asian sources of components and either need to find new suppliers in the US, Canada or Mexico, or encourage Asian suppliers to relocate to Mexico, creating a further extra regional inward FDI.

We should distinguish between market-seeking and efficiency-seeking FDI (see Dunning, 1993) and extra and intra-regional FDI. MNEs based outside the region are more inclined to set up a subsidiary in the region to serve the regional market

<sup>11</sup> Intra regional inward FDI is 6 per cent of total FDI in ASEAN and 1 per cent in SAARC.

Table: Intra-regional FDI flows as per cent of total FDI

	EU (outward)	NAFTA (outward)	ASEAN (outward)	ASEAN (inward)	SAARC (inward)
1986	36	30			
1997	49	21		12	
1999	46	18	15	6 (2001)	1

Source: IPS (2000), ASEAN secretariat, UNCTAD, Rugman and Brain (2002)

According to Businessmap, even though South Africa is a major and growing investor in other SADC countries, this seems to count for only 25% of total FDI inflows. The FDI stock of non-SADC origin in South Africa is also greater than the stock of South African outward FDI.

particularly when the difference MFN – regional tariffs is great, and when the RoO is strict. When the RoO are strict, the *extra-regional* investors need to set up all manufacturing and processing operations in one (or a few) country in the region to serve that market when it wants to satisfy strict RoO (see NAFTA example). This would not be worth it if either the difference between MFN and regional tariffs is low or when it is too costly / difficult to comply with strict RoO. Efficiency seeking extra-regional FDI would not be affected considerably, since such products produced in the RTA are likely to be (re-) exported to outside the region irrespective of RoO or regional tariff preferences in the RTA. Such re-exports to outside the region may often go to big developed country markets such as the EU, US and Japan, and for these exports preferential RoO are relevant (Cotonou, EBA, AGOA, GSP, etc.) not RTA RoO.<sup>12</sup> On the other hand some big developed countries have begun to form RTAs with developing countries (e.g. EU with individual East European and African countries) including RoO, but in this case we speak of *intra-regional* FDI.

The effect on intra-regional FDI can be complex, and would also depend on the type of operations. For instance high-fixed costs, market seeking operations would favour an establishment in one of the countries when tariffs are low as opposed to establishments in every member of the RTA. This is because the region can be served more cheaply through exports from a single (or a few) establishment in the region thereby realising economies of scale. Low-fixed costs operations could be expected to set up more efficiency seeking establishments in other members of the RTA when intra-regional tariffs are decreasing since it becomes cheaper to re-export regionally produced products. There is likely to lead to more intra-regional FDI in countries with few manufacturing capacities when RoOs are looser, e.g. allowing for diagonal or full cumulation so that others incl. non- members can supply the country that attract intra-regional FDI, than when RoO are stricter, when operations can use inputs only from one partner country.

Strict RoO can distort investment decisions when there is no CET (common external tariff) and MFN rates vary considerably, as in the case of NAFTA. Taking the example of NAFTA, strict RoO could prevent some extra-regional imports (or intra-regional production) into Mexico for processing and re-export to the US market, leaving investors to choose the US even though this may be an inefficient production location. A lower MFN tariff in the US compared to Mexico would only reinforce this trend. Another distortion can arise when using RoO provisions such as minimum domestic content, which can be easier satisfied when production costs are high (Estevadeordal and Suominen, 2003).

### *Non Tariff Barriers*

As non-tariff barriers to trade have affected trade in varying degrees, they can also affect investment. NTBs include voluntary export restraints and the threat of imposing EU quotas and using anti-dumping against Japanese exports motivated the Japanese to set up operations inside the EU. Barrell and Pain (1997) found that after controlling for relative labour costs and market size, Japanese investment flows to EC countries over 1980-1991 were significantly influenced by anti-dumping activities taken in the EC.

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<sup>12</sup> Exception apply: e.g. Japanese efficiency seeking investors in Mexico producing for the NAFTA market.

*Summary and further discussion*

Table 7 provides a summary of possible links between trade rules and FDI. On balance it appears that RTAs should lead to increased extra-regional FDI, but more ambiguous results for intra-regional FDI. An important reason for the ambiguity of the effects of trade rules is that MNEs are motivated by exploiting firm-specific assets (e.g. firm specific fixed costs) and hence wants to enjoy economies of scale and scope, in addition jumping trade barriers.

It includes simple predictions as to how trade rules in RTAs affect FDI and compare well with the general literature on FDI and integration in developed countries, though some refinement is usually needed. For example, both Blomstrom and Kokko (1997) and Dunning (1997a) acknowledge that the effects of regional integration (trade rules) and FDI further depends on pre-existing rules in the region and the extent to which regional rules will actually change such rules. Countries and industries that are already integrated prior to regional integration due to geographical and historical reasons can expect to see more limited effects than other countries and sectors. A stronger actual change to the investment climate i.e. whether national policies are changed dramatically and locked into a regional framework, will reinforce these effects. On the other hand, this could also raise the risks of policy reversal and instable regions.

**Table 7 Summary of possible links between trade rules and FDI**

		<i>Extra-regional FDI inflows</i>			
		<i>Market seeking</i>		<i>Efficiency seeking</i>	
<i>RoO loose</i>	<i>Low intra/extra tariff difference</i>	negligible		Negligible	
	<i>High intra/extra tariff difference</i>	+		Negligible (6)	
<i>RoO strict</i>	<i>Low intra/extra tariff difference</i>	negligible		negligible	
	<i>High intra/extra tariff difference</i>	++ (2)		+ (1)	
		<i>Intra-regional FDI flows</i>			
		<i>Market seeking</i>		<i>Efficiency seeking (3)</i>	
		<i>High fixed costs</i>	<i>Low fixed costs</i>	<i>High fixed costs</i>	<i>Low fixed costs</i>
<i>RoO loose</i>	<i>Lower intra regional tariffs</i>	- (4)	?	? (5)	++
<i>RoO strict</i>	<i>Lower intra regional tariffs</i>	- (4)	?	? (5)	+

- (1) It may be easier for investors to locate an efficiency seeking plant in one country of the region : cheaper imports processed for exports. This effect is more positive the more countries in a region supply the plant.
- (2) Possibly Japanese in Mexico to serve US market (while for NAFTA it was market seeking, for Mexico it was efficiency seeking); the more stricter are ROO the higher the share of the production process in the market
- (3) Relevant especially for mixed developed and developing regions
- (4) Concentration of investment in one country: more trade and fewer individual plants
- (5) Depends on trade-off between lower tariffs/transport costs and fixed costs
- (6) This could be positive, e.g. in the case of Japanese efficiency seeking investors in Mexico that happen to service the rest of NAFTA.

Dunning (1997a) offers 4 hypotheses related to the impact of the single economic market (SEM) in the EU on EU inward FDI. First, the SEM will have a positive

impact on intra-EC trade and an ambivalent effect on intra-EC FDI. Extra-EC defensive FDI could increase depending on the external tariff and efficiency seeking FDI may increase due to the competitive enhancing effects of integration, with possible investment diversion away from several investment locations towards the most suitable export platforms for the region. The SEM may diminish the importance of market size and growth and increase the importance of country specific strategic assets or location factors. Second, the SEM will have an ambivalent effect on the geographical distribution of FDI. There are however suggestions that economic integration will lead to a more concentrated geographical distribution of economic activity. Markusen (1995) argues that when countries become similar in size and wealthier, MNEs (reaping economies of scale) will come to dominate exports provided that transport costs are sufficiently high. The FDI/trade ratio will be higher in developed than in developing regions. Third, depending on both country and sector specific factors, the SEM will have an ambivalent effect on the ownership of production in the EC. MNEs are likely to dominate sectors where there are significant firm level economies relative to plant level economies and intra-firm co-ordination costs. Fourth, the consequences of the SEM will be sector specific and FDI will concentrate in those sectors that have characteristics conducive to MNEs, e.g. FDI intensive services, incl. banking and insurance and trade enhancing services.

When analysing hypotheses and empirical findings regarding the effects of the formation of the SEM in Europe, Dunning (1997b) makes several observations. First, the main dynamic impact of the FDI is through the effects on other determinants of FDI such as market size, income levels, structure of activity and agglomeration economies. SEM as an independent variable has raised extra and intra (less than extra) regional FDI not as much as other variables have increased FDI. Thirdly, the effects of the SEM are industry specific, with extra-EC FDI increasing more in FDI sensitive sector. Fourth, there was limited evidence that economic activity has become geographically concentrated as a result of the SEM, although high value added activities remained clustered and lower value activities became more dispersed. Finally, there is complementarity between trade and FDI.

