1

Regionalism for Financing Development: The Unexploited Potential

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We argue in this essay that developing countries, in their pursuit of sustainable growth, could much more fully exploit the benefits of a more open and radical regionalism. Open regionalism refers to the idea (see chapter 2 in this volume, and Birdsall and Lawrence 1999) that agreements among countries within regions can be a step toward greater integration into a global trading and financial system, as opposed to a step back from an open multilateral system. By a more radical regionalism we mean much greater integration of economies within regions, through more shared infrastructure, reduced trade barriers, enhanced policy cooperation among countries in a region, and mechanisms to achieve neighborhood objectives such as elimination of infectious diseases and the resolution of border conflicts.[1] Our emphasis is on regionalism as a strategy —as well as an opportunity—to speed the development of domestic institutions, and thus generate faster and steadier growth, and to improve developing countries' ability to cope with the challenges and the risks of deeper integration into the global economy.

We do not pretend to justify completely the logic of a more radical regionalism. We confine our argument largely to the benefits of regionalism for the financing of countries' development needs and to the role

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1. See IDB (2002) for a comprehensive discussion about the geopolitical benefits of regional integration.

of the regional development banks (RDBs) in that process. These are the topics explored in the other essays and commentaries in this volume, on which we rely for some—although not all—of our arguments.

Among economists, the benefits of eliminating borders and thus increasing market transactions and gains from economies of specialization (or scope) are self-evident. As an apparent result of these benefits, dedication to the ideal of a global or multilateral system of trade has been steadfast. In addition, regional trade agreements before the 1990s often involved increasing barriers to nonregional parties, so that regionalism seemed to violate the ideal of overall openness, diverting rather than creating trade.[2] That has changed in the last decade (Robert Devlin and Lucio Castro, in chapter 2 of this volume, conclude that the regionalism of the 1990s has generally supported global integration). The benefits of the new open regionalism are not so readily dismissed, although there is certainly still concern that proliferation of trade agreements, especially on a bilateral basis, would contribute to the "spaghetti bowl" of conflicting rules and interests.[3] Nor is trade the only issue for which economists are revisiting the potential benefits of open regionalism. Other issues include the financing of infrastructure at the regional level, the regional management of monetary affairs to limit vulnerability to financial crises, and the adaptation of regulatory standards to meet regional needs. On these and other considerations, however, there is still only a small body of work on the benefits of the new regionalism, and on its limits. That is the gap we hope this and the other essays in this volume will begin to fill.

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2. Some of the early initiatives in Latin America after World War II involved a concept of trade integration, in which preferential tariff elimination among trading partners was combined with high barriers to extraregional imports and a strong government intervention in economic activity. These regional arrangements fell into crisis in the 1980s because of the perceptions among some country members that the high levels of protection were a source of trade diversion. Indeed, as documented by José Antonio Ocampo (2001), Chile was the first country in the region to withdraw from a regional trade agreement: the Andean Pact.

3. Bhagwati has been one of the most vocal critics of the recent proliferation of trade agreements. His views are summarized in the following statement: "By the end of 2002, 250 FTAs [free trade agreements] had been notified to the WTO [World Trade Organization]. If those currently under negotiation are concluded, that number will approach 300. The result is a 'spaghetti bowl of rules,' arbitrary definitions of which products comes from where and a multiplicity of tariffs depending on source" (Jagdish Bhagwati and Arvind Panagariya, "Bilateral Treaties are a Sham," *Financial Times*, July 13, 2003, 27).

We do not disagree with that statement. A number of recent FTAs belong to the bilateral rather than the regional category, and there are significant differences between the two types. It is certainly true that a multiplicity of bilateral trade agreements, each one with its own peculiarities (including regarding external tariffs), could lead to a fragmentation of the world market, becoming an obstacle to, rather than a facilitator of, both regionalism and multilateralism. At the same time, however, Jagdish Bhagwati (1992) has recognized that if properly designed to avoid trade diversion, regionalism can lead to the achievement of multilateral trade for all.

We begin with a discussion of the sources of financing for development, focusing on their stability and sustainability. Our discussion highlights the limitations of the current system, in which external flows of development finance are limited or volatile (and often dangerously procyclical) or both. We also analyze internal sources of finance, noting that they are as much an outcome of as an input to the development process. We highlight the differences across regions both in access to external finance and in domestic saving ratios and taxation capabilities. Next we turn to the benefits of regional arrangements for attracting and retaining sources of financing, for reducing the risks and vulnerability associated with participation in the global financial system, and for increasing access to external funds via increased trade and export diversification. We argue that differences among regions indicate some justification for more region-specific strategies toward global integration than what immediate and unilateral liberalization implies. Finally we discuss the existing and unexploited potential for the RDBs to assist their member countries in developing and extending regional arrangements and in increasing their investments in regional public goods.

Three Pillars of Development Finance: An Assessment of Their Reliability and Sustainability

For the more than five decades of the postwar era, the international community has sought ways to increase levels of income and rates of economic growth in the poorer countries. The effort began with the creation of the World Bank as a sister organization to the International Monetary Fund (IMF). The Fund was instituted to assist countries with temporary balance of payments problems; the Bank was instituted to help finance reconstruction (in Europe) and to support critical investments to increase growth and thus raise income levels and promote human advancement (in the developing countries).

In many respects the development project has been successful, particularly in terms of improvement in such indicators as health and education. However, except for the East Asian region, income gains in the developing world have been relatively limited, particularly in the last two decades. Although many countries of East Asia are converging in income terms with the advanced economies, most countries outside that region have been growing more slowly, if at all, over the last two decades, so the income gap between the richest and poorest countries of the world has continued to increase—to a difference of more than 50 to 1 between western Europe and parts of sub-Saharan Africa.

Development thus remains one of the greatest challenges of the 21st century. Financing the process—including the investments in people and institutions that are necessary (although by no means sufficient) for development—is a critical part of that challenge.[4]

Financing development relies on three major pillars: (1) more stable and sustainable access to net capital inflows, including aid, (2) the buildup of domestic sources of finance through increased private saving and improved taxation systems, and (3) the generation of stable net foreign revenues through increased exports and diversification of trade.

All three pillars are undermined or enhanced by the degree to which countries (governments and the private sector) use the resulting resources well—a factor that could be labeled cost efficiency.[5] Clearly, if the financial resources that are critical but scarce are not invested effectively, the effect of the same financing on development will be reduced.

How have these three pillars performed in supporting development? A review of the experience indicates that the answer is not so well in general, and that there are sufficient differences among regions to warrant increased attention to the potential for regionalism as a strategy to enhance financing options.

Pillar 1. Foreign Financial Flows: Limited, Volatile, and Procyclical

Table 1.1 presents statistics on both private and official net capital flows since 1970 as a percentage of recipients' GDP. Total external flows have generally been between 0.5 and 3 percent of the GDP of recipient regions—far from sufficient to be relied on as a major source of new development investment or as a substitute for domestic saving. (The regional averages obscure the fact that some countries have received much more; e.g., Uganda, Tanzania, and others in Africa have at times received as much as 5 to 20 percent of their own GDP in official flows, but these are exceptions.)

Table 1.1 also reflects the changes over time in the size of external inflows. The data are divided into four periods corresponding to a period of either exuberance or turbulence in net capital flows to developing countries: the 1970s until the year before the eruption of the Latin American debt crisis; the period from 1982 to 1990; the first half of the 1990s, including 1996, the year before the East Asian crisis; and the period from 1997 to 2002. Financial flows to developing countries rose in the early 1990s, peaking at 1 to 4 percent of their GDP, and have fallen since then;

4. Development may be less a function of outside financing of investment in poor countries than of changing the economic incentives people within those countries face (Easterly 2001). Our discussion of financing for development includes sources of domestic financing and is not meant to suggest that financing can happen or make a difference without the right incentives and institutional arrangements.

5. We are grateful to Rudolf Hommes for pointing this out.

Table 1.1 Capital flows to developing countries, 1970–2002 (percent of GDP)

Region	Mean					Standard deviation				
	1970–81	1982–90	1991–96	1997–2002	1970–2001	1970–81	1982–90	1991–96	1997–2002	1970–2001
Total developing countries										
Net private capital flows	n.a.	0.80	3.65	1.08	1.69	n.a.	0.40	0.36	0.79	1.37
Net foreign direct investment	–0.01	0.51	1.63	2.37	0.87	0.27	0.01	0.51	0.28	0.97
Net portfolio investment	0.04	0.25	1.44	–0.13	0.32	0.04	0.14	0.75	0.57	0.67
Other net capital flows	n.a.	0.11	0.77	–1.33	–0.11	n.a.	0.33	0.84	0.52	0.99
Net official flows	0.81	0.97	0.48	0.51	0.74	0.20	0.33	0.33	0.29	0.33
Africa										
Net private capital flows	n.a.	1.26	1.56	1.34	1.37	n.a.	0.99	1.57	0.95	1.12
Net foreign direct investment	–0.01	0.47	0.91	2.66	0.77	0.35	0.11	0.24	1.04	1.07
Net portfolio investment	0.08	0.03	0.54	0.28	0.19	0.16	0.17	0.29	1.49	0.64
Other net capital flows	n.a.	0.83	0.38	–1.52	0.03	n.a.	0.98	1.28	0.71	1.40
Net official flows	1.06	1.41	1.27	1.01	1.20	0.32	0.90	0.97	0.22	0.66
Asia										
Net private capital flows	0.77	1.60	3.93	0.34	1.51	0.42	0.50	1.35	1.41	1.53
Net foreign direct investment	–0.06	0.54	2.48	2.26	0.99	0.30	0.13	0.76	0.28	1.15
Net portfolio investment	0.03	0.15	0.78	–0.35	0.13	0.05	0.15	0.55	0.35	0.44
Other net capital flows	0.49	0.94	0.90	–1.87	0.25	0.39	0.41	0.69	1.50	1.29
Net official flows	0.85	0.73	0.57	0.65	0.73	0.30	0.17	0.37	0.38	0.31

