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## CENTER FOR GLOBAL DEVELOPMENT ESSAY

### Integration in the Americas: One Idea for Plan B

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#### ABSTRACT

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**Unlike East Asia and Europe, the Western Hemisphere lacks a shared integration strategy, including a cooperative approach to improving the often burdensome investment climate. This essay suggests a fresh approach to regional integration focused directly on the environment for investment, rather than on trade. The idea is a collective effort to set common standards, based on international norms and newly available data, for reducing regulatory, tax, and legal barriers to domestic and foreign investment. Standards could also be set in other pressing areas, such as strengthening protection of the environment and labor. Beyond its benefits for growth, a regional investment agreement would likely boost the incomes of the poor by helping small businesses trapped in the informal sector move into the more productive formal sector. Compliance with agreement standards could be promoted through regular country report cards, or a peer review process, or dispute settlement options for investors and states. Generous transition periods and technical assistance could be offered to help countries build capacity to meet standards. Countries like Colombia, Guatemala, Mexico, and Peru that have been named top ten global business climate reformers by the World Bank could take the lead in launching exploratory discussions, with strong support from the United States and regional institutions. Leaders at the next Summit of the Americas in early 2009 might support pursuit by interested countries of such a regional investment agreement as one possible new way forward toward integration and income convergence in the hemisphere.**

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**INTEGRATION IN THE AMERICAS:  
ONE IDEA FOR PLAN B\***

Nancy Lee

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\* This essay is excerpted from a chapter in the forthcoming book, *The White House and the World: A Global Development Agenda for the Next U.S. President*.

Once there was a shared strategy in the Americas to boost growth and spread its gains. April 2008 marked the tenth anniversary of the launch of negotiations in Santiago, at the second Summit of the Americas, for the Free Trade Area of the Americas, the plan to unite a market of 880 million people. Now support for the Free Trade Area of the Americas has effectively collapsed—a victim of the deadlocked Doha Round, globalization fears, ideological differences, regional leadership rivalries, the distractions of financial instability, and the lure of subregional approaches.

Should the United States care about the demise of a region-wide integration strategy? The following argues that it should, that the risks of failure to address extreme regional inequality (between and within countries) are increasingly evident. Warning lights are flashing in the hemisphere. Political polarization and the steep rise in crime and urban violence present real threats to stability in large and small countries. Market democracies in the region need an effective regional strategy to help them spread the benefits of growth to large excluded and disaffected populations. The lack of such a strategy helps create a vacuum that some seek to fill with undemocratic, statist models that risk a giant leap backward.

The experience of Europe and East Asia demonstrates that regional integration matters fundamentally for competitiveness, growth, and income convergence. In both those regions, the largest countries have led the pursuit of progressively deeper integration. The

United States, with others, must lead the way in this hemisphere. The fifth Summit of the Americas in early 2009 looms as a challenge and opportunity in this regard.

Moreover, though further trade liberalization remains important, other economic policy challenges are emerging as binding constraints on growth and income convergence in the region. As free trade agreements confront growing resistance, the region needs to consider new integration models that help address these constraints in pragmatic, politically feasible ways. One possible model outlined here is a regional investment agreement designed to reduce microeconomic and other barriers confronting both domestic and foreign investors.