There is no standard of a region, so it is obvious that regions differ. The background paper by Te Velde and Fahnbulleh (2003) documents that regions differ in two fundamental respects with respect to investment –related provisions:

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

Table 8 documents that investment related provisions in key regions differ significantly, including differences in

- Extent of regional tariff preferences
- Restrictiveness of Rules of Origin
- Investment rules, including national treatment for pre and post establishment and presence of effective dispute settlement mechanisms
- Regional co-ordination on investment
- Type of membership: North-North, South-South, North-South, South-South-North.

**Table 8 Summary table of investment related provisions in RTAs.**

	NAFTA	MERCOSUR	CARICOM	ANDEAN	ASEAN	SADC	COMESA
<b>INVESTMENT RULES</b>							
What year did investment provisions come into force at regional level	1994	1994	1982 & 1997	1991	1987 & 1998	Few provisions	1994
<b>1 Scope and coverage</b>							
a Applicable to non-parties (when or when not)	Yes	Yes	No	Yes	AIA National Treatment		No
b Positive or negative list approach	Negative	Colonia – Negative Buenos Aires - positive	Positive	Positive	1987 – positive AIA-negative		Positive
c Main exceptions (safeguards, sectors etc.)							
<b>2 National Treatment</b>							
a Pre-establishment (all sectors?)	Yes	Yes	No	Not specified	Yes	No	No
b Are there restrictions on ownership rules? (e.g. min equity share)	Yes	No	No	No	Yes	No	No
c Operations by MNEs in the country	Yes	Yes	No	Not specified	Yes	No	No
<b>3 Most Favoured Nation and fair and equitable treatment</b>							
a granted to parties	Yes	Yes	No	No	Yes	No	Yes – fair & equitable
b non-parties	Yes	Yes	No	No	No	No	No
<b>4 Performance requirements</b>							
a Are they banned for new and existing investment?	Yes	Yes	No	Yes	No	No	No
b Do they go beyond TRIMs?	Yes	Yes		No			
<b>5 Transfers of funds</b>							
a Are transfer of funds across borders allowed	Yes	Yes	Yes	Yes	Yes	No	Yes
<b>6 Do provisions with respect to expropriation exist (nationalisation ,etc.)</b>							
	Yes	Yes	Yes	Yes	Yes	No	Yes
<b>7 Settlement of Disputes</b>							
a State-to-state	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b Investor-state	Yes	Yes	Yes under certain conditions	No	Yes	No	No
c Access to International Dispute Settlement (ICSID, UNCITRAL)	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<b>TRADE RULES</b>							
<b>9 Rules of Origin</b>							
a Do rules of origin exist	Yes	Yes	Yes	Yes	Yes	Yes	Yes
b Value Content Criterion: Domestic/Regional Value Content (RVC)	RVC 50-60%	MC40% RVC60%	N/A	MC: 50%	MC: 60%	MC: 70-35%	MC:60% RVC:35%
c Are there roll-up arrangements?	Yes	Yes	-			Yes	Yes
d Are drawback allowed?	No	Yes	-		Yes		Not after 10 years 3
e Mean/median value of restrictiveness	4	3			4	4	
<b>10 Tariff structures</b>							
a Does a Common External Tariff exist.	No MFN varies from 5.5% - 16.5%	Yes since 1995	Yes since 1991	Yes since 1993	No	No	No. Plans for CET
b Level of intra-regional tariffs and plans	0-2%	Duty free	Duty free	Duty free	0-7%	Mixture of duty free and SACU CET	Different levels of tariff elimination
c Exceptions	Yes	Yes	Yes	Andean Multinational Enterprises	Andean development Cooperation	Asean Industrial Co-operation Regional Investment Promotion Events	
<b>11 Other relevant provisions (regional enterprise schemes, regional investment funds, etc.)</b>							
			Free movement of people	Andean Business Advisory Council	Asean Investment Portals		
Investment relevant integration index (1= no; 2=middle;3=integrated) INV	3	2	2	2	2/3	1	1
Investment relevant integration index (1= no; 2=middle;3=integrated) TRADE	2	3	3	2	1	1	1

Sources: Te Velde and Fahnbulleh (2003).

Regions (with an economic motive) that desire to formulate new or change existing investment related provisions might be helped by an analysis of their effects. The experience over the past three decades shows that regions can be subdivided into four categories with respect to investment provisions: 1) regions that do not have investment related provisions except for trade rules (most RTAs); 2) regions that impose a common policy toward investment (ANDEAN in the early 70s) that is more restrictive than individual member policies were; 3) regions that choose to develop a common approach gradually over time introducing provisions that stimulate regional investment co-

operation and regional investment promotion and (begin to) grant national and MFN treatment (pre and post establishment) to foreign firms (ASEAN); and 4) regions that include comprehensive investment provisions from the beginning, including pre-establishment national treatment and effective investor-state dispute mechanisms (NAFTA).

**Table 9: RTAs and FDI inflows, selected examples**

Study	Research question; Region, countries and years; Methodology	Explanatory variables	Findings
Levy, Stein and Daude (2002)	How do RTAs affect the location of FDI?  FDI from 20 OECD countries to 60 OECD/non-OECD countries, 1982-1998:	FTA membership, Extended market host, Extended. market source, capital/worker distance, market size, bilateral trade, inflation trade/GDP, privatization capital/worker, investment. environment, common border, common language	<ul style="list-style-type: none"> <li>• FTA membership doubles FDI stocks on average</li> </ul> FDI increases upon joining a FTA with: <ul style="list-style-type: none"> <li>• more trade/GDP (openness)</li> <li>• more similar capital/worker</li> <li>• better investment environment</li> <li>• larger market</li> </ul>
UNCTAD (1993)	How does the EC Single Program (SEM) affect the location of FDI?  OECD countries, 1972-1988	Level and change in income, domestic invest, exchange rate(t), exch rate volatility	FDI flows increases with <ul style="list-style-type: none"> <li>• less exchange rate volatility</li> </ul> This may affect way in which a currency union would affect FDI.
Srinivasan and Mody (1997)	Which factors determine US and Japanese FDI?  35 OECD and non-OECD countries, 1997-1992, split out in groups of low-middle, high income countries; and EEC, Latin America, East Asia	Market size, labour costs capital costs. previous FDI infrastructure (telephone, electricity), country risk openness	<ul style="list-style-type: none"> <li>• When split by periods (77-81; 82-86; 87-92), no evidence that SEM increased US &amp; Jap. FDI (But we should bear in mind that SEM was complete only in 1993)</li> </ul>
Brenton <i>et al</i> (1998)	Does European integration increase FDI? Does it divert FDI? Are trade and FDI substitutes or complements?  FDI in and outflows, imports, exports for Eu and CEEC countries,	Population, distance, trade/FDI agreement dummies, host country economic freedom dummies, CEE dummies, host country Eu membership dummy, FDI residual (in trade regression)	<ul style="list-style-type: none"> <li>• Single European Act (1992) and Iberian enlargement : more FDI but no observed FDI diversion</li> </ul>
Pain and Lansbury (1996)	How has intra- and extra EC FDI by UK and German firms in different sectors changed with the introduction of the Internal Market Programme (SEM)?  UK and German outward FDI for seven sectors, 1980/81-1992	Sector output, factor costs, currency volatility, corporate finance conditions, non-tariff barriers (1-3 scale), SEM dummy, sector dummies	findings: <ul style="list-style-type: none"> <li>• FDI determinants differ over sectors</li> <li>• IMP introduction boosted FDI</li> <li>• IMP redirected UKFDI from US to EC</li> </ul>

In understanding the effects of RTAs on FDI, particularly in developing countries, the existing variation in investment related provisions across regions and over time has not yet been fully exploited. Existing empirical evidence has recently begun to address the links between RTAs and FDI. We will provide a more precise overview elsewhere, but table 9 provides a simple review of a few studies tentatively finding that RTAs in most cases boost extra-regional FDI and in some cases intra-regional FDI. Levy *et al* (2002) address the issue of regional integration and FDI at a basic level, using dummies for regions applying the analysis to the OECD databases thus

excluding many developing countries. The market size effect is used but it is not a true market potential function as allowance for RoO and regional preferences have not been made. Other researchers have examined individual regions; Waldkirch (2003) and Monge-Naranjo (2002) for NAFTA, Chudnovsky and Lopez (2001) for MERCOSUR. UNCTAD (2003) includes a useful overview of several regions but does not provide new empirical research.

Only one recent study, Dee and Gali (2003), examines how “new” trade provisions in Preferential Trade agreements affect the patterns of trade and investment flows. They use gravity models of trade and investment between pairs of countries over 1988-1997. They include two type of indices: 1) covering “traditional” trade provisions regarding agriculture and 2) industrial products and “new age” provisions” covering services and other provisions such as investment rules. The indices are unweighted averages of scores on sub-categories. They also control for the usual control variables in gravity equations and include three dummies for each RTA provision to measure intra-regional effects, extra-regional effects on inward FDI and extra-regional effects on outward FDI.