(table continues next page)

Table 1.1 Capital flows to developing countries, 1970–2002 (percent of GDP) *(continued)*

	Mean					Standard deviation				
Region	**1970–81**	**1982–90**	**1991–96**	**1997–2002**	**1970–2001**	**1970–81**	**1982–90**	**1991–96**	**1997–2002**	**1970–2001**
Latin America and the Caribbean										
Net private capital flows	3.50	0.24	3.36	2.55	2.38	1.23	1.13	1.08	1.29	1.80
Net foreign direct investment	0.17	0.72	1.36	3.16	1.08	0.48	0.20	0.54	0.69	1.17
Net portfolio investment	0.07	0.02	2.27	0.43	0.52	0.11	0.31	1.506	0.75	1.09
Other net capital flows	2.72	–0.46	–0.17	–1.16	0.56	1.07	0.91	1.404	0.52	1.89
Net official flows	0.58	1.17	0.39	0.39	0.67	0.19	0.68	0.501	0.64	0.58
Middle East										
Net private capital flows	–4.39	0.03	4.70	–0.92	–0.80	3.80	1.73	3.77	2.37	4.39
Net foreign direct investment	–0.15	0.18	0.66	0.62	0.23	0.39	0.15	0.18	0.19	0.43
Net portfolio investment	–0.02	0.92	1.50	–1.25	0.29	0.07	0.65	0.79	0.90	1.09
Other net capital flows	–4.07	–0.92	2.87	–0.25	–1.17	3.67	1.29	3.38	1.95	3.68
Net official flows	0.87	0.81	–0.02	0.22	0.56	0.70	0.42	0.41	0.70	0.67
Transition economies										
Net private capital flows	n.a.	n.a.	1.25	2.45	1.85	n.a.	n.a.	2.630	0.81	1.96
Net foreign direct investment	n.a.	n.a.	1.05	2.86	1.96	n.a.	n.a.	0.579	0.54	1.09
Net portfolio investment	n.a.	n.a.	–0.06	0.35	0.14	n.a.	n.a.	1.119	1.25	1.15
Other net capital flows	n.a.	n.a.	0.24	–0.66	–0.21	n.a.	n.a.	1.778	0.65	1.36
Net official flows	n.a.	n.a.	0.77	0.12	0.45	n.a.	n.a.	0.869	0.81	0.87

n.a. = not available

Source: International Monetary Fund, *World Economic Outlook* database (September 2003).

private flows rose most and then collapsed, from a peak of almost $230 billion in 1996 to only $43 billion in 2001.[6]

For the period as a whole, and for all regions of the developing world, net private flows have been more volatile (as measured by the standard deviation) than net official flows. Among private flows, foreign direct investment (FDI) as a proportion of GDP has increased steadily for developing countries as a group, whereas portfolio flows and other private flows (largely loans from international banks) have been erratic and basically collapsed in the late 1990s.

The evolution of private flows has varied significantly across regions. In Asia, net private flows increased significantly from the 1970s to the mid-1990s, but non-FDI private flows collapsed in 1997. In Latin America and the Middle East, private flows have been erratic throughout the entire period (in Latin America, after peaking in 1981, net international bank lending has been largely negative).[7] Net portfolio flows, however, which were small in the 1970s and the 1980s, increased dramatically in the first half of the 1990s. Indeed, during this latter period, about half of portfolio flows to all developing countries went to Latin America (in dollar terms). In the Middle East, private flows have been erratic throughout; this region has the highest standard deviation for net private capital flows, whether calculated for the entire period or for any of the subperiods. In Africa, net private flows have been much lower in absolute terms than elsewhere (not shown in table 1.1): Even at the peak of portfolio inflows to emerging markets during the first half of the 1990s, Africa only received 3 percent of total net private capital flows. However, net private flows have not been lower than elsewhere as a percentage of Africa's own GDP, and they have not been more volatile.

As a percentage of GDP, official flows were higher than private flows in the 1980s (except in Asia) and then fell in absolute terms in the early 1990s (and also fell in relative terms as private flows rose). Official flows rose, if only modestly, in the period from 1997 to 2002, when private flows fell. In general, official flows have been countercyclical: compensating, but

6. Total private flows to developing countries as a whole started to recover in 2003, signaling the possibility that a new cycle of external private financing for these countries had started.

For each of the subperiods analyzed, as well as for the aggregate period under consideration, table 1.1 presents the mean and the standard deviation. Because of the abundance of negative numbers, the standard deviation is a better statistic than the coefficient of variation as a measure of dispersion.

7. An interesting issue is the extent to which lending from foreign banks established in Latin America is (at least partially) making up for the decreased cross-border lending. Participation of foreign banks in Latin America has increased significantly since the late 1990s. By the end of 2001, foreign ownership of bank assets (as a percentage of assets of the banking system) exceeded 50 percent in a number of countries, including Argentina, Mexico, Panama, Peru, and Uruguay.

Table 1.2 Correlation between net capital flows to emerging markets and real GDP growth

Region	Correlation: Net private capital flows	Correlation: Net official capital flows
Africa, 1982–2001	0.36	–0.79
Asia, 1971–2001	0.32	–0.37
Countries in transition, 1991–2001	0.22	0.06
Latin America and the Caribbean, 1971–2001	0.37	–0.35
Middle East and Turkey, including Israel, 1971–2001	0.22	–0.40
Total emerging-market economies, 1982–2001	0.14	–0.23

Note: Capital flows measured as a percentage of GDP. Regional real GDP growth rates are calculated by weighting each country's growth rate by its share of regional GDP (measured in current dollars) for the corresponding year.

Source: International Monetary Fund, *World Economic Outlook* database (September 2002).

only partly, for the volatility of private flows. Table 1.2 illustrates this result by presenting the coefficient of correlation between net capital flows and real GDP growth in the different regions. The statistics show that, with the exception of the transition economies, there is a negative correlation between net official flows and real GDP growth in every region, a correlation that is especially large in Africa. In contrast, the correlation between net private flows and real GDP growth is positive. At times of sharp declines of net private flows, official flows have typically increased significantly, albeit at only a fraction of the decline in private flows (more on this below).

The highly concessional portion of official flows (ODA, official development assistance) has two important statistical characteristics, both of which are shown in table 1.3. With the exception of Africa, ODA is generally less volatile than private net flows, and its volatility has been declining in most of the regions. In addition, its importance as a source of financing differs significantly across regions, and it has generally been much more important for Africa than for Latin America. In 2001, the ratio of ODA to net private flows was only 8 percent in the Latin American and Caribbean region, compared with 61 percent in the Middle East and North Africa, 105 percent in sub-Saharan Africa, and 115 percent in South Asia.

These observations taken together indicate that relying on sustained and predictable availability of foreign private flows is not a sensible approach for developing countries—at least not for the foreseeable future. This by no means implies that countries should not try to improve their access to international capital markets. Indeed our recommendations

Table 1.3 Official development assistance to developing countries, 1970–2001

Region	Official development assistance as percent of net private flows, 2001	Official development assistance as percent of GDP									
		Mean					Standard deviation				
		1970–81	1982–90	1991–96	1997–2001	1970–2001	1970–81	1982–90	1991–96	1997–2001	1970–2001
East Asia and Pacific	19.9	0.86	0.71	0.66	0.44	0.72	0.22	0.12	0.17	0.07	0.22
Latin America and Caribbean	8.4	0.36	0.44	0.40	0.28	0.38	0.10	0.07	0.05	0.03	0.09
Middle East and North Africa	60.7	2.06	1.34	1.58	0.83	1.58	0.48	0.49	0.57	0.13	0.63
South Asia	114.5	1.91	1.60	1.53	0.82	1.58	0.36	0.11	0.46	0.11	0.47
Sub-Saharan Africa	104.9	2.39	4.75	6.04	4.30	4.04	0.41	1.07	0.64	0.14	1.55
Transition economies	25.1	n.a.	0.15	0.93	0.99	0.96	n.a.	0.19	0.18	0.26	0.21
Total	27.5	1.17	1.23	1.10	0.75	1.11	0.08	0.16	0.18	0.06	0.20
Memorandum items:											
China	3.6	0.10	0.43	0.57	0.20	0.37	0.13	0.15	0.16	0.06	0.21
India	35.5	1.15	0.71	0.70	0.36	0.82	0.28	0.14	0.24	0.03	0.35

n.a. = not available

Source: World Bank, *World Development Indicators 2003* (CD-ROM) and *Global Development Finance 2003* (CD-ROM).

include policies and development of instruments to improve access. However, the evidence is increasingly clear that bank lending and the allocation of portfolio funds by international investors to a particular country depend not only on the economic and political conditions of that country but also on international factors. The correlation of bond prices and spreads across countries has been extremely high in the last several decades, not only during global financial crises but also in normal times. Eduardo Fernandez-Arias and Roberto Rigobon (2000) show that the correlations between Mexican and other emerging market bond returns were above 80 percent during the normal period following the 1994 Mexican crisis.[8] This and other evidence indicate that the behavior of asset prices and spreads in emerging markets is partly explained by world aggregate shocks that affect the entire emerging market asset class.[9] Markets do discriminate among countries, with asset prices during crises falling less in those countries perceived as less risky in the precrisis period.[10] Although country-specific fundamentals explain the relative difference in spreads across countries, global factors external to the countries play a key role in explaining their absolute cost of borrowing.