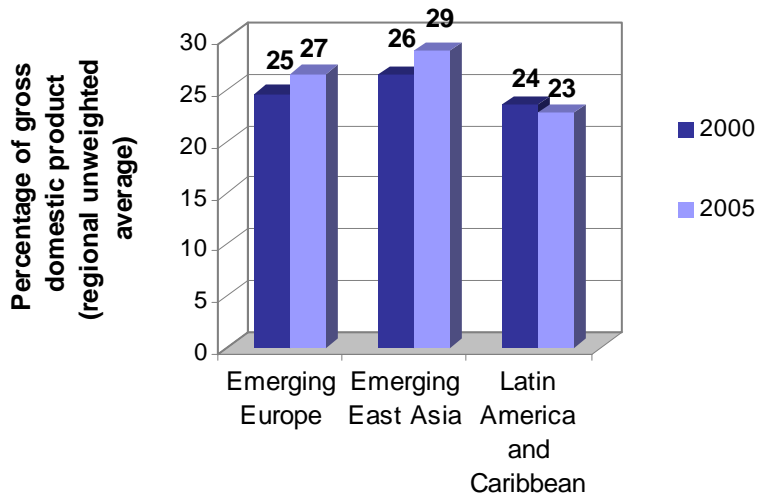
### **Why now?**

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

It is true that incomes and consumption have risen in the recent boom, and formal job creation has picked up significantly. But there is a very long way to go. An estimated 49 percent of Latin American employment was still in the informal sector in 2005. And the surging exports that ignited recent growth are largely commodities. It is hard to sustain high, job-creating growth when so much economic activity is outside the legal system and when so much of the export boom consists of energy, minerals, and food. Crucially,

Latin America differs from the most successful emerging market regions in a way that bodes ill for the future: investment as a share of gross domestic product (GDP) remains discouragingly low (figure 1).

**Figure 1: Gross Capital Formation**

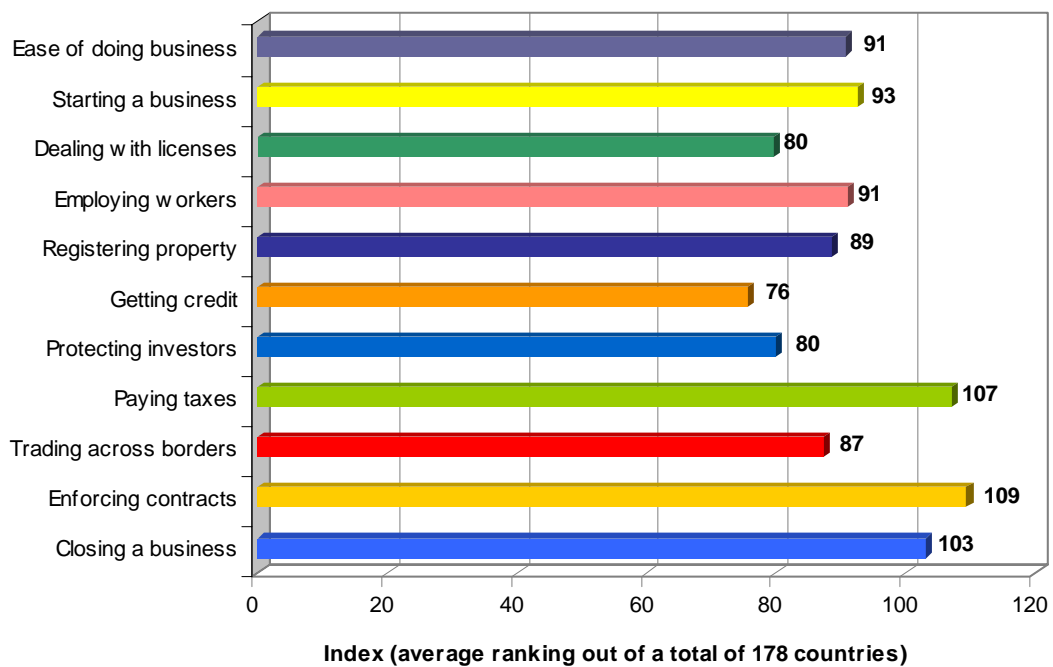


The progress made on some of the traditional barriers to investment and growth in the region<sup>1</sup>—weak macroeconomic policy, financial instability, and high formal trade barriers—has not for the most part been matched in the sphere of the microeconomic environment (figure 2).

