RESEARCH PAPER

# Regional Approaches to Integrating Small Economies into the World Trade System

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# Regional Approaches to Integrating Small Economies into the World Trade System

This paper describes small developing countries' experience with regional cooperation to meet their international trade goals, including membership in the World Trade Organization (WTO). The conclusion is that to date most types of cooperation among small countries have not been sustainable. The most useful trade capacity building occurs at the country level. Although donors have continued to encourage regional cooperation by providing substantial resources, few results have been achieved. The traditional approach—support for regional institutions—has not been successful, and different approaches are called for.

This paper makes several suggestions for more promising approaches to regional cooperation. First, rather than beginning inclusively with countries having varying degrees of commitment to the regional goal, only the most committed countries should be included initially to permit faster progress on regional goals. Other countries can be invited to join later on the basis of the established norms. Second, regional cooperation should focus on smaller, concrete actions rather than broad commitments. This will mean that technical issues (e.g., the location of a regional standards laboratory) will be addressed technically, not politically. Regional secretariats often are viewed as unresponsive to the needs of members or to opportunities for political patronage, or both. Consequently, budgets for regional bureaucracies should be minimized, with the primary emphasis placed on the involvement of officials from member countries. Finally, inclusion of one or more advanced countries in the regional grouping will substantially increase the development benefits of regional cooperation, as will low external tariffs.

## SMALL STATES AND SPECIALIZED EXPERTISE

Small countries are at a disadvantage in foreign affairs. Like larger countries, they need one foreign minister and one ambassador in important countries. The same holds true in trade policy. Membership in the WTO implies certain obligations and ongoing responsibilities. Large countries can more easily afford the cost of staff in Geneva to interact with other countries on WTO matters and specialized expertise to formulate trade policy and implement WTO commitments in intellectual property, services, or customs valuation. To illustrate the complexity of trade policy in today's world, the U.S. trade policy formation process has approximately 84 subcommittees and 8 task forces addressing the complexities of U.S. participation in the world trading system. The level of specificity and analysis such activity implies appears to put small countries in a difficult position for negotiating on trade issues. Escaith (2001) provides a detailed statement of the "diseconomies of small scale" for the small economies in the Latin American region.

One obvious solution to this problem is for small countries to band together to share costs and divide responsibility for specialized topics. For example, a group of small countries might agree to

joint representation at the WTO. For specialized needs, they might agree on a division of labor among government trade professionals—with one specializing in intellectual property, another in sanitary and phyto-sanitary issues, and another in antidumping. And beyond WTO issues, small countries might see advantages in joining together to achieve a variety of national purposes such as export promotion through coordinated institutions or a regional free trade agreement, monetary integration, financial or stock-market coordination, or other initiatives.

These considerations suggest a strong case for small countries' cooperation on trade. If this is the case, however, it should be evident in small countries' actions. If small countries really gain from regional cooperation—that is, receive benefits substantially larger than their costs—they should be willing to pursue such cooperation without donor help. Or, where donors have helped create a regional institution, small countries should be willing to maintain it after donor funding has ended.

The performance of small developing countries appears to contradict this claim. There is little evidence of sustained cooperation among small countries in any of the various aspects of trade policy or in specialized aspects of participation in the world trading system, despite considerable efforts by donors—notably, the European Union, USAID, the World Bank, and the Inter-American Development Bank—to promote regional approaches. This lack of success indicates that new, more limited and focused approaches are needed to properly address the problems of small countries.

## RECORD OF SMALL COUNTRY COOPERATION ON TRADE

### What Is a Small Country?

Developing countries come in all shapes and sizes. Which countries are small enough that they should seek cooperative regional approaches instead of national ones to meet their international trade goals? Table 1 presents developing countries based on country size.[1]

**Table 1. Developing Countries by Size Categories and Shares of Total Population and Exports**

| Population Range | No. of Countries | Share of Developing Country Total (%) | | Exports/Capita (dollars) |
|---|---|---|---|---|
| | | Population | Exports | |
| Under 100,000 | 8 | 0.0 | 0.1 | 2,543 |
| 100,000 to 1 million | 21 | 0.2 | 0.9 | 1,650 |
| 1-10 million | 60 | 6 | 9 | 495 |
| 10-100 million | 54 | 32 | 59 | 582 |
| Over 100 million | 8 | 63 | 31 | 154 |
| Total | 151 | 100 | 100 | 312 |

SOURCE: World Bank, World Development Indicators (WDI), 2002.