The traditional trade provisions affected both intra regional inward FDI stocks and extra regional inward FDI stocks in SPARTECA (investment creation), but only extra regional outward FDI in the EU and US-Israel RTA (investment diversion). The new age provisions led to net investment creation in EFTA, EU, NAFTA, MERCOSUR, SPARTECA, CER, net investment diversion in AFTA, and no impact in ANDEAN and US-Israel (tables 4-7 in Dee and Gali, 2003).

While this study has gone some way in understanding the effects of different provisions in regions on trade and investment flows, many questions have remained unanswered. For instance, their study does not address all RTAs or any with African countries; they do not include a lot of developing countries, focusing their attention on RTAs relevant for Australia; they do not compare provisions over time – while provisions can change over time (as e.g. in ASEAN); they lump all “new” trade provisions together; finally, it is not clear which type of countries within regions gain (most).

### 3.3 *Regional Integration and migration*

There are various ways in which RTAs deal with migration. OECD (2002) distinguishes between

- RTAs that provide for full mobility for people. For instance, the EU covers free mobility of workers and non-workers. COMESA foresees free movement of labour by 2025. Such agreements provide for full access to labour markets (in the case of the EU there is a currently some controversy about the effects of enlargement on intra-regional migration, and most old members states have imposed temporary controls on migration from the new members).
- RTAs that provide for mobility of certain types of people. A prime example is CARICOM which has a separate agreement on the movement of skilled nationals. It allows allowing movement of natural persons based on foreign establishments, and (when the protocol is ratified) allows for free movement for ‘skilled nationals’ and access to labour markets.

- Other RTAs that use provisions under GATS (mode 4) with some elements. Table 4 on provisions on services includes a row which deals with temporary movement of people. Some agreements facilitate the temporary movement of people. In particular, APEC has introduced an APEC business travel card facilitating visa procedures.

There are marked differences in provisions on migration or temporary movement of people. There can thus be different effects on the movement of labour within a region, although the evidence tends to show minor effects. At one extreme when full mobility of labour is granted (Treaty of Rome, EU) this has not led to significant labour mobility (intra-labour mobility covers 0.2 per cent of the total EU population, World Bank 2003). At the other extreme, GATS type commitments in regions does allow for temporary movement of people and even in this situation movement is severely limited by qualification requirements, economic needs tests and residence requirements (and thus dependent on FDI regimes).

There are few studies that examine the effects of RTAs on labour mobility. Those that are available find that there is little effect (e.g. Fuchs and Straubhaar, 2003). Intra-regional mobility for the EU is estimated to be less than 1 per cent, despite large wealth gaps between Southern and Northern European members, and persistently high unemployment differentials across countries. There also appears to be no effect of the Nordic Common Labour Market (Denmark, Finland, Sweden and Norway). For developing country RTAs (especially in Africa) the opportunities for significant intra-regional migration seem limited due to high unemployment and relatively low wage differentials (although illegal migration does take place).

#### 3.4 *Other links between RTAs and FDI*

There are various other links between RTAs and FDI. Provisions other than the trade and investment rules include free movement of people (CARICOM) and free transfers of profits which can all facilitate the establishment of intra-regional FDI. Many other provisions are region specific and cannot be easily categorised.

For instance, some regions (ANDEAN, ASEAN, MERCOSUR) have co-operation schemes which sometimes aim to establish regional enterprises by promoting joint ventures. The ASEAN region seems to be one of the most advanced in this area. The ASEAN Industrial Cooperation scheme (AICO Scheme) seeks to promote joint manufacturing industrial activities between ASEAN-based companies. More than 100 projects have been selected for special tax and tariff incentives. The initiation of these schemes may also help to foster the regional integration process as opposed to being the result of regional integration.

Some argue that the effects of RTAs on FDI are not so much about trade and investment rules, but about the increased predictability of the investment climate by locking-in general reforms (regulation, competition policies, property rights, contract enforcement, guaranteed access to members' markets and stable trade policies) in a wider context. The fact that national policies are "locked" in regional treaties should give investors additional security that policy reversals are less likely, reducing non-commercial risk. In practice this argument would depend on how strong the region is

vis-à-vis individual members in practice. The argument is also related to signalling, that signing an RTA signals an intention which can be regarded as favourable to investors.

Many argue that important effect of RTAs on FDI are dynamic, with competition creating a more efficient industry and growth, which in turn can affect FDI. Neary (2001) includes dynamic effects in a theoretical model of describing MNEs. First, there is the tariff-jumping motive as discussed before: FDI is favoured over exporting the higher the external tariff and the lower the fixed costs of a new plant. Second, the export platform motive could affect FDI as lower intra regional tariffs would favour a single plant in the region. Finally, lower intra-regional tariffs would lead to increased competition from stronger domestic firms and hence fewer FDI. On the other hand, a more efficient private sector can also raise efficiency seeking investment by becoming efficient regional suppliers as well as raise strategic asset seeking investment.

Blomstrom and Kokko (1997) also argue that regional integration leads to efficiency gains and higher growth, and thus further FDI. FDI can actually be such a catalyst through spillovers in terms of technology transfer and other linkages with local firms. There can thus be long-lasting effects on growth and productivity as opposed to a one-off effect based on a more efficient allocation of resources.

While regional integration can lead to more extra regional investment for the region as a whole, this may not lead to more FDI in each individual member. As discussed briefly before, the extent to which polarisation or uneven distribution takes place depends on the level of external MFN tariffs, strictness of RoO, market size and agglomeration effects in individual member countries. If polarisation takes place this could lead to conflict of interest amongst member states in maintaining a region and facilitating regional efforts to address investment. While increased intra-regional FDI could be expected to enhance the integration process, competition for FDI between member states can do the opposite. The attempt to reduce such competition is thought to be one of the reasons why Mercosur has begun further talks on investment issues (Chudnovsky and Lopez, 2003) – and the EU and NAFTA have included provisions on capping incentives. UNECA's annual report on regional integration shows that there is an expectation that cross-border investment and trade could lead to closer integration. If regional integration leads to further FDI with equal benefits, this could start a virtuous circle. If, however, FDI benefits member states unequally this may actually put the region in jeopardy.

Despite competition amongst RTA member states for the same FDI, which Oman (2000) argues has increased over the 1990s, it is possible to think of co-operation when competition has become too fierce or costly, or when joint investment promotion may bring benefits shared across the region. ASEAN has organised ministerial-level joint investment promotion activities to major developed country markets, with the aim to convey a strong regional image. The ASEAN secretariat has also begun various activities in the area of investment facilitation, by providing information through portals, databases, publications and statistics. It can thus be said that a region can do much more to try to promote investment than design and implement trade and investment rules. They can put in place the regional infrastructures (legal, institutional etc.) to deal with investment issues at a regional level.

Apart from trade and investment rules and regional institutions, regions can also decide to harmonise fiscal and monetary policies. For instance the Euro area (within the EU), the UEMOA and 4 out of SACU members (within SADC) have common currencies. This reduces intra-regional exchange rate variability and may reduce cross-border transaction costs, which are amongst the factors contributing to investment. Because the EU and SADC and SCAU are incomplete currency areas, there should be implications for which parts of the region are influenced.

## 4 Regional Integration and poverty: a conceptual framework

### 4.1 *RTAs and poverty: volume, price and slice effects*

An important way in which an RTA could affect poverty is through its effect on the volume of trade and investment. Section 3 discussed whether and when RTAs lead to more trade (investment, migration). Section 2 discussed how such increases in trade in goods (investment, migration) can affect poverty.

The “volume” effects on poverty reduction are greatest when RTAs are trade (and investment) creating because the poor are better off if they can get the same slice of a greater trade (and thus income) cake. On the other hand, when RTAs are trade diverting through lower internal tariffs, tax revenues can be lost. Lost revenues can offset any positive “volume” effects.

Another important link to poverty of an RTA is the “price” effect. Trade policy liberalisation (e.g. tariff reductions) can lead to lower prices. This will lower government revenues but will benefit consumers. To the extent that certain products for which the tariffs are reduced are consumed proportionally more by the poor, e.g. in the case of food imports, and when such tariff reduction are passed through to consumers, this will benefit the poor proportionally more. This effect is relevant even in the absence of changes in volumes.

There are other ways in which RTAs could affect poverty. In particular, the “slice” effect would be relevant when the slice of the same cake would be bigger for the poor as a result of signing an RTAs. This would be the case if RTAs change the poverty “focus” of trade, investment and migration (compared to multilateral integration). In other words, would it be possible for two identical countries with the same volume of trade, investment and migration have different poverty reduction profiles because of differences with respect to RTAs and the regional vs. global composition of trade, investment and migration? We will discuss this in sections 4.2, 4.3 and 4.4.