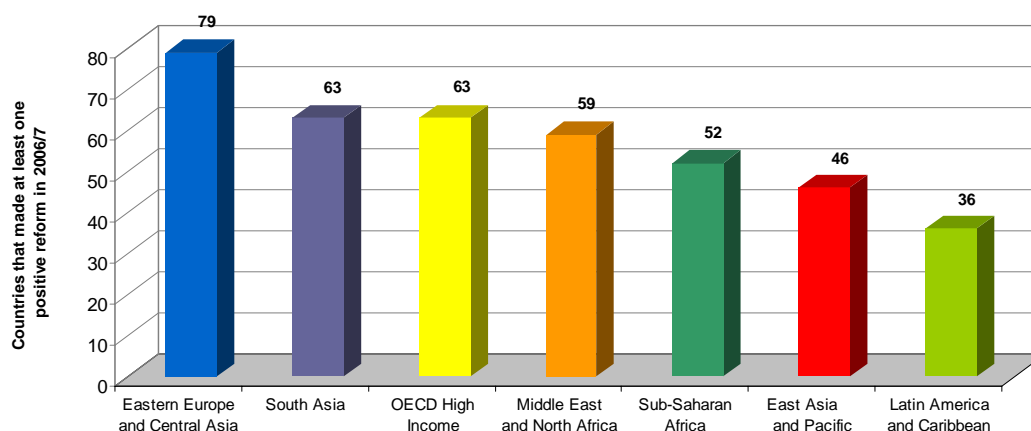
Not only does the region (with some country exceptions) rank poorly in the World Bank's Doing Business indicators, it also has the lowest share of countries making reform progress of any developing region (figure 3). Do businesses worry about microeconomic barriers? Business surveys suggest they do: the top two obstacles cited to doing business in the region are mechanisms for coping with burdensome and non-transparent regulatory

and tax systems—choosing to remain in the informal sector and corruption (that is, bribing regulatory and tax officials). If all categories of obstacles associated with burdensome regulation and tax systems are combined, we find that 53 percent of businesses cite these as the main obstacles to doing business (table 1).

**Figure 2: Latin America & Caribbean *Doing Business* Rankings - 2007**



**Figure 3: Doing Business Reforms - Share of Countries Making Progress**



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

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

Source: World Bank (2006)

Note: Shaded categories collectively define obstacles associated with the quality of the regulatory regime and tax systems.

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

\*\*Corruption covers informal payments associated with customs, taxes, licenses, regulations, and government contracts.

## **Left in the dust**

While region-wide integration progress in this hemisphere has ground to a halt, other parts of the world have forged ahead rapidly with their own strategies. More than ten countries in emerging Europe have joined the European Union in this decade and reaped striking growth and income benefits. Emerging East Asia is now knit together in cross-border production-sharing chains, shaped by foreign investment inflows, fed by parts and components trade, and facilitated by governments and regional organizations. For these two regions, integration, especially its benefits for investment, has played a central role in turbo-charging growth and income convergence.

Europe boosted investment climates through a top-down, formal enlargement process, with supranational institutions, economic systems reshaped in a common image, and massive aid. In East Asia, the role of governments and regional agreements has been to assist the regional investment strategies of private companies through trade facilitation, infrastructure development, and more recently “behind-the-border” reforms. Both approaches offer lessons for this hemisphere, though neither model is easily transferrable. The challenge is to find a third way—one that relies less on bureaucracies, uniformity, and aid than the European Union but that takes a more systematic approach to reform than did East Asia.

## **A regional investment agreement**

One possible approach that addresses the investment problem directly is a standards-based regional investment agreement or code. The idea is a collective effort to set



standards for improving the quality of regulatory and tax systems affecting both domestic and foreign investors. As in the financial and trade worlds, a standards-based approach could spread good practice without requiring supranational governance (e.g., a common regulator). Such standards could simplify and expedite systems for starting a business, paying taxes, obtaining licenses, registering property, dealing with border controls, and accessing credit and infrastructure services.

This approach is made possible by the enormous leap forward in the world's capacity to measure the microeconomic environment for investment using objective, verifiable indicators that are consistent across countries and regularly updated by third-party institutions like the World Bank. Examples of such objective indicators range from the official costs of starting a business, to the number of procedures to obtain licenses, to the number of business tax payments required annually, to the time required for customs clearance, to the strength of creditor rights based on standardized criteria.

Countries could use a regional agreement to set common standards or benchmarks based on international norms for an agreed set of investment climate indicators. A notional source of such norms might be, for example, minimum or average practice in the member countries of the Organization of Economic Co-operation and Development.