Note: Data for all developing countries included in the WDI.

[1] Political entities excluded from the World Bank's compilation of developing countries include Anguilla, the British Virgin Islands, and Monserrat. All three are members of a regional grouping of small Caribbean islands, but apparently are excluded because they are still colonial dependencies.

Eight countries, which might be called "micro-states," have fewer than 100,000 people, another 21 have fewer than one million, and 60 have fewer than 10 million. Together these 89 countries make up 6.2 percent of the population of the developing world. Geography is also an important factor in very small countries—the 14 smallest are all islands or collections of islands, 6 in the Caribbean, 6 in the Pacific, and 2 off the coast of Africa.

Sixty-four small developing countries are members of the WTO, constituting nearly half of that organization's 144 members. Another 14 are WTO observers, which implies a commitment to join the organization within 5 years. As shown in Table 1, small economies are more dependent on trade than are larger economies. The 89 countries with fewer than 10 million citizens account for 10 percent of all developing country exports, but only 6.2 percent of the combined populations of developing countries. Thus, although small economies are only marginal factors in world trade, trade is more important to them than to larger countries. The narrow range of goods that are likely to be efficiently produced in small countries means that they will be more vulnerable to shifts in prices and demand than larger economies. They will export a few commodities and import a range of goods. The last column in Table 1 shows this clearly. Per capita exports and imports of countries fall as the population rises.

Table 2 provides information on countries that the United Nations has categorized as least developed (or LDCs). As the table indicates, countries in the smallest population category tend not to be extremely poor. Only one of the eight developing countries with a population below 100,000 is in the least developed group.[2]

**Table 2. Least Developed Countries by Size Categories and Shares of Total Population and Exports**

| Population Range | No. of Countries | Share of LDC Total (%) | | Exports/Capita (dollars) |
|---|---|---|---|---|
| | | Population | Exports | |
| Under 100,000 | 1 | 0.0 | 0.1 | 467 |
| 100,000 to 1 million | 10 | 0.6 | 6.8 | 559 |
| 1-10 million | 20 | 17.6 | 23.7 | 69 |
| 10-100 million | 16 | 61.7 | 51.2 | 42 |
| Over 100 million | 1 | 20.1 | 18.2 | 46 |
| Total | 48 | 100 | 100 | 51 |

SOURCE: World Bank, World Development Indicators (WDI), 2002.

Note: Data for all LDCs except Tuvalu.

Least developed countries show the same tendency for per capita exports to decline sharply with increasing country size. Nevertheless, they export far less than other developing countries in the same population category. Overall, per capita exports of least developed countries are about one-sixth of developing countries generally. Thus, least developed countries are poor in part because they trade little with the rest of the world.

[2] Tuvalu, with a population of about 10,000, is a second small least developed country, but the World Bank indicators provide no data on it so it is excluded from both tables.

In practice, the definition of "small economy" used by donors has generally been flexible and inclusive. Among the inter-governmental working groups for the Free Trade Area of the Americas (FTAA) is one for identifying the technical assistance needs of small economies for participation in the FTAA. The 17 countries for which technical assistance requirements have been identified include all of the micro-states of the Caribbean, the small economies of Central America, in addition to Bolivia and Peru, the latter of which has a population of 25 million.

For the purposes of trade capacity, however, population is not a particularly strong indicator. Hong Kong and Singapore have become major exporters and centers for a wide range of specialized expertise on trade issues. In Africa, Mauritius is a similar case. Despite a population of only slightly more than 1 million, it exports nearly as much as Kenya and more than Tanzania, despite the far larger populations of these two countries. Mauritius exports more clothing to the United States than all of continental Africa combined, and has become a source of trade expertise and investment for other African countries. Its emergence as a "large" exporting country has occurred over the past three decades as the result of favorable policies and investments.

## How Might Small Countries Cooperate?

Small countries might want to cooperate for a number of trade-related purposes, which can be categorized in two groups: (1) meeting WTO requirements and (2) achieving national purposes.

The main forms of cooperation suggested in each category are described next, along with indications—based on a review of the literature and a limited number of interviews with experts—of the extent to which the approach has been sustainably used by developing countries.

Over the last several decades, small countries have experimented with regional cooperation on trade and trade-related matters. The most promising means of identifying what is likely to work in the future is to look at what has been successful in the past. In principle, the experiments that have saved costs for countries, or increased their effectiveness, or both, are those that are sustainable. These are likely to be continued. This sustainability test is critical to assessing the underlying commitment to the activity, for the idea of regional solutions to problems of small countries is an "evergreen" one that both donors and small countries regularly propose as a panacea.