### 4.2 *Does Regional Integration change the poverty “focus” of trade*

Trade policy reforms have economic effects on (a) prices of traded products (b) output, wages and employment opportunities in affected sectors, and (c) the government’s fiscal position. Research could focus on import prices and consumers to address (a), and export performance to address (b), although one should also consider if any sectors have evidently suffered from competition from cheaper imports. Most of the literature is in the context of international trade at a global level. RI is a policy reform that affects trade at the relevant regional level. Against each of the three issues, we consider how may affect trade and poverty in a manner that is different from how global trade affects poverty.

- a) Prices of traded goods. Open international trade implies domestic prices of traded goods should tend (downwards in nearly all cases) towards world prices. In the case of RI, there is only convergence of regional prices, which will tend to be above world prices. If there is a common external tariff lower than pre-RI tariffs,

then regional (domestic) prices will decline. Thus, the principal effect of RI will be to reduce prices of goods traded within the region. This will benefit consumers, and would be expected to benefit producers in some countries in the region (those able to expand exports) at the expense of others (those with relatively high initial protection who face increased competition from regional imports). The overall effect on poverty will depend on which products are traded regionally and how prices are affected, but consumers gain. In this context, it would be worth asking whether poor people consume relatively more products traded intra-regionally than products traded extra-regionally.

There is another issue related to the pattern of tariff liberalisation. In RTAs, tariff liberalisation will be uniform across all products eventually reducing all tariffs to zero (possibly with some exceptions). However, due to pressure groups, multilateral negotiations may reduce tariffs in a way that benefit the non-poor. On the other hand a Common External Tariff would not be immune to political pressure and hence may not be pro-poor. Also, while RTAs strive towards free trade (as required by GATT/WTO article XIV), few developing country RTAs actually have achieved this (ANDEAN an exception) and some may have exemptions through the “enabling cause”.

- b) Static and dynamic output effects. In principle countries should raise their output as they specialise on the basis of comparative advantage (static effect). But not all countries may benefit to the same extent. Often, the bigger members of the developing country RTA’s will have a competitive advantage (typically in basic manufactures) and will benefit the most. The smaller members are likely to face increased competition from imports so production will not increase as much. *Ceteris paribus*, the poverty impact is beneficial in large countries and adverse in small countries. The small countries may benefit if they can export food within the region, and growth in agriculture typically benefits the poor.

RTAs can affect poverty through dynamic output and productivity effects such as through competition and scale. Many argue that important effects of RTAs are dynamic, with competition creating a more efficient industry and growth. Lower intra-regional tariffs would lead to increased competition (Neary, 2001). The new trade theory emphasises long-run productivity effects of trade (Grossman and Helpman, 1991). Productivity spillovers can occur via importing and exporting (Coe and Helpman, 1995; Coe, Helpman and Hoffmeister, 1997). Not only does a country’s efficiency increase due to allocation effects, trade helps actors to learn from each other and appropriate R&D spillovers. These learning effects can be translated into long-run efficiency gains. Unfortunately, there is little evidence for these dynamic effects. Schiff and Wang (2003) find that “there has been no empirical evidence of the dynamic effects of RIAs based on their impact on technology diffusion from partner and non-partner countries”. They then go on to show that NAFTA imports has raised productivity (between 5.5-7.5%) in Mexico through imported foreign knowledge stocks, while extra-regional imports did have no effects (but this may be due to the specifics of NAFTA). These are long-lasting effects that can in the long-run benefit the poor. There can also be long-lasting effects on productivity through learning by-exporting, and such effects may be appropriated particularly when dealing with more developed partners and these tend to be extra-regional.

- c) The effect on tax revenue depends on the pre- and post-RI pattern of trade and tariffs. Import liberalisation might be expected to reduce government revenue, as tariffs are typically an important source of tax revenues. This effect is reinforced when RI leads to trade diversion (Viner, 1990). There are a number of reasons why import liberalisation may not be associated with lower tariff revenues. First, the lower tariff rates discourage evasion and avoidance so collection efficiency increases. Second, quantitative restrictions may be converted into tariffs. Third, the tariffs may apply to an increasing value of imports. This may arise either because demand is elastic or because there was also devaluation (which increases the domestic price of imports). If tariff revenue declines, as it typically does, the revenue can in principle be compensated by increased revenue from other taxes (mostly domestic sales). In practice, however, tax revenues have tended to decline.

The presence of import barriers or restrictions creates an anti-export bias by raising the price of importable goods relative to exportable goods. Removal of this anti-export bias through trade liberalisation would induce a shift of resources from the production of import substitutes to the production of exports. The factors used intensively in the production of exports, land and rural or unskilled labour in poor countries, should benefit most. On the other hand, factors employed in the production of import-competing goods, mostly urban capital and labour, may suffer losses. Typically, import supply from the rest of the world responds more rapidly than domestic export supply, so liberalisation imposes adjustment costs (losses tend to be immediate whereas export gains can take time). As RI does not involve exposure to imports from all the rest of the world, only from the region, adjustment costs (hence adverse poverty effects) are lower, but so are the possible gains.

There is another effect of trade on poverty in RTAs, but this is based at the distribution of the benefits. The benefits of regional integration may not be evenly spread amongst members of a region. Venables (1999) argued that South-South agreements will tend to lead to divergence of income levels of members states, while North-North agreements may lead to convergence of income levels. The explanation of this is based on the position of countries in a region compared to those outside the region. Countries with a comparative advantage (e.g. in manufacturing) closer to the world average do better in a region than do countries that are at the extreme position as the latter are more likely to switch import suppliers (of manufactures) and face trade diversion costs. This explanation is based on manufacturing, but it is less clear when other sectors are also included. Nevertheless, possible divergence due to relocation effects may actually put RIAs under strain, as may have been the case in the EAC. While peripheral countries to the EU such as Ireland have caught up in terms of productivity levels with other members of the EU apparently through trade and FDI spillovers, there was a degree of divergence and agglomeration in developing regions such as East African Community and the Central American Common Market both dating back to the 1950s and 1960s. This also brings home the fact that the distribution of gains amongst member states may affect further regional integration processes.

In general, as intra-regional trade among low-income countries tends to be lower than high-income countries (see e.g. Page, 2000, table 7.1 for 1996, ranging from more than 50% of total trade in EU15, less in NAFTA, MERCOSUR, ASEAN, 13% in

ANDEAN and CACM, 12% in SADC to just 4% in SAARC) and limited to fairly simple products (basic manufactures and perhaps food), the overall trade impact may not be great. However, the level and the share of intra-regional trade appear to be on the increase, although not in all regions in all years - see MERCOSUR and the EU which experienced a decline in the intra-regional share of trade over the last 5 years. Trade is probably more underrecorded in low-income countries than in high-income countries. Further, it is likely that intra-regional trade will be higher when income levels are higher and markets are larger, because higher income levels and larger markets allow specialisation and intra-industry trade amongst members. Hansohm (2002) argues that it is not surprising that progress in regional economic integration in Africa has remained modest because the expected benefits of regional integration are lower because of low-incomes and limited complementarities amongst countries.

**Table 10 Share of intra-regional trade in total exports and imports**

<i>RTA</i>	<i>Exports</i>			<i>Imports</i>		
	1990	1995	2002	1990	1995	2002
EU (15)		64.0	61.6		65.2	61.9
NAFTA (3)	42.6	46.0	56.5		37.7	38.1
ASEAN FTA (10)	20.1	25.5	24.0	16.2	18.8	23.6
MERCOSUR	8.9	20.5	11.5	14.5	18.1	17.0
ANDEAN	4.3	12.3	10.2	7.7	12.9	13.9
CARICOM	9.5	9.8		12.3	16.4	
SADC	3.1	9.9	10.0 <sup>1</sup>	5.1	9.9	10.2 <sup>1</sup>

Source: WTO (2003), *International Trade Statistics*; and Chauvin and Gaulier (2002)

<sup>1</sup> 1999

In some regions, there will be one large member (measured in terms of economic market size<sup>13</sup>) that derives most benefit (because it has a comparative advantage in regional manufactures, e.g. Kenya in EAC). The smaller countries are only likely to benefit if they produce niche products, e.g. if they are able to expand food exports to the large member. This distributional effect implies that the large member may have to compensate smaller members (a similar argument applies to distributing revenue from a common external tariff) – although in principle all countries should benefit from trade. Failure to agree compensation is one reason for RI among low-income countries to fail.

Because regions among developing countries typically affect a small share of total trade, and the trade effects are likely to be small, the revenue effects are also likely to be small. In developed-developing country regions, where trade diversion is more likely, revenue effects will be greater, making policy to offset any effects on income distribution more difficult.