The resulting volatility can be highly detrimental to a country's access to financing for development. For example, uncertainties in the global economy increased significantly in 2002, and many of these uncertainties originated in industrial countries. Important developments included the continuation of slow growth in all industrial regions of the world; the scandals in the corporate sector of the United States, which increased uncertainties about the true profitability of major companies; and the uncertainties generated by a possible armed conflict with Iraq. Investors, facing a riskier environment, shifted the composition of their portfolio toward a greater weight of safer assets. This, of course, implied a shift toward more liquid assets (such as industrial countries' government paper and some selected companies' liabilities with a high credit rating) and away from developing countries' liabilities (as well as industrial countries' junk paper). This increased the cost of international financing for developing countries and, in some cases, closed countries' access to international capital markets.

8. The exception was Venezuela, with a correlation of 73 percent.

9. Guillermo Calvo and Enrique Mendoza (1999) argue that certain features of investors' behavior explain the mechanics of contagion; namely, the transmission of an adverse shock to one country to other emerging markets. It is well known that at the time of the Russian default in 1998, leveraged investors had to exit other emerging markets to cover their losses in Russia.

10. Fernandez-Arias and Rigobon (2000) show that the magnitude of increased spreads in individual emerging markets following the Russian crisis corresponded with the initial levels of the spreads. Among Latin American countries, the largest increase in spreads occurred in Venezuela (the country with the highest precrisis spread), and the smallest in Mexico (the country with the lowest precrisis spread).

In addition, of course, there is the possibility that rapidly increasing inflows of private capital, as in the mid-1990s, are speculative and less likely to be cost-efficient, because they contribute to an asset bubble rather than to a highly productive investment, as may have been the case in some countries of East Asia.

Official flows, although they have been countercyclical and ease somewhat the adjustments countries have had to make for the volatility of private flows, are, unfortunately, not entirely reliable. Although they have risen slightly in the most recent period under consideration in this study (1997–2002), they are still universally below their levels of the 1980s (as a percentage of recipient-region GDP), even in Africa and Latin America, where GDP has not risen much. For the poorest countries, there is an additional problem. Although portfolio flows to them are so low that globally induced volatility is not an issue, they are more heavily reliant on grants and concessional loans as a percentage of their GDP than are many emerging markets on private flows. Official flows at the country level are not particularly reliable either: Paul Collier and David Dollar (1999) show that as poor countries undertaking major reforms begin to recover some growth, the official flows on which they are relying to adjust have often declined.[11]

Moreover, as with private inflows, official inflows may not have always contributed positively, or at least not as positively as hoped, to the financing of development. Poor use of official loans in the world's poorest countries clearly contributed to their build-up of unsustainable official debt, finally provoking the internationally agreed-on heavily indebted poor countries' program of debt forgiveness. As implied by the discussion above, the negative correlation between GDP growth and official inflows (table 1.2) reflects in part the greater demand for official help in countries and regions doing less well. At the same time, the large negative correlation for Africa is consistent with statistical evidence that in this region, in which publicly financed investment has been high relative to private investment, overall investment returns have been low (Devarajan, Dollar, and Holmgren 2001).

For the middle-income countries, there is the uncertainty associated with increased questioning of the lending practices of the IMF and other multilateral organizations. Broadly speaking, there are two views. The first argues that the large bail-out packages supplied by the IMF to emerging markets since the Tequila Crisis have created a moral hazard problem. The argument is that private investors tend to overlend to emerging markets in good times based on the expectation that a rescue package from the

11. The inefficiencies of the donor system for transferring resources are substantial (Easterly 2002), and between the US and European donors there is a difference in view about such basic financing issues as whether poor countries should be able to borrow at all or be confined to grant financing. Nancy Birdsall and John Williamson (2002) argue in favor of grant financing for the poorest countries with a history of unsustainable public debt to official creditors.

IMF will protect them from potential investment losses in bad times.[12] The second view is that the rapid development of international capital markets and the inflows, at times huge, into developing countries have significantly reduced the efficacy of traditional IMF rescue packages. Relative to the private flows, there are simply not enough funds available at the IMF to do credible old-style bailouts.

Although debate continues, the fact is that multilateral organizations seem to be behaving more cautiously than in the past with respect to supporting countries in difficulty.[13] Moreover, recognition of the moral hazard problem has led the IMF to advance two proposals to increase private sector involvement in crisis resolution: the inclusion of collective action clauses in all sovereign bond contracts, and a proposed sovereign debt restructuring mechanism (SDRM).[14] Although private lenders have indicated their intention to support the wider use of collective action clauses (CACs), they strongly reject the implementation of an SDRM. At the time of this writing, it is unclear how this debate will be resolved. Delays in solving the IMF–private sector debate are costly for developing countries, as they create increased uncertainties about the rules of the game for accessing funds from multilateral organizations as well as from private sources.

Pillar 2. Funding Development Through Private Saving and Taxation

Domestic saving continues to be the largest source of financing for development in developing countries. The Monterrey Financing for Development Initiative explicitly calls for efforts to increase domestic saving. Domestic savings are made up of private and public saving (the difference between tax revenues and public expenditures). We discuss each type of saving in turn.

There is an ongoing and unsettled discussion about the relationship between domestic saving rates and growth. What comes first, saving or

12. See the Meltzer Report (IFIAC 2000) for a more extensive discussion of this argument.

13. Some have argued that the IMF's unusually long negotiation process with Argentina in 2002–03 was a case in point, though the subsequent loan to Brazil is a counterexample.

14. Advocates of CACs argue that this is an appropriate way to deal with the holdout or rogue creditor problem, which occurs when a minority of creditors delay crisis resolution until their demands are met, to the detriment of other creditors and the debtor. Proponents of CACs believe that this problem can be solved by binding all bondholders to the will of a supermajority. The SDRM proposal can be better understood by comparing it to bankruptcy courts that currently exist for private-sector companies. By applying to sovereigns' debt negotiations with the private sector some of the principles used in the resolution process of corporations in default, the SDRM aims at insulating governments from adverse court judgments during the process of renegotiating debt contracts and hastening the renegotiation process, advocates claim.

growth? In the 1970s and 1980s, the idea that domestic saving would finance investment and therefore lead to increased growth was the central motivation for the financial liberalization undertaken in many developing countries. The intellectual leadership for these policies came from Ronald McKinnon (1973), who argued that the removal of interest rate ceilings would encourage higher private saving and investment ratios.

However, reality did not follow the theoretical predictions. In a number of developing countries, financial liberalization was followed not by increased saving and growth but, rather, by financial collapse. The issues of delaying financial liberalization until after other liberalizing reforms were completed and of ensuring adequate banking supervision before financial liberalization were then put on the table (Diaz-Alejandro 1985). Evidence mounted indicating that causation runs from growth to saving, and not necessarily from higher saving to higher growth.[15]

That does not mean it is not worth encouraging both private and public saving. Even if there is no direct causality from saving to growth, policies to encourage saving make sense (Plies and Reinhart 1999). For one thing, low (and declining in particular) domestic saving rates contribute to large current account deficits that often lead to currency crises, inhibiting growth.[16] High and stable domestic saving rates also can offset the disruptive consequences of volatile international capital flows.

It does mean that in the case of private saving, governments' short-term and direct policy instruments are relatively limited. The only possible exception comes from evidence that with the institution of a fully funded private pension scheme in Chile, private saving rose (without completely offsetting declines in public saving). However, few developing countries today can finance the fiscal cost of the transition to such a system, which requires support for current pensioners coming from general revenues rather than from the contributions of current workers. Differences across regions in average private saving illustrate that other policy instruments for encouraging private saving are indirect at best.

Table 1.4 presents the evolution from the mid-1960s to the mid-1990s of gross private saving as a ratio of gross private disposable income[17] for a sample of industrial countries and for developing countries grouped by regions, based on Loayza et al. (1998).[18] Private saving ratios in East Asia,

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15. See, for example, the papers by Carroll and Weil (1993) and Gavin, Hausmann, and Talvi (1997).

16. As noted by a number of observers, low and decreasing domestic saving rates were an important factor leading to the Tequila Crisis in 1994.

17. The subperiods in table 1.4 do not correspond to those in tables 1.1 and 1.3 because such as classification was not available for the private savings ratios.