Two caveats are in order for the analysis below. First, because of the paucity of analytical or descriptive studies of much of the experience of countries in these areas, the findings in this paper are sometimes based on thin information. The conclusions should therefore be regarded as tentative. Where major changes in donor approach are suggested, additional research may be warranted.

Second, "sustainable use" of any tool in this context means that developing countries have cooperated, using their own resources to maintain the cooperation. Developing countries have shown themselves willing to engage in a range of regional initiatives, as long as donors paid the bills. But the number of cases where a supra-national effort is fully supported by contributions from participating developing countries appears to be much smaller.

### *Meeting WTO Requirements*

- ***Standard Setting.*** The increasing complexity of technology has created the need for a variety of standards of quality or composition. Standards organizations can certify firms' production

as meeting international standards. And such standards can be used to prevent importation of products that do not meet national metric, safety, or health standards.

? *Experience suggests:* Small developing countries have shown little interest in regional collaboration in this area. The most ambitious effort, by the countries of Central America, was the Central American Institute for Research and Industrial Technology (ICAITI). ICAITI was created and maintained for several decades with substantial donor funding, but was finally closed in the late 1990s when the Central American governments were unwilling to continue its funding.[3]

- ***Meeting Foreign Sanitary and Phyto-sanitary (SPS) Requirements.*** For agricultural products in particular, developed countries have established complex rules for plant diseases and pesticide contamination. Constantly changing, these rules are frequently highly specific to particular products. Consequently, potential exporters of products subject to SPS requirements need access to up-to-date, product-specific expertise.

  ? *Experience suggests*: USAID has had some success in providing expertise regionally in the Caribbean, but no cases were identified of developing countries cooperating jointly on their own. Moreover, the typical channel for information flow is between the producer and his buyer or marketing agent in the importing country. Collaboration, or cost-sharing, among individual producers, whether in one country or several, is likely to be a more effective channel for such information than inter-governmental efforts. The major supermarket chains are gradually becoming the *de facto* channels for development and transmission of relevant standards to producers of agricultural products in developing countries. Consequently, collaboration with such firms to maximize the development impact of such standards (e.g., by working to assure that smaller agricultural producers can participate, as USAID is doing in one current project).

- ***Implementing Safeguards.*** WTO member countries have the right to implement safeguards temporarily to impede or prevent imports from threatening important national interests, as long as the safeguarding country is prepared to compensate for losses. This is the basis, for example, on which the United States imposed temporary tariffs on steel imports. To implement safeguards in a WTO-consistent fashion requires specialized expertise that trade officials in very small countries are unlikely to possess.

  ? *Experience suggests:* COMESA has considered providing such services to its members, but has not so far begun to provide such services.

- ***Seeking Redress.*** Any exporting country may encounter a trading partner's unfair trade practices. WTO procedures for seeking redress are complex and legalistic. Consequently, smaller, poorer countries might want to cooperate regionally to develop the specialized expertise necessary to seek redress.

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[3] Donor interest in such matters appears to be evergreen. A recent World Bank paper by Hufbauer, Kotchwar, and Wilson (2001, p. 34) proposes that Central American countries set up a regional standards institute to avoid duplication by five national organizations. There was no apparent indication in the paper that the authors were aware of the ICAITI experience.

? *Experience suggests*: No cases were found of small developing countries collaborating in this way. The Rules Division of the WTO provides some assistance to developing countries for remedies. The assistance is generic, however, and does not include filing of complaints.

### *Achieving National Purposes*

- ***Market Widening Through Regional Trade Agreements (RTA).*** Small countries, especially similarly placed countries, have frequently sought to use RTAs as a vehicle for national economic growth. The rationale is typically that an RTA provides greater scope for gradual industrial development through widening of small markets, while offering protection from highly competitive world markets. Theory suggests that after producing for regional markets firms will be better prepared to compete in world markets. Thus, the RTA is a competition "hothouse," preparing infant industries for later competition in world markets.

  ? *Experience suggests*: There is little indication that developing countries' regional collaboration in preferential trading arrangements has succeeded in promoting the long-term interests of the participants. Such arrangements have typically not even succeeded in being implemented according to the operational goals established for them. Experience also suggests that firms nurtured in hothouse environments seldom learn the lessons needed to compete in world markets. This complex topic is discussed later in the section on "The Special Problem of Regional Trade Agreements."