To understand whether *services* liberalisation at regional level provides better outcomes than liberalisation at world level, and whether RTAs could affect the

<sup>13</sup> Small does not imply necessarily poor. For instance, Singapore is very rich compared to other ASEAN members. That is why we refer to small in economic size.

poverty focus of trade in services we could follow Stephenson (2002) who defines four different categories of services

1. Infrastructure-type services: financial, telecom, energy and transport
2. Business-type services: distribution, professional services, other business services, tourism, construction and engineering services, and environmental services
3. Social services: educational and health services
4. Other services: recreational, cultural

It is argued that in order to attract the most efficient service provider in the capital intensive category 1, it would make sense to liberalise beyond the region. World-wide services providers are likely to have better access to capital than services providers from a South-South region. For less capital intensive category 2, tourism is a relatively liberalised sector (although GATS often includes qualified commitments such as subject to national approval); construction and engineering services and professional services on the other hand depend on qualifications and national standards, so that RTAs may play a useful role in order to facilitate recognition across borders (within the region first). The third type of sectors is sensitive to national concern and it could be easier to liberalise these sectors amongst countries with similar levels of development, language, culture, etc. RTAs could act as a catalyst. The fourth category is mixed. Hence, for some sectors RTAs could be an appropriate starting level. However, it is premature to fully analyse differences in services liberalisation now as many regional protocol have not been ratified by all parties and those that have, have been in force for a short period.

#### *4.3 Does Regional Integration change the poverty “focus” of FDI*

Various factors determine whether RI changes the poverty focus of FDI. Table 11 below uses the FDI and development framework set up in table 1 to examine whether global MNEs could be expected to have a distinctive impact on development and hence poverty than regional MNEs. It argues that regional MNEs (in a typical developing country region) could have both advantages and disadvantages over global MNEs, but in practice very little work has been done in this area.

While there is by now quite a lot of evidence on differences between foreign and local firms (see section 2.2), there is not much on the effect of the source country of FDI. Some evidence, for developed countries, suggests that US firms pay higher wages and are more productive than other MNEs including from the EU in the UK (Te Velde, 2002a). Generally it seems that the potential benefits of global liberalisation are greater than of regional integration, but that the potential losses will also be greater. This implies that active public policies (as we discussed in section 2) increase in importance with global versus regional integration.

**Table 11 Regional Integration, FDI and development**

Impact Area	Indicators	Regional vs Global Integration
<b>Employment and Income</b>	<ul style="list-style-type: none"> <li>• Employment generation inside foreign firms</li> <li>• Wage levels for staff with given characteristics</li> </ul>	<ul style="list-style-type: none"> <li>• Global MNEs from the EU and US may pay higher wages than regional developing country MNEs.</li> <li>• Global MNEs may be more productive and hence create more employment in the long-run, but their superior productivity may also crowd-out more domestic employment.</li> </ul>
<b>Physical capital</b>	<ul style="list-style-type: none"> <li>• Fixed capital formation</li> <li>• Financial transfers</li> </ul>	<ul style="list-style-type: none"> <li>• Global MNEs will have better access to finance than regional MNEs</li> </ul>
<b>Market access</b>	<ul style="list-style-type: none"> <li>• Share of inputs imported</li> <li>• Share of output exported</li> </ul>	<ul style="list-style-type: none"> <li>• Global MNEs may export more than regional MNEs</li> <li>• Regional MNEs will source more regionally (because they may have regional networks); but this is not the case when global MNEs invest in order to source locally</li> </ul>
<b>Structure of factor and product markets</b>	<ul style="list-style-type: none"> <li>• Concentration in product and factor markets</li> <li>• Profit margins</li> </ul>	<ul style="list-style-type: none"> <li>• Profits of regional MNEs are more likely to stay within region, while global MNEs may send profits to their headquarters. But the effect for the host-country may still be the same.</li> </ul>
<b>Technology, skills and management techniques</b>	<ul style="list-style-type: none"> <li>• Skill level of employees</li> <li>• Training budgets</li> <li>• Output per employee</li> <li>• R&amp;D budgets</li> <li>• Types of technologies used</li> </ul>	<ul style="list-style-type: none"> <li>• Global MNEs will have more access to skills, technology and management techniques, compared to regional MNEs</li> </ul>
<b>Fiscal revenues</b>	<ul style="list-style-type: none"> <li>• Fiscal payments</li> <li>• Grants to foreign firms</li> </ul>	<ul style="list-style-type: none"> <li>• Many fiscal grants have been wasted to attract global MNEs; there may be regional competition but this often for global start MNEs such as Intel and General Motors</li> </ul>
<b>Political, social and cultural issues</b>		<ul style="list-style-type: none"> <li>• Regional MNEs are more likely to be culturally and politically acceptable</li> </ul>

The dynamic effects of FDI are often emphasised, and this can be an important way to address poverty in the long-run. Blomstrom and Kokko (1997) argue that regional integration leads to efficiency gains and higher growth. FDI can actually be such a catalyst through spillovers in terms of technology transfer and other linkages with local firms. There can thus be long-lasting effects on growth and productivity in addition to a one-off effect based on a more efficient allocation of resources. Not surprisingly, many studies examining the wealth effects of regional trade arrangements find large wealth effects. Wealth (or GDP) effects can ultimately benefit the poor depending on the distribution of the gains.

In practice, regions amongst developing countries affect only a small share of total FDI, i.e. intra-regional FDI is low as a percent of total FDI for low-income regions for SAARC, ASEAN, and even for SADC. One could infer from this that regions do not have an important role to play with respect to the overall poverty focus and impact of FDI. However, this would be wrong. Crucially, while trade rules in regions aim to at best create trade amongst members, trade and investment rules aim to raise investment from both members and non-members.

A dynamic issue relevant to the poverty profile across the region relates to the spread of investment across members. The possible divergence amongst members of developing country regions as a result of an uneven spread of benefits amongst (Venables, 1999) can be enhanced by agglomeration effects. Agglomeration effects refer to a spatial clustering of economic activities and is another way through which investment affects poverty. Agglomeration can occur within a county (e.g. cities) or across countries. Clusters of economic activities can lead to efficiency gains for instance because a pool of specialised support services is feasible due to economies of scale (e.g. Porter, 1998). If relocation effects occur within a region, this may lead to efficiency gains which may reinforce further relocation effects. This would lead to further divergence or convergence, which could affect the distribution of gains from

and ultimately the motives for regional integration processes. On the other hand, as argued in Ethier (1998) smaller (and possibly poorer – though this is obviously not the case in regions such as ASEAN) countries may actually have incentives to form a region in order to attract investment away from other members, particularly extra-regional FDI. This may be the case when regional tariff preferences allow foreign investors to set up beachhead locations in a small (or poor) country to serve the entire regional market.

Agglomeration effects occur through local and foreign investment. It would thus be important to ask how (intra and extra) foreign direct investment would affect regional integration processes in addition to other factors (parallel national reforms, country size, political and security issues, etc.). Competition for FDI may lead to the introduction of more efficient and organised regional policy and institutions, but there is also a possibility that such competition undermines regional integration efforts. Similarly, if not all countries can benefit from an increased amount of FDI or do not have the capabilities to benefit from it, this may also undermine regional integration efforts. FDI may affect the establishments of regional institutions relevant to FDI. For instance, competition for FDI between member states is thought to be one of the reasons why Mercosur is beginning to have talks on investment incentive issues (Chudnovsky and Lopez, 2003).

#### *4.3 Does Regional Integration change the poverty “focus” of migration*

The first notable issue is that intra-regional migration is low in developed and developing country regions, see table 12, as a percentage of total population. Obviously this can differ in other regions, e.g. in SADC where South Africa is experiencing significant immigration. On the other hand the intra-regional share of immigration is a quarter for MERCOSUR and a half for ANDEAN. This is higher than the intra-regional shares of FDI and trade, and this may indicate that that migration is likely to take place amongst neighbours. For the EU, the intra-regional share of immigration seems lower than that of trade and FDI. Also, the Filipino contract workers seem to prefer the Middle East over their own region ASEAN (8%). This can also be said for Indonesian labour flows. Overall the numbers are of limited significance, certainly compared the importance of FDI as per cent of total investment ([www.unctad.org](http://www.unctad.org)), or trade as per cent of GDP.

Secondly, the main source of remittances and most of the skills gained are both more likely to be associated with South-North migration rather than South-South. We can thus preliminary conclude that RTAs have a limited impact on poverty through migration (compared to say trade or investment), although we should emphasise that further research is required. Also, this does not deal with temporary movement of people, which can also be important in delivering services, which is in essence a trade issue (see coverage of trade in services).