18. See Loayza et al. (1998) for the countries included in every region and for methodological details.

Table 1.4 Gross private saving/gross private disposable income (percent)

Region	1965–73	1974–84	1985–94	1965–94
Africa				
Average	19.5	11.2	10.7	11.6
Standard deviation	1.9	11.5	9.2	10.3
East Asia				
Average	21.4	27.3	28.6	26.8
Standard deviation	4.3	5.9	8.9	7.4
Industrial countries				
Average	24.6	23.3	23.2	23.6
Standard deviation	5.2	4.9	4.8	5.0
Latin America				
Average	16.4	15.4	10.9	14.1
Standard deviation	7.4	6.6	7.4	7.4
Middle East				
Average	10.9	20.2	19.7	18.4
Standard deviation	3.9	16.4	10.4	13.4
South Asia				
Average	14.4	18.8	23.3	19.5
Standard deviation	5.3	5.0	4.6	5.9

Source: Loayza et al. (1998).

where economies were growing, increased consistently during the period under study, reaching levels comparable to those of industrial countries, albeit with a higher degree of volatility. Private saving ratios in South Asian countries (in which there also was growth, although it was less rapid than in East Asia) showed an increasing trend as well. In sharp contrast, gross private saving rates in Africa and Latin America, in which economic growth has been negligible, have been low—half the level of those rates achieved in Asian countries—and declined throughout the period from the mid-1960s to the mid-1990s. In Middle Eastern countries, after significantly increasing from the mid-1960s to the mid-1980s, private saving ratios declined in the 1990s as the price of oil declined.

The differences in average growth rates across regions are not the only explanation of regional differences in saving rates: Differences in financial sector depth (domestic capital markets and confidence of small savers) also explain some of the gap in private saving ratios between Latin America and Asia.[19] Demographic differences also matter. Loayza et al. (1998) show that young-age dependency ratios (population younger than 15 years old as a percentage of working-age population) have a negative effect on private saving rates.[20]

19. See, for example, Edwards (1995).

20. See also Kelley and Schmidt (1995, 2001) on the effects of demographic changes on savings, investment, and growth in East Asia compared with Latin America and other regions.

In principle, increasing public saving is a much more direct and accessible policy instrument than increasing private savings: Public saving is merely the difference between government revenues and government spending. We concentrate on the revenue side (i.e., on governments' ability to raise adequate revenues through taxes) and focus on taxation performance rather than on the behavior of overall public saving because a given public saving ratio is consistent with an infinite combination of levels of expenditures and revenues. Developmental efforts require some minimum level of expenditure on the provision of public goods, however, especially in the social areas. Although we would not want to seem to minimize the importance of fiscal discipline in the sense of spending and borrowing no more than the expected revenue stream affords, and of spending resources well, the fact is that a critical challenge facing most developing countries is that of developing the capacity to raise sufficient tax revenues to provide the level of public goods needed to advance the development process, whether directly or through sustainable public borrowing. Adequate tax revenue greatly simplifies for governments the challenge of financing countercyclical expenditures during economic downturns and of avoiding significant fiscal imbalances that, by weakening macroeconomic stability, would debilitate the sustainability of the development efforts.

Problems facing developing countries in establishing an adequate tax system have been studied extensively.[21] The most common difficulties include, first, a large share of the agricultural and informal sectors in many countries, which limits the collection capacity of personal income taxes and other modern taxes used in industrial countries; second, deficiencies in the institutions in charge of tax administration; and third, the severe limitations in the generation of reliable tax statistics, which constrain policymakers' efforts to assess the potential effect of specific tax reforms. In addition, concentration of political power in the richest percentiles of the population partly explains the resistance in certain countries to efficiently use personal income and property taxes.

Table 1.5a shows a comparison of tax revenue ratios to GDP in industrial countries and in developing countries by regions. Data for each region are an unweighted average for a sample of countries using the most recent data available from the IMF Government Finance Statistics Yearbook.[22] On average, industrial countries' ratios of tax revenues to GDP

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21. See, for example, Tanzi and Zee (2000).

22. The industrial countries group includes France, Germany, the United Kingdom, the United States, and Sweden. Southeast Asia includes Indonesia, Korea, the Philippines, Thailand, and Singapore. The South Asia group is formed by India, Pakistan, and Sri Lanka. The Middle East incorporates Bahrain, Egypt, Iran, Israel, Jordan, Morocco, Syria, and Tunisia. The Latin American and the Caribbean group includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Mexico, Panama,

Table 1.5a Government tax revenue
(percent of GDP)

Region	Percent
Africa	15.9
East Asia	16.1
Industrialized countries	39.4
Latin America and the Caribbean	17.0
Middle East	17.6
South Asia	12.7
Transition economies	29.1

Note: Data reported are unweighted averages of the latest available in the period 1997–2001.

Sources: International Monetary Fund, *International Financial Statistics* (February 2004), International Monetary Fund, *Government Finance Statistics Yearbook* (2002), and World Bank, *World Development Indicators 2003* (CD-ROM).

are about twice the level of those of all the developing regions, with the exception of the transition economies.[23] The positive correlation between tax ratios and development is no surprise. Countries with higher levels of income and development also have the capacity to raise more taxes.[24]

Table 1.5b presents the most important components of tax structures around the world. Again, there are crucial differences between the tax systems in industrial countries and those in developing countries. First, developing-country regions are much more reliant on consumption taxes compared with income taxes, although their overall tax take, even for consumption taxation, is lower than in the developed countries. Even

Peru, Uruguay, and Venezuela. Africa includes Cote d'Ivoire, Ghana, Kenya, Mauritius, Sierra Leone, Zambia, and Zimbabwe. Finally, the group of transition economies includes Bulgaria, the Czech Republic, Kazakhstan, Poland, Russia, and Ukraine.

The averages in tables 1.5a and 1.5b are unweighted because we are only including a sample of countries in every region and not the entire group of countries. However, the analysis does not change if the statistics are weighted. The most important differences in table 5a would be that the ratio for industrialized countries would decline to the low 30s because of the large share of the United States (in terms of GDP), and that the ratio for Latin America would increase to the low 20s because of the importance of Brazil in the sample.

23. Exceptional cases among developing countries with ratios close to those in industrial countries include Brazil (29 percent) and Israel (39 percent).

24. See, for example, Easterly and Rebelo (1993). There is no theory on the *optimal* level of taxation for a given degree of economic development, indicating that developing countries do best to focus on the appropriateness of their tax structures (see Tanzi and Zee 2000). An adequate design of tax structures and institutions will minimize distortions while increasing revenue collection.

Table 1.5b Composition of tax revenue (percent of GDP)

Region	Income taxes[a]			Consumption taxes		Property tax	International trade tax	Social Security tax
	Total	Individual	Corporate	Total	Of which: Value added tax or sales			
Africa	4.24	1.47	1.27	6.40	2.56	0.27	4.58	0.40
East Asia	6.09	2.53	2.44	6.47	2.85	0.56	1.15	0.81
Industrialized countries	14.04	9.68	2.57	9.80	6.63	2.42	0.05	11.68
Latin America and the Caribbean	3.92	0.81	2.21	7.78	4.05	0.70	1.98	2.72
Middle East	4.97	1.57	2.46	6.13	4.04	0.37	3.53	1.52
South Asia	2.94	0.86	1.79	4.30	3.46	0.26	1.98	0.00
Transition economies	7.80	3.54	n.a.	10.04	n.a.	0.69	0.70	9.12

n.a. = not available

a. Sum of individual and corporate tax may not equal total because some tax revenue is not allocated between the two categories.

Note: Data reported are unweighted averages of the latest available information in the period 1997–2001 (when available).

Sources: International Monetary Fund, *International Financial Statistics* (February 2004) and International Monetary Fund, *Government Finance Statistics Yearbook* (2002).

where consumption taxes emphasize the value added tax, as in Latin America, collection rates are much lower than the statutory rates because of the exclusion of many final goods and services.[25]

Second, in industrial countries the lion's share of revenues raised by income taxes comes from personal taxes, whereas in most developing countries, the corporate income tax is more important. The reliance of developing countries on some forms of corporate taxation makes the countries vulnerable to the increasing cross-border mobility of capital.[26] Large, multinational firms can reduce their tax burden by simply relocating their mobile capital. Problems in collecting personal income taxes explain the relatively higher reliance of developing countries on consumption taxes (and the increasing popularity of value added tax in some regions). In Latin America, for example, revenues from personal income taxes as a percentage of GDP are the lowest in the world because high personal exemption levels leave a large number of potential taxpayers out of the tax net, and because there is a significant degree of tax evasion. Issues on taxation in open economies as well as some specific recommendations for developing countries are presented in appendix 1.1 at the end of this chapter.

Third, the tax ratio on international trade is higher in developing countries. In Africa and the Middle East, revenues from taxes on international trade are more than 20 percent of total tax revenues. Even in East Asia they are much more important than in the developed countries, representing 7 percent of total tax revenues compared with less than 0.1 percent of this revenue in developed countries.

There are also notable differences across developing countries in tax structure. Tax systems of transition economies most closely resemble those of industrial countries. The overall tax ratio and the revenues from social security taxes as a percentage of GDP are close to those in industrial countries, and the reliance of these countries on taxes on international trade is very small. As noted earlier, Africa and the Middle East are heavily dependent on trade taxes, whereas Latin America has eschewed trade taxes and relies heavily on consumption and payroll taxes.

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25. In Latin America, reforms to tax systems were significant, especially in the first half of the 1990s, with a marked emphasis on implementation of the value added tax, a form of taxation that has been favored by multilateral organizations because, when designed as a broad tax on consumption, it does not distort the relative prices of products transacted between producers. See Ebrill et al. (2001) for a comprehensive discussion of the implementation of value added tax in developing countries. Problems in collecting other categories of taxes may create an incentive to rely on the more easily collected value added tax. The danger, of course, is overreliance on this form of taxation. See Lora (2001) for a summary of tax reforms in Latin America. Also, on issues of taxation in Latin America, see Shome (1999).