- ***Export Promotion.*** Small neighboring countries often export similar goods or services. Consequently, the scope exists for economizing through joint efforts to market products abroad or to develop new products beyond the capacity of individual countries (e.g., through promoting tourism that includes several countries with different attractions).

  ? *Experience suggests:* Caribbean countries appear to have had some success in coordinating tourism strategies and in pursuing policy action such as "open skies" for air travel that promise benefits to the participants. This effort appears to be primarily the result of individual national tourist agencies cooperating, rather than of replacement of a national effort by a regional one. In other areas, combined export promotion entities appear to be few except where donor support is involved.

- ***Monetary Integration.*** Some groups of developing countries have adopted a common currency to simplify participation in the world economy. Monetary and balance of payments management can be centralized in a single monetary authority for all the countries in the currency union.

  ? *Experience suggests*: The three currency areas involving developing countries—the Eastern Caribbean monetary union, the CFA-franc zone in West Africa, and the Rand area in Southern Africa—appear to have operated successfully. They limited the capacity of political leaders to pursue expansionist monetary policies, and regional central banks have a reputation for being managed more capably than most other regional institutions. Central banks are distinguished from other institutions by their relative freedom from

budgetary constraints. A regional central bank can be financed through *seigniorage* without recourse to budgetary outlays of member government.

- ***Regional Stock Markets***. Some small countries have promoted regional stock markets and other forms of regional financial integration as vehicles for promoting savings and increasing access to capital for new investment.

  ? *Experience suggests*: A regional network of stock markets has little prospect of sustainability. Stock markets are likely to flourish only with high volumes that ensure liquidity and with low transactions costs—neither of which is characteristic of any network of national stock markets. A single regional market is a more promising direction and can help meet regional needs for capital and savings where financial markets are free and transactions costs are low. In some cases, developed-country stock markets have provided larger firms in poor countries with access to capital.

- ***Regional Trade Negotiators***. Small countries may agree that each lacks the specialized expertise necessary to effectively negotiate their national interests. A regional mechanism for trade negotiations implies granting a specialized staff authority to protect cooperating countries' interests. These persons would have knowledge of the decision-making process in multilateral negotiations in WTO or FTAA or other relevant forums.

  ? *Experience suggests*: The most notable experiment is the CARICOM countries, which have established a Regional Negotiating Machinery (RNM) to speak for member countries in WTO and FTAA negotiations. This has permitted the development of a skilled team of negotiators to represent the interests of members. However, the diversity of interests among member countries has meant that the RNM might occasionally have to defend the least common-denominator position. Such positions typically defend the *status quo* and may not represent the best interests of the members for the future. In FTAA negotiations, the RNM negotiators have sometimes been viewed as defensive and obstructionist. Also, the RNM appears to be substantially donor-funded, so its sustainability is yet to be demonstrated.

- ***Economic Policy Coordination*.** Some have suggested that small countries in any sub-region work together to assure that national economic policies are consistent with those of neighboring countries.

  ? *Experience suggests*: Large developed countries have had little success in economic policy coordination beyond comparison of national intentions and forecasts. Little can be gained by small countries working in this area, because their impact on the world economy, or on each other, is typically small.

## THE SPECIAL PROBLEM OF REGIONAL TRADE AGREEMENTS

Most of the vehicles for regional cooperation discussed in the previous section have received little attention by either developing countries or donors. The single largest area for cooperation among small countries has been the creation of regional free trade groups, or RTAs. A summary of the experience of the regional groupings with small developing countries is shown in Exhibit 1.

## Exhibit 1. Major Regional Groupings with Small Developing Countries

**CARIBBEAN COMMUNITY AND COMMON MARKET**

CARICOM was established in 1973 by four small Caribbean basin countries after 15 years of earlier efforts to promote regional integration among former British colonies in the region. Membership has since grown to include OECS countries and several others and now includes 14 countries. Repeatedly regional free trade was to be achieved, but deadlines were replaced by new initiatives that implied commitments at a time farther in the future. The most recent manifestation of CARICOM is the Caribbean Single Market and Economy (CSME) founded in 1994. Nevertheless, Brewster, *et al.* (2002, 9) state that "the lack of knowledge of regional affairs throughout the region is alarming. The bulk of the population knows little about CARICOM, let alone understands what the CSME entails. Regionalism has largely been an elitist occupation."