**Table 12 Intra-regional migration**

	Intra-regional migration as % of population	Total migration as % of population	Intra-regional as ratio of total immigration
<i>Immigration</i>			
Argentina	1.28%	4.92%	0.26
Brazil	0.05%	0.52%	0.10
Uruguay	1.31%	2.92%	0.45
Paraguay	3.81%	4.51%	0.84
MERCOSUR	0.37%	1.42%	0.26
Bolivia	0.11%	0.93%	0.12
Colombia	0.17%	0.32%	0.53
Ecuador	0.44%	0.76%	0.58
Peru	0.04%	0.24%	0.17
Venezuela	3.21%	5.66%	0.57
ANDEAN	0.78%	1.47%	0.53
CARICOM (early 90s)	1%		
EU (2000)	0.80%	Ranges from 2.2 in Spain to 4% in UK and Netherlands to 5.6% in France and 8.9% in Germany and 37% in Luxembourg	< 0.20 for most EU member states (except 0.33 in Spain)
<i>Emigration</i>			
Philippines contract workers			0.08 (to ASEAN)

Sources: Fuchs and Straubhaar (2003), World Bank (2003) and Thomas-Hope (2002), World Development Indicators, Wickramasekera (2002)

#### 4.5 Regional Integration and poverty: non-trade and non-FDI routes

Various processes usually coincide with regional integration in various degrees depending on the region. Besides direct effects such as improved market access for trade in goods, investment, and more recently trade in services, there can be increased functional co-operation in regional infrastructure, security and protection of democracy, increases in market size and income levels, convergence and divergence amongst members of RTAs, co-operation in terms of movement of natural persons and regional investment funds and social programmes.

#### *Regional social programmes and investment funds*

Some regions specifically include regional investment bank or structural fund (ANDEAN, EU) often to finance development of backwards parts (countries, provinces) of the region. Ireland received 6% of GDP worth on structural funds in the 90s to finance infrastructure projects. Most recently, the FTAA has attempted to include a regional fund to support the adjustment effects of small and vulnerable states in the region.

### *Links Trade - Investment - Migration*

While this paper discussed the effects of RI on trade, investment and migration, there could also be effects on the connections amongst trade, investment and migration, which may ultimately affect poverty. Trade, investment and migration are linked. There are various papers that discuss links between FDI and trade (e.g. Barrell and Te Velde, 2002; can be substitutes or complements), trade and migration (Schiff, 1997), and FDI and migration (there is likely to be an association given the fact that there is significant capital flight and brain drain from several developing countries), but it is not clear how RI processes affect these interactions. However, such interactions may also be needed when examining the effects of RI on poverty via the effects on trade, FDI and migration.

### *Stepping stone or stumbling blocks*

There are a number of explanations for the increase in popularity of RTAs. One view is based on frustrations with the speed of multilateral liberalisation such as in the GATT and WTO. For example, Krugman (1993) argues that RTAs are easier to negotiate and implement than multilateral agreements as they typically involve fewer negotiating parties endeavouring to reach agreement on a narrower range of issues (though this may now not be the case anymore). Bhagwati (1993) advanced a related argument in putting the new regionalism down to US interests in a greater regional focus to trade negotiations through NAFTA and more recently the FTAA. The same issues can be raised with the current Doha round.

An alternative explanation is the 'domino theory' that exploits the fact that RTA's may result in trade and investment diversion. The greater the number of nations included, the greater the pressures on non-parties. Thus, a single initial agreement, if it is important enough, stimulates expansion of that agreement and/or proliferation of others.

Researchers disagree on whether RIAs are stepping stones or stumbling blocks to further liberalisation. Would an easier to negotiate RTA imply a slower level of multilateral integration (which would theoretically be more efficient) or would such a RTA decrease the interest in and ability of further multilateral integration. For instance, negotiating RIAs would attract scarce resources away, possibly from effectively negotiating at multilateral level. On the other hand negotiating experience gained at regional level might be relevant for negotiations at multilateral level.

There are others reasons why regions might be stumbling blocks (or stepping stones)? First, regions can lead to trade creation. Secondly, regional agreements could be less secure than other types of integration (customs unions normally survive by becoming countries; no FTA has ever survived more than 20 years), see Page (2000). This can have consequences for policy responses and benefits to the poor. If the benefits to the poor depend on the long term effects of trade, such long term effects may be less forthcoming within unstable regions. Hence, if poor people would like to capture benefits from regions, the immediate effects become more important, and will alter the choice of policy as identified in section 2.1 on trade and poverty. If there are negative effects from trade diversion, then the benefits will be reduced.

### *Voices of the poor in RTAs*

In sections 4.2 and 4.3 we posed the questions whether regional integration could alter the poverty focus of trade and FDI. In part this may depend on the economic conditions of the members of a RTA compared to non-members. But another part this may also depend on whether certain interest groups are able to negotiate certain outcomes. For instance, would vulnerable groups within countries be better represented in a region than at multilateral levels? There does not seem to be a lot of direct evidence for this, but is nevertheless a question worth asking, because better representation at the negotiating table may lead to more desirable outcomes (i.e. a more desirable poverty focus).

### *Deepening regional integration*

We have so far painted a mainly static picture of a Regional Integration Process through provisions on trade, investment and migration (although this does not preclude that the effects of static provisions can be dynamic and long-run). The only way in which we described the regional integration process as a dynamic process was through changes in and inclusion of more investment provisions. There is another way though which the regional integration process can be seen as dynamic. This is when regional integration leads to further functional co-operation including in areas that are not directly trade or investment policy oriented. It could include deepened integration in areas such as infrastructure and energy. This may have indirect trade and investment effects and could lead to significant poverty effects. In reality few developing country regions have achieved a high degree of regional co-operation. Deepening regional integration, particularly in Sub-Saharan Africa with the possible exception of SACU, has focused on implementation in the area of trade liberalisation, but clearly other routes are possible. One should thus pose the question whether the effects of regional integration on poverty are due to the limited way in which regional integration processes are implemented, in addition to whether regional integration can affect poverty in theory.

## 5 Conclusions

This paper discussed the relationships between regional integration and poverty. The main purpose of this review was to provide a framework that can inform those responsible for regional trade policy with respect to the presence of such links and where available with respect to the effects of available policy options on poverty. A second aim was that the resulting mapping should also be useful in identifying a checklist of areas relevant to assess the impact of RI on poverty in individual countries, and for this we would also need some hypotheses that can be tested in individual case studies.

### *Identifying the links between Regional Integration and Poverty*

The first aim of this paper was to set out linkages between regional integration and poverty. This conclusion contains the routes from RI to poverty on the basis of a simple mapping of four sets of links describing how poverty in a country is affected by RI processes.

This paper brings together the building blocks to examine the effects of regional integration on poverty. It discusses the routes from RI to poverty on the basis of a simple mapping of four sets of links describing how poverty in a country is affected by RI processes:

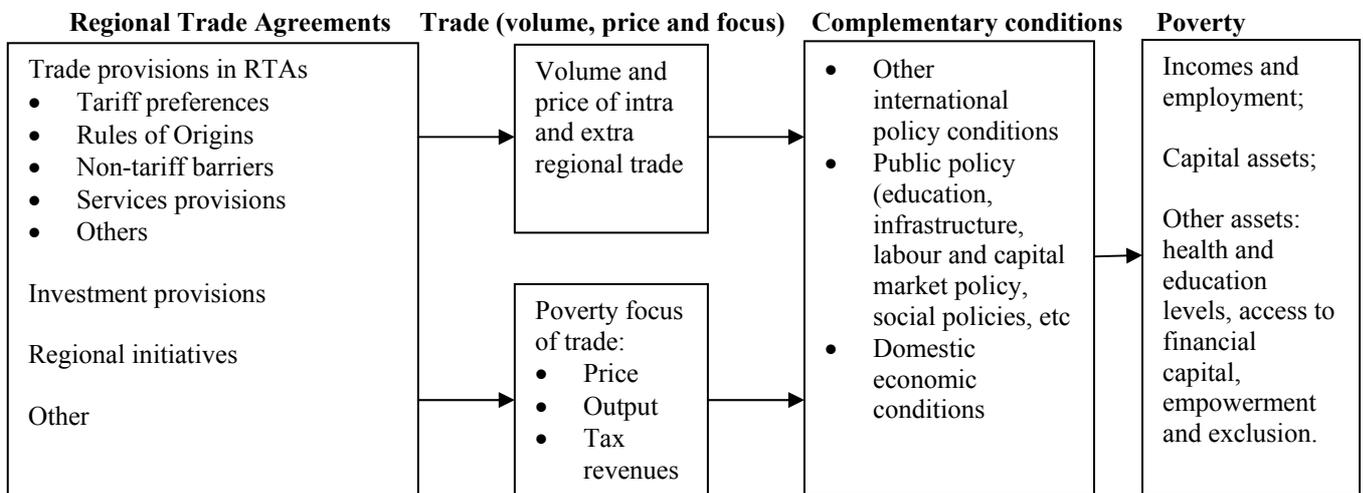
- RI can affect poverty through increased volume and/or poverty focus of trade
- RI can affect poverty through increased volume and/or poverty focus of investment
- RI can affect poverty through increased volume and/or poverty focus of migration
- RI can affect poverty through other routes

The first set of links between RI and poverty is through trade. Chart 3 covers a number of building blocks. RTAs include certain provisions that may affect the volume, price and “poverty focus” of trade. This may in turn affect different characteristics of poverty intermediated through complementary conditions including public policies. For a country that is a member of a particular RTA we should be asking a number of questions to unravel the effects of RTAs on poverty through trade. Similar questions could be addressed for a country that is not a member of the RTA, as it may nevertheless be affected, for example through trade diversion effects.