The aim would be to foster reforms consistent with a set of universally applicable principles such as the following:

- Simplification. Systems should be as simple as possible in terms of the numbers of steps, documents, and approvals needed.
- Use of computerized systems. Online applications and approvals standardize requirements, limit discretion and scope for corruption, and improve transparency and accountability.
- Reduction of direct costs and fees. Fees charged for procedures and approvals should be minimized and made transparent.
- Time limits. Reasonable limits should be set on the time needed for approvals and decisions.
- Transparency. Regulations, documents, and procedures should be standardized and published on websites, along with the authorities responsible for decision-making and enforcement.

The World Bank's annual Doing Business reports demonstrate that reforms consistent with these principles are well within the reach of both low- and middle-income countries.

### ***Beyond the microeconomic environment***

Such an agreement could also serve as a flexible vehicle for addressing other major investment climate issues. It could, for example, include confidence-building standards to lock in macroeconomic policy improvements, such as limits on public debt and tax burdens. And it could be used to address the increasingly urgent challenge of strengthening standards for protecting the environment and labor (in ways perhaps more effective than are possible in trade agreements).

The region could consider something like the European Stability and Growth Pact standards limiting financial vulnerability. Members of the European Monetary Union must, for example, limit their ratios of public debt to GDP to 60 percent. While monetary union provided the direct policy impetus for debt limits in the European case, Latin America's history of debt problems offers a rationale for debt ceilings even without a common currency. The enforcement difficulties of the Stability and Growth Pact suggest the need to avoid overselling such limits, but most analysts agree that the pact has nevertheless had a significant restraining impact on fiscal and borrowing behavior.

Tax burdens remain a major issue in much of the region. Business taxes as a percentage of profits average 54.5 percent for Latin America and the Caribbean, compared with 38.8 percent for high-income countries.<sup>2</sup> And businesses in the region on average pay forty-nine different taxes, while businesses in high-income countries on average pay eighteen taxes.<sup>3</sup> The agreement proposed here could set a cap on the overall business tax burden from the combined effects of all taxes. It could function as a kind of alternative maximum tax (a mirror image of the U.S. alternative minimum tax). Businesses could calculate the combined tax burden across all taxes as a share of profits versus the share based on the alternative maximum tax rate and pay whichever is lower. In addition, the agreement could include commitments to consolidate the number of taxes paid by businesses to some threshold level.

With respect to the environment, common regional standards would help cross-border investors who produce for a variety of markets, and it would facilitate cross-border production sharing. Companies may view the downside of mandatory standards in areas like vehicle fuel mileage as offset at least partially by cross-country consistency and predictability.

Regarding labor protection, the International Labour Organization has already defined standards and conventions to which many countries in the region are signatories. The problem may not be a lack of standards but a lack of enforcement.<sup>4</sup> In this connection, the value added of a regional agreement may be its capacity to provide incentives and support for better performance. Here the idea is not to ease the burden on investors but to impose consistent obligations with respect to the treatment of labor so that countries with better regimes do not feel competitively disadvantaged.

### ***Why multilateral?***

Each country already has a clear incentive to undertake unilateral investment climate reform and race to the top. Although unilateral reforms make sense (as in the case of trade reforms), experience demonstrates that multilateral agreements can help drive reform and increase its benefits. They can lock in reform. They can help rationalize the reform approach to foster the critical mass of related reforms needed to achieve desired outcomes. They can spur countries to mobilize the machinery of government to identify specific steps needed for implementation. And they can better inform investors of policy progress, given the transparent process of negotiating multilateral agreements.

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

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

### ***Selective obligations and most-favored-nation treatment***

The reforms contemplated here serve both domestic and foreign investors. For this reason, this approach could be pursued with more flexibility than has often been the case for multilateral agreements grounded solely in the logic of reciprocity. Countries could be given the freedom to sign on to one set of standards, say, the microeconomic standards, and not others, for example, the macroeconomic standards, without destroying the benefits of the agreement for other participating countries.

For reasons of economic efficiency and to maximize gains, it would make sense for the standards to be applied on a most-favored-nation basis. It would be distortional and burdensome to design one licensing system, for example, for domestic investors and foreign investors from participating countries, and another for investors from nonparticipating countries. To preserve the incentive to participate in the agreement, however, the mechanisms for promoting compliance, such as access to dispute settlement and capacity-building aid (which are discussed below), could be made available only to member countries.