**CENTRAL AMERICAN COMMON MARKET**

Established in 1960, the CACM has included five Central American countries, and quickly led to free trade in manufactured goods, but not agricultural products. The CACM was first interrupted in 1969 by war between two members, and then in the early 1980s by non-payment of intraregional trade debts. It has moved from an initially high external tariff at the outset to much lower, but not fully harmonized tariffs at the end of the century. The CACM has never had a reliable means for settling trade disputes. Since 1999, one member has unilaterally imposed a 35 percent tariff on another, its grievance being the member's ratification of a boundary treaty with a third country.

**COMMON MARKET FOR EASTERN & SOUTHERN AFRICAN COUNTRIES**

The largest regional grouping in Africa, COMESA includes 20 countries of North, Central, and Southern Africa. It was established in 1994, replacing an earlier grouping, the Preferential Trade Area, created in 1981. About half of the member countries eliminated tariffs on intraregional trade in 2000, subject to rules of origin that have never been fully agreed among the member countries. Goals for 2004 are full trade liberalization and establishment of a common external tariff. COMESA's progress in eliminating tariffs among member countries has been more rapid and complete than that of most other developing country groupings. Nevertheless, it does not have an effective conflict resolution mechanism, and individual members have been able to treat imports from other members arbitrarily. Uncertainty about such uncertainties, as well as about political stability in some countries (e.g., Zimbabwe) has meant that few businesses have been willing to invest based on access to a COMESA-wide market.

**ECONOMIC COMMUNITY OF WESTERN AFRICAN STATES**

Established in 1975, ECOWAS includes 15 Western Africa countries. The target date for full customs union was 1990, then 2000, and is now set for 2005. Trade liberalization is still far from complete, and the 2005 deadline will also be postponed. Movement of goods is incomplete even in some of countries of the region. Kufuor (2000, 138) cites a report by the ECOWAS Secretariat that in 1999, 174 roadblocks existed along the road linkage Lagos-Cotonou-Lome-Accra-Abidjan-Ouagadougou. Eight francophone countries that form the West African Monetary Union (UEMOA), a subset of ECOWAS, maintain a common currency. These countries have considerably more monetary stability than other West African countries. ECOWAS has proposed monetary union of the non-UEMOA countries, to be followed in 2004 by integration into a single monetary zone. As with trade liberalization by 2005, this will not happen. ECOWAS's prospects are limited by political instability and conflict within several of its members, the expectation of future instability, and varying commitments to regional issues. More important, the largest member of ECOWAS, Nigeria, has serious internal political and economic problems that probably will need to be resolved before it can be a regional anchor for the smaller countries.

**ORGANIZATION OF EAST CARIBBEAN STATES**

The OECS group includes nine small Caribbean states with populations ranging from 12,000 to 150,000. Together, the population of the grouping is less than 600,000. Also a member of CARICOM, the OECS was established in 1981, following earlier unsuccessful regional efforts that included the West Indies Federation and the Eastern Caribbean Common Market. The treaty establishing the OECS explicitly envisaged joint overseas representation and common services, as well as economic integration.

**SOUTHERN AFRICAN DEVELOPMENT COMMUNITY**

SADC was originally established as a grouping of "front line" states to reduce economic dependence on South Africa. With the end of Apartheid, South Africa became a member, and SADC's focus became one of economic integration of Southern Africa. Nine of the SADC members are also members of COMESA. Though some steps have been taken toward harmonization of COMESA and SADC nomenclature and procedures, the two institutions are still operating at substantial cross-purposes. Nev ertheless, the size and stability of the South African market provides a more reliable basis for investment in the smaller SADC countries than do any of the other RTA groupings discussed here.

Experience in promoting RTAs should be examined in three ways. First are traditional static economic concepts of trade diversion and trade creation that economists use to analyze the impact of RTAs. Second are dynamic effects that may come from "infant industry" effects of RTAs, providing an initially protected environment for firms that may eventually achieve competitiveness in world markets. And third is the question of whether RTAs provide a reliable platform for firms to make investment decisions that would bring "infant industry" as well as other dynamic effects into play.

### Trade Diversion and Trade Creation

Economists traditionally base their analysis of the impact of regional groupings on the concepts of *trade diversion* and *trade creation*. Trade diversion occurs when a country ceases to import a product from the low-cost source on the world market and buys instead from a country within the free trade area whose price is higher than the world market price, but lower than the world market price plus the RTA's external tariff. The country has lost in two ways. It is importing a higher-cost product, and it has lost the tariff revenue previously collected on the import of that good.