- **Regional Trade Agreement :**
  - What are the goods trade provisions (tariffs, rules of origin, NTB)
  - Are there specific provisions for trade in services
  - What are the investment provisions
  - Are there any other provisions (e.g. on migration, Customs)?
- **Trade (volume, price and focus)**
  - How have provisions in the RTAs affected the volume and price of intra and extra regional exports and imports (and the trade balance) of goods and services
  - How has the RTA affected the poverty focus of trade

- Does regional liberalisation lower import and domestic prices of products (goods and services) consumed directly by the poor or used in production processes that benefit the poor indirectly.
  - Has the RTA resulted in increased output in each country or have certain countries gained more than others.
  - Does the RTA lead to trade creation or trade diversion, and what are the effects of this on fiscal receipts.
- **Complementary conditions**
  - Does RTA include provisions that are different from other international policies and agreements such as the WTO.
  - Does the country have the capabilities to withstand competition with imports or exports in sectors with comparative advantage in the region.
  - Are public policies (labour, infrastructure, trade facilitation, education) geared towards enhancing import competition and export capabilities.
  - Does the government redistribute income or assets, through taxes, support for incomes, and provision of public goods, temporarily through safety nets or permanently to compensate (relative) losers of RTAs.
- **Poverty**
  - How does trade affect incomes and employment of the poor
  - Are there trade impacts on capital assets (equipment, land)
  - Other assets: health characteristics, education levels, access to financial capital, empowerment and exclusion.

**Chart 3 Regional integration and poverty via trade**

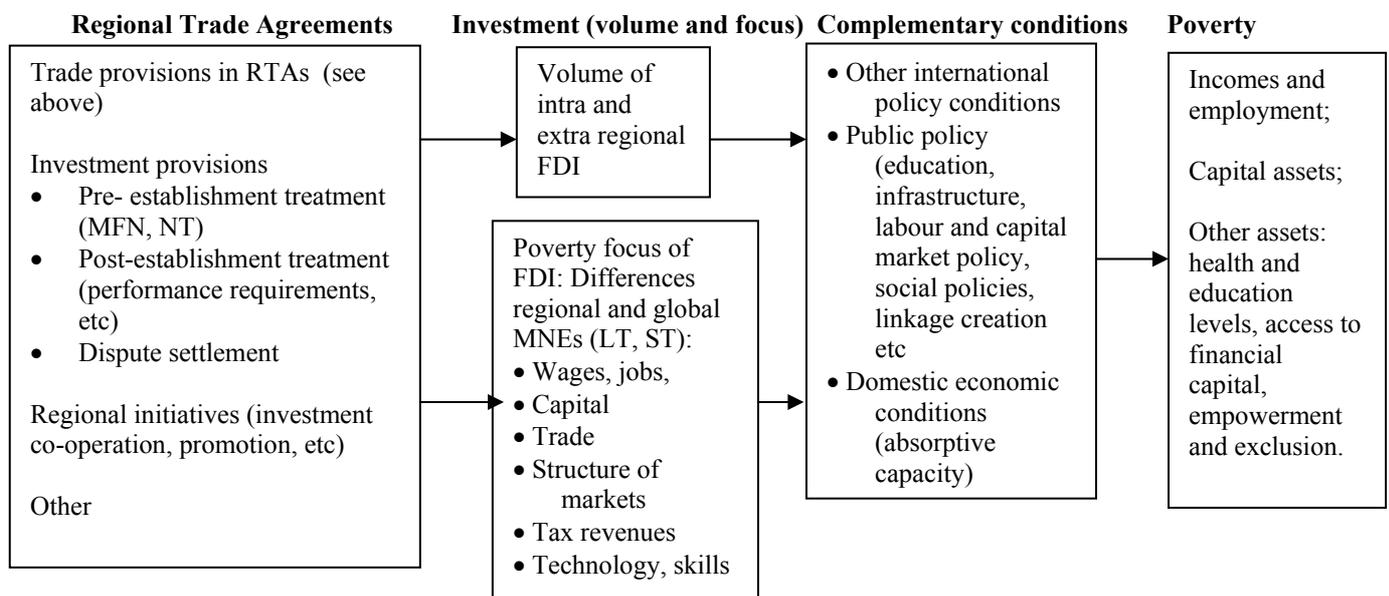


The second set of links between RI and poverty is through foreign direct investment. Chart 4 covers a number of building blocks. RTAs include certain provisions that may affect the volume, and “poverty focus” of investment. This may in turn affect different characteristics of poverty intermediated through complementary conditions including public policies. For a member of a particular RTA we should be asking a number of questions to unravel the effects of RTAs on poverty through investment, in addition to the questions already asked regarding trade effects.

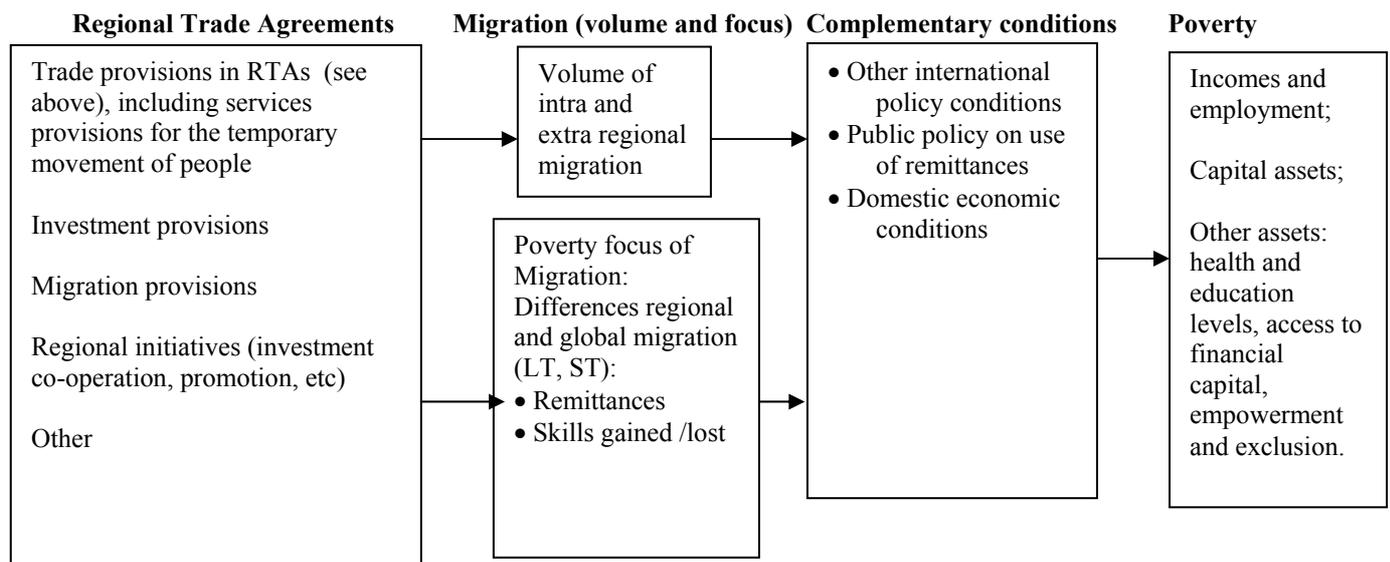
- **Foreign Direct Investment (volume and focus)**

- 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 MNEs, regional MNEs and domestic firms with respect to
  - Wages, jobs,
  - Capital
  - Trade
  - Structure of markets
  - Tax revenues
  - Technology, skills
- **Complementary conditions**
  - Does RTA include provisions that are different from other international policies and agreements such as the WTO (e.g. GATS, TRIMS) or bilateral investment treaties
  - Does the domestic private sector have the capabilities to withstand competition 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 and employment of the poor
  - How does the investment affect the level, productivity and distribution of capital assets (equipment, land)
  - Does investment affect other assets: health characteristics, education levels, access to financial capital, empowerment and exclusion.