26. Even the OECD countries face this problem—especially those within the European community.

The real message from these international comparisons is that regional differences are significant when it comes to finding alternative sources of finance for development. Divergences in the design and effectiveness of tax systems are joined by regional differences in access to international capital markets and by behavior of private saving rates.

Pillar 3. Generating Resources Through Higher Export Ratios and Trade Diversification

Moving ahead in the development path involves the acquisition of a large number of import products. Imports of goods and services essential for growth and development in turn require foreign exchange. In countries with no restrictions on the convertibility of domestic currency into foreign currency, the demand for foreign currency, if large enough, can lead to significant changes to the exchange rate in a flexible exchange rate regime or to important losses of foreign exchange reserves—both scenarios having negative effects on the real economy. Countries that have some intervention in the foreign exchange markets cannot avoid these problems completely, or must resort to interest rate increases that also have real costs.

Net changes in foreign exchange flows can only be avoided if imports are fully financed with proceedings from exports or from net international capital flows. The volatility of net capital flows discussed above does not serve well the purpose of sustained acquisition of necessary imports. Indeed, a typical feature of adjustment in developing countries following a significant decline in capital inflows is their resorting to big declines in imports as the only way to generate necessary current account surpluses. Improvement in export ratios, therefore, is the only way to complement (and offset) the fickle behavior of net capital flows.[27]

Export-promoting policies need not involve increased intervention by government in the economy. In many cases, a reduction in barriers to trade, most notably reduced import tariffs, will increase exports. Because imports are an important input in production, a decrease in tariffs (especially on capital and intermediate goods) is equivalent to a reduction in costs and is, therefore, an improvement in international competitiveness. A more open and competitive economy involves higher ratios of both exports and imports to GDP.

However, tariffs and import and export quotas are not the only barriers to trade that are associated with borders separating nations; in many developing countries, after more than a decade of trade liberalization,

27. Emphasis on exports as a motor of growth in many developing countries responds precisely to the perception that the large inflows of capital observed in the first half of the 1990s will not be repeated in the foreseeable future.

they may not even be the major barriers. Other important factors in some regions and subregions are lack of transportation infrastructure across borders and bureaucratic or even corrupt customs arrangements; these factors matter most for small countries with many neighbors that have limited access to the sea (e.g., many countries in sub-Saharan Africa and some, like Bolivia and Paraguay, in Latin America).[28] Also important in raising the costs of trade can be differences in languages, cultures, and domestic regulations.[29] Examples of costs to investors in this category are the collection of information particular to a country's legal system, additional expense related to lawyers' services, hiring staff knowledgeable in the local language, and adapting products to the particular customs of the country.[30]

The task of dealing with these trade barriers (imposed by developing countries themselves or by industrial-country trade partners) is an enormous one. It involves much more than the reduction of tariffs and of nontariff barriers. It often involves institutional changes (e.g., in customs arrangements) and new investments in infrastructure that make demands on resources and on administrative capacity as well as institute policy changes.

For some developing countries whose exports are highly concentrated in a few commodities, the issue is not only or mainly to increase their exports but, rather, to diversify them. Dependence on commodity exports is problematic both because of the secular decline in world prices and because of their price volatility, implying (for countries dependent on them) substantial vulnerability to terms-of-trade shocks. Diversification of exports would be encouraged through better access to more trade partners. For other countries, the main issue is overall expansion of exports. Brazil, for example, has the lowest commodity dependence ratio in Latin America, but it has a low overall trade ratio. This low ratio,

28. See Gallup and Sachs (1999), and Radelet and Sachs (1998) for the negative effects of the wrong geography, independent of trade policy and institutions. In a comment on chapter 2, Willem Buiter notes that landlocked countries are particularly disadvantaged when trade is restricted, referring specifically to central Asia.

29. James Anderson and Eric van Wincoop (2001) classify some of these as non–rent generating, in comparison to tariffs.

30. Failure to adapt products to local tastes is not easy to distinguish from imposed barriers. Mexico City's consumption of Mexican beer, Modelo, outweighs by far the consumption of US beer even when tariffs on beer between the two countries were eliminated in 2002. Does this consumption pattern reflect the particular taste of Mexicans? Not according to the *Wall Street Journal*, which reported tie-ups (that would be illegal in the United States) that prevent competition by US beers. Likewise, in January 2003, the US court of appeals ruled an indefinite postponement of cross-border trucking, effectively preventing Mexican trucks from operating on US highways on the basis that further analysis of the environmental and safety impacts were needed. Fortunately, this latter case was resolved in 2004 in favor of Mexico.

Table 1.6 Indicator of trade openness (ratio of exports plus imports of goods and services to GDP)

Region	1970–79	1980–89	1990–99	2000–01[a]	Change from early 1970s to early 2000s	Change from first to last year
East Asia and Pacific	32.5	45.4	60.9	77.2	44.6	52.1
Latin America and Caribbean	22.6	26.0	29.5	35.5	13.0[b]	16.3
Middle East and North Africa	77.5	62.6	63.3	69.5	–18.1[b]	–19.9
South Asia	15.8	20.2	27.1	32.1	16.3	21.2
Sub-Saharan Africa	53.7	54.4	56.2	63.0	9.3	16.0
Transition economies	n.a.	45.8	63.5	75.0	29.2[c]	19.0

n.a. = not available

a. For Latin America and the Caribbean and Middle East and North Africa, average for 2000–01 only.
b. For Latin America and the Caribbean and Middle East and North Africa, change from the 1970s to 2001 only.
c. For transition economies, change from the 1980s to 2002.

Source: World Bank, *World Development Indicators 2003* (CD-ROM).

combined with Brazil's dependence on foreign inflows, makes it all too vulnerable to adverse external shocks.

How have developing-country regions performed in terms of the volume of increased overall trade and export diversification? Table 1.6 shows for each region the ratio of exports plus imports of goods and services to GDP (the trade ratio), one indicator of trade outcomes, for the 1970s, 1980s, 1990s, and early 2000s, and the changes over the entire period. Table 1.7 shows the countries' dependence on commodity exports.[31] These two tables need to be analyzed together to understand the nature of the challenge for different regions in increasing and diversifying their exports.

The East Asian and Pacific region has seen the largest increase in its trade ratio (by 52 percentage points between 1970 and 2002), with it reaching a relatively high level by the early 2000s. That increase is associated with a large decline in the region's dependence on commodity exports (as its manufacturing exports grew). Commodity exports as percentage of total merchandize exports in East Asia declined to 20 percent in the early 2000s, falling to the lowest current level among the developing-country regions (an average of 20 percent in the early 2000s). The high

31. The ratios in table 1.6 were calculated by adding the value of exports and imports of all countries in every region and then dividing that aggregate by the total GDP of countries in the region. A similar methodology was used in table 1.7.

Table 1.7 Commodities exports (percent of merchandise exports)

	1970–79	1980–89	1990–99	2000–01[a]	Change from early 1970s to early 2000s	Change from first to last year
East Asia and Pacific	61.1	47.2	22.8	20.0	–41.1	–48.2
Latin America and Caribbean	79.6	74.0	56.2	51.5	–28.1	–32.7
Middle East and North Africa	94.9	88.5	83.2	86.3	–8.6	–7.6
South Asia	49.8	41.3	23.9	21.9	–27.8[b]	–29.9
Sub-Saharan Africa	81.2	87.1	67.5	67.1	–14.2[b]	–14.1
Transition economies	n.a.	n.a.	45.6	44.6	n.a.	–3.1

n.a. = not available

a. 2000 for South Asia and sub-Saharan Africa.

b. For South Asia and sub-Saharan Africa, change from 1970s to 2000 only.

Source: World Bank, *World Development Indicators 2003* (CD-ROM).

trade ratio in the Middle East reflects its high dependence on oil exports. It is the region with the highest dependence on commodity exports overall, making it especially vulnerable to fluctuations in the price of oil.

Latin America and South Asia have relatively low trade ratios. Between the two, Latin America is still much more dependent on commodity exports—indeed, it remained more reliant on these exports in the 1990s and early 2000s than South Asia was in the 1970s. Africa has had relatively high trade ratios for decades, but these ratios have clearly reflected its concentration in commodities, on which the region remains highly dependent. The low amount of intraregional trade in sub-Saharan Africa (8 percent of all trade, compared with almost 50 percent in Asia; Birdsall 2004, table 3) reflects poor cross-border infrastructure and other problems as well as trade barriers; the resulting difficulty in achieving specialization and economies of scale, given the small size of many economies, reinforces the difficulty of reducing commodity dependence by diversifying into manufacturing. Finally, the transition economies have seen healthy increases in their trade ratios during the 1990s and early 2000s.

Implications of the Evidence on Sources of Financing for Development

Two conclusions emerge from this analysis. First, net capital inflows are too volatile to be counted on—even taking into account official sources. Increases in domestic sources of finance, through increased private saving, more efficient and effective taxation systems, and increased exports (particularly noncommodities), are therefore essential if development needs are to be financed predictably and sustainably.[32]

Second, differences in the relevant indicators of domestic financing sources and capacity—including private saving, tax revenue capacity, and export volumes and diversity—are substantial across regions. There is diversity within regions as well (e.g., in private saving rates across countries), but there are also substantial commonalities within regions in tax structure, in measures of trade and commodity dependence, and in access to external private capital. Those commonalities indicate that there is some logic in complementing country policies with more regionally based strategies for financing development.