Trade creation, in contrast, occurs when production shifts from the domestic economy to that of another member of the RTA. Before formation of the RTA, the product was not imported because the domestic price, while higher than the price in the trading partner, was lower than that price plus the tariff. The shift in production thus results in more efficient production.

For developing countries, the experience has been that little trade creation occurs. Instead, imports that previously came from world markets now come from other RTA members. Schiff (2002) provides a compelling justification for this view.

### Infant Industries and RTAs

Many proponents of RTAs accept the trade diversion–trade creation dichotomy as true in a static sense, but irrelevant in a dynamic one. The principal rationale that has been used to justify RTAs is the "infant industry." Firms producing manufactured goods inside the RTA will initially have higher costs than the world market; but costs will come down as they learn, and they will eventually be able to compete in world markets themselves, giving the country an export capacity.

Yet the empirical record of RTAs in this regard has been, at best, extremely disappointing. Few of the firms that prospered in regional groupings such as the Central American Common Market (CACM) were able to prosper when external tariffs were lowered and they were forced to compete in world markets. The CACM countries did indeed demonstrate a capacity to export to world markets once trade liberalization occurred, but the new exports tended to come from either new indigenous firms or from foreign investors. This is exactly the outcome that Keesing and Singer (1990) predicted, arguing that "hothouse" firms learned three lessons that made them incapable of competing later in world markets: (1) that quality didn't matter; (2) that delivery schedules were unimportant; and (3) that product presentation or packaging was irrelevant. These lessons do not prevent success where high tariffs prevent competition, but they make exporting to world markets impossible.

The failure of past RTAs to support the infant industry rationale should not be interpreted to mean that such infants do not exist. Indeed, the experience of the Asian tigers, among others, has shown that government promotion or subsidization of firms can produce dramatic and cumulative

change in comparative advantage over the space of several decades. It is a question of the most effective tool for promoting infant industries, and RTAs have not been shown to be effective in this.

Some have argued (Salazar-Xirinachs 2002b) that the "new" regionalism—RTAs with a low common external tariff wall—is much more likely to yield positive results than the "old" regionalism, where tariff barriers to the products of nonmembers were very high. Using very low-powered tests, Salazar-Xirinachs suggests that the recent RTAs in Latin America have tended to be more trade-creating than trade-diverting. This view has some merit. In any case, low overall tariffs will limit the scope for trade diversion. And to the extent that RTA negotiations cause countries to reduce tariffs on imports from nonmembers below their pre-RTA levels, overall levels of distortion in the economy might be reduced.

Some have suggested that RTAs might play a positive role in a different kind of infant industry—that of trade negotiations. In this view, RTAs among poor countries provide a training ground in negotiation and policy development for trade that will help the member countries in the WTO. This argument surely has some merit. But it should also be recognized that trade negotiations require time and effort. Some African countries belong to several regional RTAs as well as to the WTO. Limited numbers of policy staff may find themselves unable to manage satisfactorily the burden of several simultaneous negotiation processes.

### Do RTAs Deliver What They Promise?

A third issue of RTAs is the uncertainty of the environment that they create. Few RTAs created in recent decades have implemented the tariff reduction schedule announced at the outset. Elimination of non-tariff barriers and arbitrary treatment of imports have been still rarer. Developing country RTAs have typically lacked any enforcement mechanism to require participating countries to live up to their obligations. Consequently, in practice, most RTAs have not provided the environment that they promised at the outset—one where private firms can invest with confidence because the future environment is predictable.

Even where an RTA among small developing countries has provided a relatively stable and predictable environment—for which the CACM is the only clear case—the combined market of a group of small countries is still a small market. Unless firms can move from regional to world markets, the impulse to economic growth will be limited to the time until the regional market becomes saturated. In the case of the CACM, very few firms were able to make the leap.

### The Special Case of North–South RTAs

While recent literature (Schiff 2002, World Bank 2000) has been skeptical of the value of RTAs among small developing countries, it has embraced the idea that poor countries would benefit substantially from RTAs with developed countries. Spain with the EU, or Mexico with the North American Free Trade Agreement, or small Southern African countries with the Southern African Development Community (viewing South Africa as a developed country) appear to have benefited significantly from an RTA with larger and more advanced economies. The smaller economies benefit from the tendency for developed-market economies to be much larger and more stable (less subject to policy shifts that close their borders) and for the attraction of lower labor costs to outweigh agglomeration effects for industry.