### ***Potential gains***

The gains from such an agreement may be very large indeed. Cross-country studies suggest that major and comprehensive improvements in developing country regulatory quality could boost per capita annual growth rates by around 2 percentage points.<sup>5</sup> As investment climate problems fall especially hard on micro, small, and medium-sized firms,<sup>6</sup> attacking these obstacles could also advance equity in the region by helping newcomers to product and capital markets. And the evidence suggests that a better regulatory environment would likely substantially boost the growth response to lower trade barriers.<sup>7</sup> A regional investment agreement would therefore complement and expand the benefits of bilateral and sub-regional trade agreements.

### ***Fostering compliance***

Participating countries could consider a gamut of soft to hard options for promoting compliance with agreement commitments, ranging from transparency to peer review and

dispute settlement options for investors and states. The simplest and least intrusive approach would be to construct a process for regular third-party reporting on country progress. Annual report cards could be published with the agreed standards and each country's actual performance. A notch up on the surveillance scale would be to institute a system of peer review. Countries could gather regularly to discuss each other's progress and perhaps issue assessments. The most ambitious approach would provide recourse to dispute settlement. An investor-to-state arbitration process could be made available to investors who allege failure by a state participating in the agreement to comply with agreed standards. This process could serve domestic as well as foreign investors if consistent with domestic law. In cases where states do not honor arbitration judgments, foreign investors could request their home countries to pursue state-to-state dispute settlement as a backup means of promoting agreement compliance.

### ***Transition periods and capacity-building assistance***

Generous transition periods and ample technical assistance could be offered to countries willing to make ambitious commitments and progress. It would be desirable to set relatively high performance standards but give countries that initially fall short the time they need to build the capacity to meet the standards. During the transition period, countries should have access to useful technical assistance to help them with the difficult task of strengthening their regulatory, policy, and legal institutions and systems. As this technical assistance would be directed at clearly defined goals (meeting specific agreement standards within a specified time frame), recipient countries are likely to ensure that it is productively used. The assistance could be provided by participating

countries that already meet the standards, by the international financial institutions, or by both.

### **Launching discussions: Initial steps and the U.S. role**

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

The United States would have much to gain from a successful agreement, which could significantly boost the region's contribution to its growth. It could play a crucial role by responding positively and quickly to an initiative from interested emerging markets. The following are three recommendations for steps the United States could take to advance this effort.

*Encourage the Inter-American Development Bank to take an active supporting role and engage the private sector.*

As the largest shareholder of the Inter-American Development Bank, the United States could encourage that institution to convene discussions among interested countries. Such discussions should involve the private sector, both small and large firms, as a vital and logical partner in this effort. The Inter-American Development Bank could also provide



essential technical input as it did in the early days of the discussions on the Free Trade Area of the Americas.

*Mobilize aid for capacity-building technical assistance.*

The United States could take the lead in mobilizing aid to help governments meet agreed regulatory, tax, and legal standards, from its own institution-building aid budget and from the international financial institutions.

*Work with others to use the Summit of the Americas process to advance discussions.*

In 2009, the leaders of the region will gather in Trinidad and Tobago for the fifth Summit of the Americas. The Summit provides an opportunity for leaders to give political impetus to discussions by supporting work on an agreement among interested countries. Especially in the likely absence of agreement on resuming negotiations on the Free Trade Area of the Americas (just after the new U.S. administration takes office), pursuit of a regional investment agreement could supply one possible new way forward for progress toward regional integration in this hemisphere.

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### Notes

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<sup>1</sup> Zettelmeyer 2006.

<sup>2</sup> World Bank 2007b.

<sup>3</sup> World Bank 2007b.

<sup>4</sup> Elliott 2007.

<sup>5</sup> See, for example, Djankov, McLeish, and Ramalho 2006; Loayza, Oviedo, and Servén 2008.

<sup>6</sup> Birdsall, De la Torre, and Menezes 2008.

<sup>7</sup> See Bolaky and Freund 2004 and Haar and Price 2008, chapter 13.