Open and Radical Regionalism: Benefits and Strategies

We here discuss the benefits of open and radical regionalism and argue that this kind of regionalism is a good strategy for strengthening countries' sources of financing for development. By open regionalism, we mean regionalism viewed as a step toward helping countries to integrate further into the global economy. Devlin and Castro (in this volume) conclude that the regionalism of the 1990s has been essentially open. Similarly, Barry Eichengreen and Jeffrey Frankel (1995, 89) conclude that regionalism "has been used as a device for overcoming entrenched resistance to multilateral liberalization and for building coalitions favoring liberalization over wider areas."[33] Open regionalism may have been easier to manage during a period of global growth; still, this approach needs to be maintained and strengthened going forward, if a spaghetti-like framework of multiple regional (and bilateral) trade agreements is not to undermine an optimal open multilateral trading system (see, e.g., Bergsten 1997).

By radical regionalism, we refer to the idea that cooperative approaches within regions in the development of regional public goods can compensate for the failures of markets (IDB 2002). Because of various market imperfections, including externalities and information asymmetries, certain goods and services needed for development will not necessarily be provided by the markets. Concerted agreements among countries in a

32. Ironically, as domestic sources of finance improve, terms of access to international capital markets would also likely improve; international creditors and investors would become more confident in obtaining a positive return on their investment as a country diversifies its sources of finance to service the external debt on a timely basis.

33. It is important to emphasize that by no means do we want to dismiss the importance of global efforts, such as those undertaken by the WTO or by proposals of multilateral organizations, to promote international dialogue at the global level in key areas. A welcome example is the proposal for an International Tax Dialogue jointly proposed by the IMF, Organization for Economic Cooperation and Development, and World Bank on March 13, 2002.

region in a variety of areas, not only trade, can facilitate the provision of these goods and services.

We discuss the benefits of regionalism and the implications for greater emphasis on regionalism as a strategy in four areas: trade, infrastructure and economic and social institutions, arrangements to limit financial vulnerability, and negotiating strategies for adapting to a global system.[34] Willem Buiter, in his comment on chapter 2, notes that regionalism is the first-best solution to the problem that arises when the externality in public good provision is strictly regional in scope. This is usually the case for infrastructure and for certain economic and social institutions. For trade and for monetary arrangements to limit financial vulnerability, however, a global solution is best (the latter is true because, as Buiter notes, across regions, participants can benefit from the likelihood that economic shocks are less likely to be positively correlated). At the same time, we argue that regionalism, even when second-best, may also have benefits when it is an alternative to a first-best but unattainable global solution. It may also have benefits if, as an economic arrangement, it strengthens healthy political ties (as many would argue is the case with respect to the European Union). It is in that spirit that we outline the benefits of regionalism.

Regional Trade

Regional trade agreements directly enhance financing capacity to the extent they increase and diversify trade among partners (referring to pillar 3). When they include an industrialized country (as does the North American Free Trade Agreement [NAFTA], e.g., and as would the Free Trade Area of the Americas), they also increase access to foreign investment flows (referring to pillar 1). In chapter 2, Devlin and Castro discuss the benefits to member countries of recent regional trade agreements. For example, the Asia Pacific Economic Cooperation (APEC) forum launched in 1993 has led to a large increase in APEC intratrade, as well as a significant increase in overall exports by many member countries. This is the result of an important reduction in the level of protection, with average tariffs among APEC members having been halved between 1988 and 1998.

Latin America and the Caribbean provide clear evidence of the benefits of regional trade integration. In this region, more than half of noncommodity exports go to intraregional markets. Thus, regional integration is providing an impetus for export diversification into products with larger value added. Moreover, Robert Devlin and Antoni Estevadeordal (2001) show that these trends are occurring with no significant evidence of trade diversion.

34. We do not discuss the benefits of labor mobility.

Mexico's gains from NAFTA exemplify to a large extent the potential benefits to be gained from regional trade agreements. Not only have Mexico's annual exports more than tripled since 1993, but Mexico's export composition has also changed dramatically from a structure dominated by oil to one in which noncommodity exports with high value added have been increasing systematically. Moreover, Mexico's access to sustainable external sources of finance has improved significantly as FDI flows have accompanied the impressive growth of Mexico's total exports.

Countries that were candidates (and those that still are) for becoming members of the European Union have experienced important benefits from the treaty between EU countries and eligible countries from central and Eastern Europe. In particular, these countries have benefited from virtually free access for their industrial exports since 1995. Trade between the European Union and eligible candidates increased by 300 percent in the eight years from 1993 to 2001. Moreover, FDI between the partner countries in the treaty has systematically increased, even during the economic slowdown of the early 2000s and during the overall global fall in total FDI from 2000 to 2001.

Infrastructure and Economic and Social Institutions

Transborder infrastructure, programs to contain contagious diseases, watershed management, and management of such regional bads as environmental spillovers are all examples of regional public goods. They all refer to the provision of goods and services that are essential for development but that are not provided by markets or by single nations. Although these examples initially need, rather than generate, financing resources, they indirectly enhance the future availability of financial resources for development. In addition, they create the appropriate environment for foreign direct investment. In many cases they increase trading options and, by reducing costs, make members more competitive in global as well as regional markets.

In chapter 3, Marco Ferroni discusses extensively the concept of regional public goods. In a nutshell, pure regional public goods are those services or resources whose benefits are shared by countries in a region and that satisfy two conditions. The first is that one country's consumption of the services or resources does not subtract from the amount available to other countries. The second is that no country in the region can be excluded from the benefits. An example is investment in agricultural technology that is specific to a region or subregion because of that area's geographic characteristics.[35] Most of what we refer to as regional public

35. Jeffrey Sachs (2000) has argued that production technology in tropical regions has lagged behind temperate zone technology in the areas of agriculture and health. His recommendations call for concerted efforts to develop technologies specific to the needs of the tropical economies.

goods are not pure public goods in the strict sense, as they combine national and transnational benefits. Efforts to deal with shared natural resources, such as the Nile River Basin Initiative or the Mekong River Commission, and with transborder roads and other transportation infrastructure that have excludable properties are examples of regional public goods.

Exploiting the benefits from regional public goods requires a cooperative strategy on the part of at least two countries. Indeed, because regional efforts are constrained by the difficulty of coordination, or collective action, among countries, any outcome of regional cooperation can be thought of as a regional public good.

In recent years, there has been considerable attention in the development community to the problem of suboptimal investment in global public goods (see, e.g., Ferroni and Mody 2002; Kaul, Le Goulven, and Schnupf 2002; World Bank 2001). Although there is no way to make systematic comparisons, we suspect that the level of underinvestment in regional public goods within developing country regions is even greater. At least investment in global public goods brings clear benefits to the developed countries; thus, the latter nations took the lead in developing the Montreal Protocol (agreeing on reductions in ozone-depleting emissions) and are now managing the initiative to reduce global financial contagion (e.g., through development of international banking standards; see the chapter by Rojas-Suarez in this volume for a perspective from the developing countries on the Basle II initiative). In contrast, there has been extraordinarily little investment in, for example, transborder transportation in sub-Saharan Africa—to the point that it is still easier to travel from west to east Africa by flying through Europe than directly. The benefits to Africa's small, landlocked countries of a better transportation infrastructure would probably be very high.[36] The same would be true for regional electricity grids (now being developed in Central America) and for regional arrangements to reduce customs delays by harmonizing customs procedures.

In short, the level of underinvestment up to now implies a long list of investments with potentially high returns. Many of these opportunities would attract private investors if countries were to establish with their neighbors the necessary regional frameworks that would promise predictability, guarantee property rights, and so forth.

Regional Arrangements to Limit Financial Vulnerability

A major problem facing developing countries is the volatility of international capital flows. Regional arrangements can play a role in dealing

37. Birdsall (2004) suggests that for this reason the donors as a group ought to assess more systematically the potential benefits of supporting cross-border regional investments.

with this difficulty. There are two kinds of arrangements: regional financial integration, and regional financial cooperation to support a country or countries within the region that are facing liquidity problems as a result of loss of access to the international capital markets.

Financial integration agreements usually involve eliminating restrictions to cross-border financial operations by institutions from countries within the region. These arrangements, therefore, contribute to the increased availability of sustainable capital flows (pillar 1) and the development of financial markets (enhancing pillar 2). After the East Asian crisis in the late 1990s, countries in that region started initiatives to harmonize and standardize their bond markets. As reported by a number of analysts, the crisis motivated regional financial cooperation because of the region's desire to diversify their sources of finance beyond those available in the US and European capital markets.[37] Identifying impediments to the development of the government bond market at the local level (such as inappropriate legal and clearing systems) has been the first step. Thus, integration efforts have given impetus for reform at the domestic level.

In Latin America, the move toward financial integration has taken both an informal and a formal path. The informal process has manifested itself through the large and increasing participation of foreign banks, mostly from developed countries. This indicates a de facto integration with developed countries, rather than regional integration. The formal process has taken the form of formal regional agreements. Mexico is likely to benefit from NAFTA provisions aimed at allowing the operation of financial institutions among the three countries in the group and at avoiding discriminatory treatment of financial institutions. For the most part, however, among developing countries, progress has been quite limited, largely being restricted to efforts by Caribbean countries to develop a regional stock market (Barbados, Jamaica, and Trinidad and Tobago) and to the effort in Central America for the harmonization of capital markets.