## REGIONAL COOPERATION¾ WHY HASN'T IT WORKED?

The evidence gathered on regional cooperation suggests little success despite great effort by countries themselves and through major donor support. Regional cooperation appears to be attractive in principle, but disappointing in practice. Why don't small countries cooperate? On review of past efforts of individual cooperation, at least five factors emerge.

- ***Membership in a regional grouping is seldom unambiguous.*** Even where "mini-states" are involved, like those of the Eastern Caribbean, questions arise about who to include and who to exclude. Questions about changes in structure to permit new members or to retain existing members whose commitment is flagging will always arise. Membership tends to grow over time, and purpose is consequently redefined. Countries that want to cooperate more closely are held back by the larger group.
- ***The "free rider" problem is ever-present.*** Countries are more willing to join regional groups than to contribute to their support. Where maintenance of a regional institution requires independent governments to make discretionary payments, the institution is usually underfunded. Under constant fiscal pressure for domestic expenses, developing countries often hope that other members, or donors, will make up for their contribution shortfalls. The European Union became strongly institutionalized only after funding became automatic, or independent of the decisions of the member governments. Another alternative in "free rider" cases that tends to be sustainable is where one dominant member is willing to assume a disproportionate share of the costs in exchange for cooperation from its smaller neighbors. South Africa may play this role in regional cooperation with neighboring smaller countries.
- ***Attitudes of individual members change over time, requiring continual renegotiation of understandings.*** In a five-member group, a change by government in one member can be expected each year. New governments frequently question the priorities and decisions of the previous government, particularly at the outset of their tenure. Attempts to renegotiate regional agreements are one manifestation of this problem.
- ***The political benefits of regional arrangements come at the outset; later, political costs will outweigh them.*** Closer regional cooperation is endorsed in principle. It provides "photo-ops" for politicians and opportunities for speeches. The obligations of regional efforts—such as budgetary payments to regional institutions, or imports that threaten politically important firms—are generally away from the limelight, and tend to be avoided. As Enrique Iglesias, President of the Inter-American Development Bank, said of past economic integration efforts, "Non-compliance, unpredictable and informal remedies to trade and investment problems have been a persistent weakness of Latin America and the Caribbean's regional agreements and indeed were quite devastating for the old regionalism" (Iglesias 2000, 6).
- ***Regional institutions have governance problems.*** Many regional institutions have been fields for combat among member governments who seek to promote their own national interest, or use the organization for patronage. The involvement of donors in funding the institutions further complicates governance.

## A NEW APPROACH TO REGIONALISM

The failure of past efforts does not mean that efforts to promote regional cooperation among small countries are hopeless. It does mean so that cooperation needs to take into account the lessons of the past. A more promising direction for regional cooperation might include some of the following elements:

- ***Begin with a core of the most committed countries.*** Rather than beginning with a larger group of countries with varying commitment to the regional objectives, the regional group should include only the most committed so progress can be made quickly. After the group has made real progress, other countries can join—on the basis of the structure already agreed by the earlier members. The European Union began with a committed core of six countries that established the ground rules for later members. Had the EU begun as a cooperative effort by all of the current members, it would surely have failed.
- ***Focus on concrete results, not commitments***. Broad promises of international cooperation are easy to make, and particularly easy for a subsequent government to ignore. A concrete action such as a jointly funded WTO mission in Geneva or a cooperative trade promotion unit is more likely to be judged later on its merits, and, if successful, lay the basis for cooperation on larger projects. U.S.–Canada free trade, the base for NAFTA, was preceded by several decades by the U.S.–Canada free trade agreement on motor vehicles and parts, a low-key arrangement for a single industry.
- ***Address technical issues technically.*** Political agreements among countries tend to achieve consensus by political compromise, sometimes at the cost of efficiency. The optimum location for a regional testing laboratory for CARICOM members would likely be Miami, but political negotiation among members for its location might lead to its location in a member country with inferior air service.
- ***Minimize regional bureaucracy.*** Governments are reluctant to pay for services that they do not control, and regional secretariats tend to either move out of the control of individual members or become captive of the country where the secretariat is located.
- ***Connect with large, more developed countries***. As discussed in the previous section, regional trade arrangements with advanced countries tend to yield more benefits to small countries than does free trade among poor countries. The participation of a large country in other cooperative arrangements also appears to have benefits. The "free rider" problem is solved by the large country paying a substantial portion of the costs, with the small members being effectively subsidized. Decision-making also tends to be facilitated by the presence of one major "shareholder." Thus, the dominant position of South Africa has allowed SADC to move faster and farther than other African cooperative arrangements.
- ***Push for low external tariffs.*** Where countries are committed to RTAs, the economic distortions and trade diversion will be minimized when the external tariff that the RTA applies to nonmembers is low and uniform.

