Learning from Europe's Efforts at Integration and Convergence:

Lessons for Developing Countries' Integration Policies

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The theoretical underpinnings of convergence funds are rooted in the new theories of economic geography and the endogenous growth models. They explain persistent spatial disparities between core and peripheral regions in the process of economic growth as being the result of the attractiveness of core regions for mobile resources that are absorbed by economic activities with increasing returns to scale. Core regions can thus collect the gains of geographic specialization from agglomeration effects as long as these effects are not jeopardized by congestion effects. Given technical indivisibilities of lump-sum infrastructure investment with long gestation periods, imperfect foresight of private capital markets in financing such investment, and their character as collective goods (non-rivalry, non-excludability), convergence funds are financed from public funds, in particular by taxing activities and factors of production in core regions. To be effective in terms of not substituting for own funds in the recipient countries that could be used otherwise (fungibility problem), recipients must be fungibility constrained—that is, external savings should add to but not replace local savings. Analogies to development aid inflows come to mind. Development aid can prevent fungibility problems from becoming serious if the recipients are poor and if the projects to be financed are characterized by lumpiness. Regions benefiting from convergence funds are the more fungibility constrained, the more such funds finance infrastructure with a high minimum amount of capital binding and the more they change supply conditions and thus raise income and domestic savings. In order to give full justice to

convergence funds, opportunity costs for those financing the funds must be taken into consideration as much as the beneficial effects of some degree of regional disparities.

This calls for distinguishing the effects of convergence funds seen from a single recipient's view and those seen from the net view of recipients and donors. While the recipient's assessment can easily be positive if domestic infrastructure could have been financed from non-local sources only, donors may forgo growth if financing infrastructure in donor regions would have been more productive.

<<A>> Have European Union Convergence Funds Lived up to Expectations? <<end>>

Unlike so-called shallow integration schemes focusing on internal free trade only (like the North American Free Trade Agreement), the European Union (EU) stands alone as a model of deep integration with common policies and supranational institutions. Consequently, the EU is the only regional integration scheme whose long-standing history with convergence policies using structural funds can be assessed.

In a meta analysis, Dall'erba and de Groot (2006) first take stock of the econometric literature on the funds' impact on economic growth and then use formal meta regression analysis techniques to explain why outcomes from the first step show such divergence in results. In fact, the variance in results is striking. Studies find that structural funds have a range of effects on economic growth, from statistically positive effects, which nonetheless have certain side conditions, to statistically insignificant or even negative effects. Side conditions comprise a number of "good policy conditions" such as low unemployment, high research and development, or no impact of corruption on the allocation of funds. Side conditions affecting structural funds in a negative way are expenditures for the Common Agricultural Policy (CAP) and a high degree

of centralization in national tax collection.[1] There is strong similarity to arguments in the debate regarding the effectiveness of development aid, which stresses the indispensable nature of a "good policy" environment and struggles with the diminishing-returns issue, the endogeneity problem, and the reverse causality issue between growth and structural funds or aid, respectively, Likewise, as in the recent aid literature, affiliation of authors to countries or institutions benefiting from the allocation of funds is found relevant in the Dall'erba and de Groot analysis. As a result, the authors suggest meta analysis techniques in which the variable to be explained is the size of effect. The size of effect is derived from comparing the outcomes of several individual studies on the effect of a 1 percent increase in the amount of structural funds received on the growth rate under different definitions of funds' resources and growth.

<<A>> Insights and Limits to Findings from Research on EU Structural Funds <<end>>

What the studies cited above have in common is the importance of the institutional environment in which EU structural funds are embedded, mobilized, allocated, and disbursed. Such environment comprises general indicators such as the Sachs-Warner index of institutional quality but also digs deeply into EU specifics when it comes to the CAP or the degree of fiscal decentralization, which differs by member states.

While the common result is helpful for focusing on the degree of institutional quality in regional integration schemes among developing or least developed countries, it is also disenchanting, as it impedes the transferability of EU experiences to other integration schemes that fail to operate common policies or to host common institutions.

Pure developing-country South-South integration schemes that exist without membership of industrial economies (South-North integration) can be categorized into two groups: an Asian

and a Latin American–African type. The Asian type is informal, minimizes contractual commitments, stresses "open regionalism," pools national sovereignties but does substitute them for communitywide sovereignty, and thus survives with a minimum level of "bindingness." Extreme heterogeneity in historical roots, economic structures, and size has made this nonbinding type of integration the only credible option.

The other type has been very much influenced by the EU experience and for many years has sought to establish formal commitments, milestones, targets, contracts, and stepwise integration processes. The list of failures including disintegration steps, dissolution, stagnation, and decay is almost as long as the list of new endeavors, especially since the early 1990s, when a second wave of integration (after the first one in the 1960s) inspired many countries to follow the European single market program. Therefore, it does not come as a surprise that the largest similarity between EU policies and the past experiences in South-South integration schemes has its roots in the second type of integration in Africa.