The second kind of regional financial agreements aims at establishing a regional financing arrangement to supplement existing international facilities. This kind of initiative attempts to somehow relax the immediate constraints associated with limited and highly volatile access to net

37. In the view of a number of analysts of the Asian crisis, the lack of a well-developed regional bonds market played a role in the effects and magnitude of the crisis. The argument is that, in the absence of regional bond markets, a large portion of the huge stock of international reserves was invested in US dollar– and European currency–denominated assets. These investments were recycled back to the region in the form of short-term dollar–denominated debt through local banks (because there was no developed domestic bond market). The resulting currency and maturity mismatches in the context of managed exchange rates created severe fragilities in the Asian financial systems. See Rhee (2000).

international flows, both private and public.[38] A good example is the Chiang Mai Initiative in Asia, which consists of a network of bilateral swap agreements, including those between China and Japan. Through an agreed surveillance process in which countries assess each other's performance, the initiative also tries to minimize contagion effects in the region. In his comment on chapter 5 Roberto Zahler also cites the Association of South East Asian Nations' (ASEAN) pilot macroeconomic surveillance and monitoring schemes; the Arab Monetary Fund's provision of liquidity for intraregional trade; the Latin American Reserve Fund, which complements the IMF in providing liquidity financing during crises (e.g., following the currency crisis in Ecuador, the Latin American Reserve Fund lent about $400 million to the Ecuadorian government in 1999 to support its balance of payments; this loan, which constitutes the largest amount of funds disbursed by the Latin American Reserve Fund, has been amortized on a timely basis); and the operations of subregional development banks such as the Andean Development Corporation and the Arab Investment Guarantee Fund.

Regional Negotiating Strategies in a Global Economic System

The design and implementation of the rules of the game in today's global economic system do not necessarily reflect the priorities of developing countries. Nancy Birdsall (2003) refers to the reality of asymmetry in the way global rules are set, resulting from the greater power and resources of the richer economies.[39] In the current environment, in which industrial countries have in place a number of trade restrictions adversely affecting developing countries, developing countries are better positioned to negotiate the rules of the game in trade through regional blocs than by isolated efforts. The smaller economic size of developing countries weakens their ability to negotiate the rules of the global system, except to the extent with which they cooperate with each other. Their failure to get a good deal in the Uruguay Round can be compared with their initial success (on a few issues, such as acknowledgment of their right to use compulsory licensing to acquire medicines in the case of clear public health needs) in the initial meetings of the current Doha Trade Round, when several large developing countries agreed on a common negotiating strategy.

An example of how a regional strategy could strengthen developing

38. Buiter, in his comment on chapter 2, argues that regional IMFs and bilateral swap agreements are only acceptable as a fourth- or fifth-best approach—although they are still better than nothing at all.

39. Thus Oxfam (2002) titled its analysis of the global trading system "Rigged Rules and Double Standards." See also Birdsall and Clemens (2003) on the resulting responsibilities of the rich countries given their commitments to work with poor countries for achievement of the Millennium Development Goals.

countries' negotiating capacity in trade agreements comes from Latin America. Until its recent weakening (with Argentina's financial collapse, and before that with the Brazilian devaluation), the existence of the Southern Cone Common Market (Mercosur) and the possibility that it would be extended to include Chile, Bolivia, and the members of the Andean group in Latin America created a position of strength for Brazil and its Mercosur partners in discussions of the Free Trade Area of the Americas with the United States. Although at the time of this writing it seems more difficult, and recognizing that Latin American countries are far from homogenous and that their objectives are not always aligned, there would still be benefits to the region of developing a common negotiating strategy on issues such as agricultural subsidies to counter with strength the domestic political pressures in the United States that might otherwise dominate the final agreement.

Sustaining a common regional negotiating position is not easy, however. It requires that all governments adhere to the open portion of open regionalism. The Andean Group initially failed to work because members wanted to keep their markets closed. In the early 1990s, the fact of the agreement helped overcome entrenched protectionism. More recently, however, some member governments, including Venezuela under Chavez, have returned to nationalism, undercutting the benefits of the subregional agreement.[40] The risk has been heightened by the recent trade agreement between the United States and Colombia and Peru. Separate agreements are difficult to resist for individual countries, but they risk undermining their ability to sustain a common Latin American position in a negotiation with the United States.

A good example outside of the trade area of the use of a regional strategy to strengthen access to financing for development is the New Partnership for Africa's Development (NEPAD). African governments agreed on a common framework emphasizing their own peer review of country commitments to economic and political reforms in return for a commitment from donors to provide development finance. NEPAD represents an approach to design and monitoring of country policies at the regional level as a mechanism to better lock in predictable donor financing.

Role of RDBs in Guiding Regionalism and Enhancing the Sources of Financing for Development

Effective regionalism is no mean feat. It requires overcoming difficult coordination problems among the countries concerned. This is obvious in

40. The IDB and the Andean Development Corporation have not used conditionality or other visible initiatives at the country level to prevent the reversions to trade barriers that could lead to the dissolution of the Andean agreement.

the case of open regional trade agreements, which require not just agreed border arrangements but also deep integration in the sense of mutually agreed-on regulatory, safety, and other standards.[41] However, in contrast to the comprehensive regional integration of the European Union, most regional integration efforts in developing countries do not envisage the creation of supranational institutions to deal with collective action problems. To some analysts, the absence of supranational institutions able to enforce policy decisions aimed at ensuring the continuous improvement of the integration arrangements is an important weakness. For example, Robert Pastor (2001, 5) argues that a major shortcoming of the NAFTA charter is that it assumes that the social, economic, and political consequences of dismantling trade and investment barriers will be trivial: "NAFTA . . . overlooked the concept of externalities . . . that markets generate unintended but costly social, environmental, and political consequences."[42]

The combination of collective action problems in regionalism efforts of developing countries and the absence of supranational institutions indicates how important the RDBs can be in supporting regional strategies. There are at least four critical roles of the RDBs in their support of regional strategies for financing development.

First and most obvious is that they provide a coordination mechanism for member countries to plan and finance the provision of regional trans-border infrastructure and other regional public goods requiring large initial investments. The potential coordination role of the RDBs has been dramatically underutilized because they have not had a simple financing mechanism for such regional goods; their principal instrument is a loan to an individual country that must carry the borrower's guarantee. Such country-based loans raise the problem of *ex ante* definition of each country's expected benefits from an investment, and thus each country's appropriate liability. (Even in the case of the highly concessional soft windows of the banks, for which borrower guarantees are not relevant, there is the need to allocate repayment of principal.) The only straightforward instrument the RDBs have for financing regional goods is, therefore, their very limited grant facilities (table 1.8). It would make sense for their members to use more of their net income to infuse their grant facilities with more resources if they are to realize their full potential as instruments of regionalism.

Still, such projects as the Central American electricity grid and the initiative to develop the Peru-Ecuador border region as part of the peace

41. Nancy Birdsall and Robert Lawrence (1999) discuss the public good nature of such deep integration at the regional level, and the resultant benefits for developing countries.

42. See Rojas-Suarez (2002) for a discussion of supplementary economic and financial policies that might be needed to ensure the sustainability of a Free Trade Area of the Americas in the absence of supranational institutions with the capacity to enforce policy agreements.

Table 1.8 Average annual loan disbursements and grant approvals of multilateral development banks, 1995–2002[a]

Bank	Loans (millions of dollars)	Of which: Regional (percent of total)	Grants (millions of dollars)	Of which: Regional (percent of total)
African Development Bank	1,319	1.42	49	16.48
Asian Development Bank	4,761	0.20	162	19.52
European Bank for Reconstruction and Development	2,206	n.a.	112	23.83
Inter-American Development Bank	6,124	1.24	87	34.36
World Bank	20,255	n.a.	n.a.	n.a.

n.a. = not available

a. Or years available.

Notes: Inter-American Development Bank figures are for authorized loans; Asian Development Bank figures are for loans excluding equity investment; African Development Bank figures include loans and grants; European Bank for Reconstruction and Development figures are gross disbursements; and World Bank figures are the sum of IBRD and IDA disbursements for foreign and local expenditures, and include HIPC. Grant figures are approved grants for technical cooperation.

Sources: Annual reports of the Inter-American Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, and World Bank, and statistical indicators of the African Development Bank.

agreement between the two countries (both projects organized under the umbrella of the IDB and financed in part through the limited IDB grant funds) and the Asian Development Bank's (ADB) plan to improve regional gas transmission in the central Asian republics provide examples of the tremendous potential—so far largely unrealized—for the RDBs to support regional goods and, through these, to help catalyze the increased trade and increased attractiveness for foreign investment that constitute more sustainable financing sources for development.

Second, the RDBs provide technical support to regions in support of negotiating trade agreements both among developing countries in a developing region and between groups of developing countries and developed countries. For example, the IDB, along with the Organization of American States, has provided and helped finance the Secretariat for the Free Trade Area of the Americas planning. Moreover, the ADB has made resources available to support APEC's World Trade Organization capacity-building initiative through its technical assistance program.