## IMPLICATIONS FOR USAID

The preceding analysis suggests four conclusions for USAID programming. First the agency should be careful about how it promotes regional cooperation. Second, it should reexamine its support for RTAs. Third, where regional cooperation appears appropriate, promotion of markets for specialized technical services may offer more benefits than regional institutions to provide such services. Finally, USAID should be clear about its purposes in regional missions.

### View Regional Cooperation Efforts with Caution

USAID should be particularly wary of RTAs, as discussed in the next paragraph, but it should be cautious of most forms of regional cooperation as well. The tendency to establish regional USAID missions in support of regional institutions reinforces pressure to support regional approaches even where they have not yielded results. The most promising approach to regional cooperation lies in pursuit of technical activities that offer clear economic benefits to each member. These approaches could include regional cooperation on transportation, communication, or electric power infrastructure or policy, or on promotion of exports of common interest through regional tourism campaigns or standards enforcement. In supporting such activities, however, donors should test government commitment to the regional activity by establishing firm deadlines for action and financial commitments by member governments, and resolutely end financial support when deadlines are not met.

### Re-examine Support for RTAs

The analytical case for promoting RTAs is extremely weak, as demonstrated by Schiff (2002). Even when they work well, most such arrangements are likely to worsen the economic welfare of their members in comparison with trade liberalization on a multilateral basis. To date, RTAs have usually not worked well. Many developing countries lack the policy stability over the medium and long term that would make them candidates for investment in export-oriented production by neighboring countries. Developing country RTAs lack the machinery to prevent unilateral interruptions of trade by individual members or to compensate firms disadvantaged by such behavior. Despite the various justifiable complaints about access to developed country markets, such markets are much more stable, predictable, and capable of absorbing increased exports than any grouping of developing countries.

RTAs with more advanced countries are a much more promising vehicle for national economic growth. Where RTAs among developing countries appear to offer clear benefits—such as reinforcing political commitments to good performance on economics or governance—USAID should press for low external tariffs and minimal regional bureaucracies.

### Promote Private Markets for Specialized Technical Services

Where regional cooperation appears appropriate, promoting creation of a market for private sector specialists is more promising than creating regional institutions. Regional institutions, as discussed in the previous section, have numerous problems with ownership, inflexibility, and lack of common long-term commitment among members. In the long run, governments should be encouraged to buy

the specialized services that they cannot efficiently acquire with in-house staff. Donors should help stimulate the market for such services, not short-circuit them by subsidizing regional bureaucracies that will be less responsive to the needs of individual countries. Cost sharing by donors with governments interested in acquiring specialized services is a useful device for promoting a services market and demonstrating the commitment of the requesting government. The requesting government is likely to demand better performance from consultants that it must pay.

### Clarify Purposes in Regional Missions

It is important that donors distinguish between benefits of regional approaches that accrue to the donor and those that accrue to the countries. Donors are likely to want to establish regional offices or hubs when dealing with the needs of regions with many small countries. Doing so can conserve staff and overhead resources, even when most donor services are delivered bilaterally to each country. This is quite distinct from delivering services through new or pre-existing regional institutions.

The danger in using regional institutions to deliver services is that the donor may become "captured" by the institutions it was meant to serve. The donor's office acquires a vested interest in strengthening the regional machinery and loses the capacity to look disinterestedly at that machinery's strengths and weaknesses, or progress or the lack of progress. In attempting to make regionalism work, the donor becomes caught up in never-ending regional political negotiations. Regional agreements might be viewed as needing to be renegotiated. A new director general of the regional machinery might be thought to be needed. Individual members might be seen as needing to be convinced that the regional institutions are valuable and worth supporting.

In sum, regional programs that serve groups of smaller countries can economize on staff and overhead resources and simplify the work of the donor mission. But this advantage should not become a justification for promoting regional vehicles. As this paper has shown, most development decision-making takes place at the country level, and even small countries are reluctant to delegate much responsibility to regional institutions.

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