In the francophone West African Economic and Monetary Union, for instance, a so-called community solidarity tax exists that compensates net importers (basically the landlocked Sahel countries) for tariff revenue lost due to the removal of internal tariffs. Part of the proceeds from this tax may be used to finance the cost of eliminating regional disparities (Doe 2006). In the companion scheme of Central Africa, a similar tax existed in the early days of Central African integration. Finally, the South African Customs Union (SACU) provides for a common external tariff and a common excise tariff for this common customs area. All customs and excise taxes collected in the common customs area are paid into South Africa's national revenue fund. The revenue is shared among members according to a revenue-sharing formula as described in the agreement. South Africa is the custodian of this pool. Only the member states' shares of

Botswana, Lesotho, Namibia, and Swaziland are calculated, with South Africa receiving the residual. SACU revenues constitute a substantial share of the state revenue of these four countries.[2]

Neither in Latin American nor in Asian integration schemes were intraregional tax sharing or allocation of public funds negotiated with the goal of removing regional disparities. Yet it is evident that, due to weak institutional foundations of regional integration in Africa (including lack of enforcement capacities), the modest schemes like the solidarity tax were unable to reduce regional disparities.

This is not to say that the issue of regional disparities has not been tackled in Latin America and Asia. Yet, because of the national rather than supranational approach to integration to which Latin American member states and those of the Association of South East Asian Nations (ASEAN) adhere, regional disparities were tackled mainly through a special regional focus of infrastructure projects financed by the two regional development banks: the Inter-American Development Bank and the Asian Development Bank. The latter, for instance, was the driving force behind the Greater Mekong Subregion Project, which promoted transport capacities in the backward area linking the Indochinese states and the Yunnan Province of China to the more advanced ASEAN economies (Cuyvers 2002). Salazar and Das (2007: 11) argue that, except for Brunei, Singapore, and to lesser extent Malaysia, the other founding member states of ASEAN have limited capacity to provide financial support and to transfer resources to the poorer Indochinese states of Cambodia, the Lao People's Democratic Republic, Myanmar, and Vietnam. As a result, fiscal redistribution between richer and poorer member states mostly did not occur.

Standard HOS trade theory suggests that the poorer the median member state in South-South integration is, the more such integration is income diverging (Venables 2003). The reason is that freeing internal trade leads the costs of trade diversion to fall on the poorest state. This is the country that has the most abundant unskilled labor and thus, prior to integration, tended to import relatively capital-intensive goods from the cheapest source. After integration, the more industrialized member state benefits from trade that gets diverted from outside to inside the integration scheme. This suggests that regional disparities in South-South integration will not be eroded but, at least in the short run, will be cemented or even extended. The postwar experience of South-South integration provides ample evidence for many distributional conflicts after divergence has occurred, irrespective of whether or not such disparities would have shown up without integration anyway. Thus there is demand for policies to reduce regional imbalances. Yet, with weak regional institutions, weak tax bases, and low initial economic interdependence, neither the domestic private sector nor the domestic public sector is likely to support and operate an EU type of structural fund. Nor will a horizontal fiscal redistribution scheme be established. Time preference rates in these regions are notoriously high, so the future benefits of redressing regional disparities are given low priority in domestic policies. If international development policies have lower time preference rates (which is likely), they could become financiers and managers, provided that they can withstand the pressure of local pressure groups to distort the regional allocation of infrastructure funds toward projects of national importance only. The historical experience of the Southern African Development Cooperation Conference (until 1993), which became eligible for external funding of infrastructure projects of regional importance, points to the risk of mislabeling infrastructure projects with a national scope as “regional” projects.

Nevertheless, the EU in particular should feel responsible for keeping regional imbalances in Sub-Saharan African integration schemes at bay. In the context of European Partnership Agreements, the EU will conclude four bilateral free trade arrangements comprising all Sub-Saharan African states. After long transition periods, the agreements will ultimately end with free trade conditions inside the four groups and with the EU. As argued, trade theory signals welfare-impeding trade diversion effects to the detriment of the poorest member states, unless they are offset by the positive effects of opening EU markets fully to African products. European Partnership Agreements seem well designed to host structural funds financed by the EU in favor of peripheral African states, which are threatened by marginalization should the EU enforce South-South integration. Rather than just spending project funds in a focused spatial way, the EU could also think of preferred budget financing in favor of backward states by simultaneously hardening the budget constraints for the more advanced countries in order to maintain a budget cap for the African integration scheme in total.

Success, however, seems conditioned on taking the lessons of EU structural funds seriously. Often structural funds are threatened by redundancy: that is, by "doing what comes naturally" or by doing it in an unconditional way. There are too many critical views on the ineffectiveness of EU structural funds that one could easily ignore if the transferability of the concept to poor developing countries is on the agenda.

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1. For a positive yet conditioned assessment, see Beugelsdijk and Eijffinger (2005); Cappelen and others (2003). Insignificant results are noted by Rodriguez-Pose and Fratesi (2004), while others stress the importance of binding factors like institutional quality (Ederveen, de Groot, and Nahuis 2006) and fiscal decentralization (Bähr, Stierle von Schütz, and Wrede 2007). The negative impact of the CAP is underlined by Esposti and Bussoletti (2004).

2. http://www.dfa.gov.za/foreign/Multilateral/africa/sacu.htm.