**Chart 4 Regional integration and poverty via investment**



**Chart 5 Regional integration and poverty via migration**



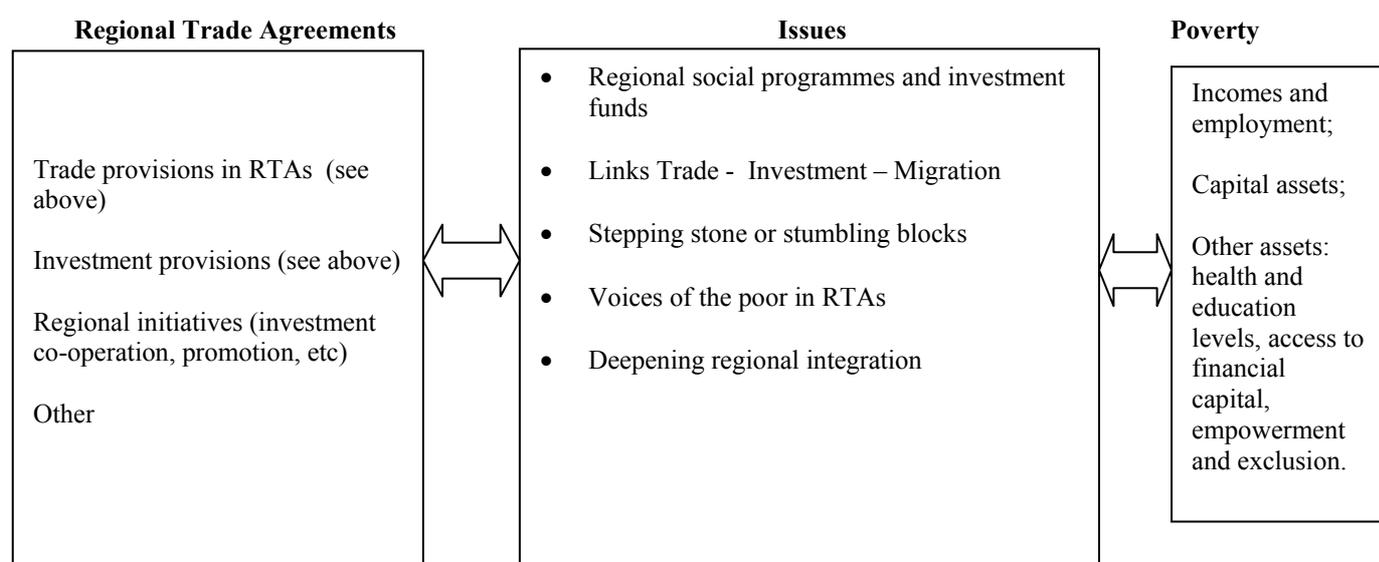
The third set of links between RI and poverty is through migration. Chart 5 covers a number of building blocks. RTAs include certain provisions that may affect the volume, and “poverty focus” of migration. This may in turn affect different characteristics of poverty intermediated through complementary conditions including public policies that facilitate the use of remittances. For a member of a particular RTA we should be asking a number of questions (in addition to those listed above) to unravel the effects of RTAs on poverty through migration.

- **Provisions relating to labour and migration**
  - How have provisions in the RTAs affected the volume of intra and extra regional migration
  - How has the RTA affected the poverty focus of migration, i.e. what is the difference between global and regional MNEs migration with respect to
    - Skills gained/lost
    - Remittances
  -
- **Complementary conditions**
  - Does RTA include provisions that are different from other international agreements relating to migration (e.g. GATS,)
  - Does the domestic private and public sector have the capabilities to withstand the temporary loss of skills and can they absorb the skills gained in return migrants
  - Are public policies geared towards channelling remittances towards the poor.
- **Poverty**
  - How does migration affect incomes and employment of the poor
  - Capital assets (equipment, land)
  - Other assets: health characteristics, education levels, access to financial capital, empowerment and exclusion.

The fourth set of links can be termed “other” links and relate to non trade and non-FDI issues in RTAs that may affect poverty or trade and FDI issues that affect regional integration processes. These issues included:

- Is the RTA associated with long-run or dynamic effects through competition and scale effects
- Is the RTA associated with convergence or divergence of income levels and how has this affected the regional integration processes
- Does the RTA include regional social programmes and investment funds
- Are there any significant links between an RTA and poverty through migration
- What are the links amongst Trade effects- Investment effects – Migration effects of RTAs
- Can the RTA be seen as a stepping stone or stumbling blocks towards further (multilateral) integration
- Have negotiations on the RTA included effective representation of poor people

**Chart 6 Regional integration and poverty: non-trade and non-investment routes**



*Further research*

This paper explored the expected (and actual, where evidence is available) effects associated with the above links. Gathering such evidence should make it possible to gain a better understanding of how regional integration affects poverty. For instance, some general empirical findings in the literature include (as testable hypotheses for individual countries/RTAs):

- RTAs boost intra-regional trade through tariff reduction; very strict rules of origin may dampen intra-regional trade or tariff preference take-up. The effect on trade will be greater if initial tariffs are higher, if tariff cuts are bigger, if rules of origin are not strict and if countries can easily comply with rules for using preferences. Regions that include countries with low incomes and trade

in similar and simple products can expect less gain from specialisation (which could affect their motives in deepening regional integration).

- Effects can interact: RoO are more relevant if preferential tariff rates are substantially lower than extra-regional tariffs
- RTAs are likely to lead to increased extra-regional FDI; various RTAs have led to net investment creation. Trade and investment provisions in RTAs can both affect investment, but the precise effects will depend on a range of factors.
- Increased trade and investment is likely to lead to faster economic growth and poverty reduction particularly when economic conditions and appropriate public policies are in place. However, for poorer people many such effects will be indirect as they are less well integrated in the formal international economy. Moreover, investment has a tendency to raise income inequalities if not counteracted by public policies.
- The intra-regional share of trade and investment in the trade and investment is lower for developing regions than for developed regions, so regional integration covers a smaller share of trade and investment. While trade provisions are important for increasing intra-regional trade and hence the intra-regional share (without aiming to divert trade), trade and investment provisions in regions are also likely to raise extra-regional FDI and hence the effect on the intra-regional share of investment is ambiguous.
- The intra-regional share of migration is low as a per cent of total population (e.g. compared to the importance of FDI as per cent of total investment, or trade as per cent of GDP), and while South-South agreements may help to spur migration, it does not deal with South-North migration associated with remittances.
- An important effect of regional integration can be through non-traditional provisions such as services and investment provisions and functional co-operation in energy, infrastructure, regional development banks, regional investment promotion and regional enterprise schemes. However, many regions amongst developing countries, particularly low-income countries, have not a long history in trying to implement a significant amount of new provisions in addition to tariff reductions.
- There are obviously noticeable differences in the amount of provisions in RTAs. Some RTAs with middle to high income countries include investment provisions, and several RTAs include services and migration provisions, while most have implemented (and all have plans) reductions in tariffs. Few regions have deepened and implemented regional integration to encompass significant integration of transport and energy issues. So, especially for RTAs amongst low-income countries, a important question is to what extent they have included and actually implemented provisions and why.

Unfortunately, much of the available evidence is based on multi-country or multi-region studies, deals with averages and fails to identify which provisions in which RTAs have what effect (on trade, FDI, poverty etc.) in which country. While we have documented that trade and investment provisions differ markedly across RTAs and across time, (econometric) studies that examine the effects of regional integration often use simple dummy variables to describe regions. This is problematic for those who want to negotiate the best possible type of regional agreement: in reality no region is the same and some guidance is required on best-practices in provisions in RTAs. For many other links we do not have evidence at all. Further, the

implementation of provisions varies across regions, and some regions have achieved a higher degree of functional co-operation.

This paper suggests two ways in which we will aim to contribute to an improved understanding of the effects of regional integration on poverty (but there are many other ways). The first is to conduct a more detailed study on the effects of specific trade and investment provisions on trade and investment. A background paper motivates more clearly an empirical study on the links between investment related provisions and FDI (Te Velde and Fahnbulleh, 2003).

Secondly, we will aim to test the mapping structure set out in this paper and as summarised in the first part of this conclusion on the basis of two case studies. There are various countries that would be relevant for this. Due to time constraints it will be possible only to do this for two countries. Bolivia, part of LAIA and ANDEAN (and FTAA due to start in 2005) and associate member of MERCOSUR and featuring in the EU and US GSP systems, and coupled with having one of worst poverty records in Latin America may be a good first case study to examine the effects of RTAs. A second case study in Africa will be Tanzania. Tanzania is a member of the CBI, EAC (old and new) and SADC and is also part of others such as GSP systems and the Cotonou Agreement, but withdrew from COMESA. At first sight the two countries also differ with respect to implementation. Bolivia has implemented more provisions for a longer time in ANDEAN compared to Tanzania in COMESA. Tanzania seems an example of limited implementation of regional provisions as is common in most African RTAs (except those in the South), while ANDEAN has included investment provisions since the 1970s, zero intra-regional tariffs as well liberal migration and services provisions. So this selection could be used to shine an empirical light on (and refute, but not accept) often made remarks such as: regional integration does not work for low-income countries' development because the theory says benefits are minor, or it does not work because regional integration has not been implemented properly.

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