Third, RDBs have the ability to provide a regional public good essential for development: the transmission and utilization of region-specific knowledge. That ability positions them to help countries within their respective regions design specific policies most appropriate to countries' economic needs and political constraints. The regional differences in financing sources and institutions that can further development lend support to the need for policy design with region-specific features. In chapter 4, Liliana Rojas-Suarez points to the problems faced by developing countries in adopting and implementing international standards set by global multilateral institutions, such as the IMF and the World Bank, for strengthening financial systems.[43] Showing that a too-rapid implementation of some of the financial standards may bring unwanted side effects to some countries, Rojas-Suarez calls for the design of transitional country- and region-specific policies that, in the short run, may diverge from the international standards but that, in the long run, would contribute to achieving them. Although recognizing that responsibility for policy decisions rests ultimately with the country themselves, the author makes a case for a key role for RDBs: Because the RDBs have extensive experience in dealing with the particular economic and financial features of their regions, they are well equipped to help countries in identifying constraints to the effective implementation of the standards. RDBs can also exploit synergies in designing common solutions applicable to several countries within the region.

Fourth, to the extent that developing countries are better represented in their respective RDBs than in the World Bank and the IMF, the RDBs provide a greater sense of ownership to developing countries of domestic economic and institutional reforms. Judicial and legal reforms, strengthening of the rule of law and property rights, rationalizing tax systems, improving banking supervision, and so forth are all critical for increasing export competitiveness and attracting foreign investment. The RDBs can provide a mechanism for transmitting positive policy contagion across countries within a region, especially to the extent that RDB loans are a mechanism for supporting positive policy change.[44] The African Development Bank, for example, can play a central role in support of the NEPAD process mentioned above. Ownership by developing country members of the RDBs also invites their contributing, through research and other efforts, to improving the workings of the international financial system, taking into account the difficulties that problems in the system pose for the developing countries, given their less deep financial markets and their greater vulnerability to global crises.

Similarly, the RDBs also can play a strong role in representing their developing country members in discussions of reform of the international financial system, through research and other efforts.

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43. Other global standards-setting bodies include the Basel Committee on Banking Supervision and the Financial Stability Forum.

44. Birdsall (2004) discusses the effects of greater ownership by borrowers of the IDB, where borrowers control 50 percent of the votes as well as the leadership.

Additional examples of how RDBs can enhance each of the three pillars for financing development follow.

Role of RDBs in Enhancing Sustainable Access to International Capital Markets

Although RDBs are direct providers of net capital flows to developing countries and are, therefore, part of the statistics presented in table 1.1, a key challenge for these institutions is the design and development of financial products that improve the sustainability of net capital flows to countries in their region. In chapter 5, Manuel Hinds advances specific policy recommendations in this regard. Two of the proposed recommendations are the creation of a series of instruments aimed at enhancing debt issued by their member countries through eliminating asymmetry of information, and liquidity loans aimed at ameliorating the effects of contagion on financially healthy countries.[45]

There remains much work to be done in this area, and there is no consensus on what kind of instruments could serve the countries' needs while at the same time protecting the international credit standing of the corresponding RDB. Enhancing a country's access to international capital markets through the issue of RDB guaranteed debt is a case in point. Although some analysts strongly support the use of these instruments, others caution RDBs about the potential risks to the institutions. After the default by Argentina, the downgrade by Standard and Poors in October 2002 of three bonds issued by Argentina, Colombia, and Thailand backed by partial guarantees from the World Bank has only increased skepticism among those who oppose an extensive use of this instrument. Although the credit rating did not affect the creditworthiness of the World Bank itself, a number of analysts have argued that the downgrade damaged its credibility as perceived by bondholders and credit rating agencies. There is even more controversy over the idea of the RDBs supplementing the IMF's financial resources in dealing with liquidity crises. In discussing Hinds's chapter, Roberto Zahler puts emphasis instead on the role of RDBs in prevention, calling for them to design vulnerability indicators and early warning systems and to help the IMF in the design of debt workouts (where the RDBs' possibly greater knowledge of the local political economy might contribute to quicker and more sustainable resolution of difficult allocation of losses among taxpayers, depositors, and local and foreign creditors).

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45. Hinds also suggests that financial integration could be further developed within regions. Certainly, increasing regional cooperation among banking supervisors and regulators would be useful. Some of Hinds's other suggestions, for example, that the RDBs require borrowers to obtain market credit ratings, are criticized by Zahler in his commentary.

The RDBs can play a significant role in promoting initiatives and reforms to improve the environment for sustainable foreign flows. The provision of regional goods such as the coordination of transport infrastructure among neighboring countries or the collective efforts to fight infectious diseases, needs the support of RDBs. As discussed above, provision of these regional public goods improves the overall investment climate and therefore helps attract foreign direct investment. In addition, RDBs can effectively support needed reforms (albeit to different degrees in the different regions) to the judiciary systems, the establishment of adequate property rights, and sound bankruptcy laws. Because countries within a region or subregion often share common institutional arrangements and laws as well as similar market practices, RDBs can exploit important synergies in designing and implementing common reforms to countries within a region.

RDBs' Contribution to Increased Private Saving Ratios and Improved Taxation Systems

RDBs are in a good position to help countries identify and prioritize reforms needed to improve their private saving ratios. Countries in Latin America have shared similar experiences during the eruption and resolution of financial crises. The IDB is, therefore, well aware of the fragilities that characterize the Latin American financial systems and can effectively and promptly support policies to strengthen financial systems in this region. In Africa, the African Development Bank could be a critical force in developing a regional consensus for encouraging reduced fertility, eventually supporting higher private saving by increasing the ratio of workers to children—a critical contributor to the saving and investment surge that began in East Asia three decades ago.[46]

Turning to the taxation systems in developing countries, here again we have a strong case justifying the adoption of regional policies with the support of RDBs. Take, for example, the high reliance on international trade taxes in Africa and the Middle East. The challenge for these regions is the improvement of other forms of taxation, such as consumption taxes, and the strengthening of tax administration systems to decrease levels of evasion. Only under those circumstances can governments in these regions reduce their dependence on the highly distortionary taxes on international trade.

In the transition economies, reforms need to be directed mostly at the creation (in some cases) or strengthening (in other cases) of modern tax institutions. Discrimination in the application of taxes across enterprises (including with the purpose of preventing firms from failing) still remains

46. See the essays in Birdsall and Sinding (2001).

in a number of countries.[47] The achievement of accession to the European Union is undoubtedly the greatest incentive for the potential candidates in this region to reform their tax systems. This is certainly one of the clearly stated objectives of the European Bank for Reconstruction and Development in supporting countries in this region.

RDBs' Role in Augmenting Trade-Related Resources

For the reasons advanced above related to the intrinsic knowledge of RDBs about the peculiarities of countries in their region, these institutions have the capacity to help countries identify areas of needed domestic reform (elimination of distortionary tariffs, exemptions, or other trade barriers, for example) that would enhance subregional and regional integration efforts. Helping countries to understand the benefits and limitations involved in every stage of trade liberalization, as well as enhancing their capacity to negotiate trade agreements, could provide a major contribution toward a sustainable global integration. In a nutshell, open regionalism can be enhanced by RDBs.

Final Remark

The discussion in this introductory chapter has provided but a taste of the rich analysis that the reader will find in the rest of the chapters in this book. Throughout, experts on the subject and their commentators discuss at length the different facets of regionalism and advance specific proposals and policy recommendations to strengthen the role that RDBs can play in enhancing the sources of financing for development. It is our hope that their contributions will motivate a more open and more radical regionalism throughout the developing world.

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47. See Tanzi and Tsiboures (2000) for a comprehensive discussion of the progress on fiscal reforms in the transition economies.

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Appendix 1.1
Lessons from Taxation in Open Economies

The increasing mobility of capital has given rise to a new literature on taxation in open economies. One branch of theoretical analysis predicts two outcomes. The first is that in their efforts at retaining foreign direct investment, countries will engage in a race to the bottom; that is, countries will engage in tax competition that drives corporate tax rates to levels below what is optimal from a social perspective. Evidence of tax competition within OECD countries is presented by Reint Gropp and Kristina Kostial (2001) who show that between 1988 and 1997, the OECD average statutory corporate tax rate declined from 44 percent to 36 percent while the dispersion around the average also declined significantly. The second impact on taxation resulting from increasing capital mobility is that to offset the losses in taxation revenues from corporations, countries would redistribute the tax burden from mobile capital onto less mobile factors, especially labor. This may result in more regressive tax systems.[48] Supporters of this analysis recommend the harmonization of capital tax rates between countries or regions potentially subject to engage in a suboptimal tax competition.

A second branch of the literature argues that countries significantly differ in other respects that are more relevant than tax systems for corporations, so that the emphasis on corporate tax rates as a determinant to net inflows of foreign direct investment should not be overstated.[49]

Although the issue of competition versus harmonization of corporate tax rates remains unresolved even in more developed countries, several policy recommendations that are consistent with alternative theoretical analysis can be advanced for developing countries. The first is that countries should agree to national treatment of capital; that is, foreign investors should be treated no less favorably than domestic investors. As the 2001 United Nations' *Report of the High-Level Panel on Financing for Development* (the so-called Zedillo Report, p. 46) indicated, "national treatment

48. A review of the literature on tax competition is contained in Wilson (1999). The theoretical analysis regarding the difficulties to tax corporations' income in small open economies derives from Diamond and Mirrlees (1971).

49. For example, Baldwin and Krugman (2002) argue that wealthy countries are in a better position than less developed countries to offer capital favorable external economies such as an established base of infrastructure or accumulated experience. These benefits allow some countries to levy relatively high tax rates without the danger of losing mobile capital. Indeed, when dividing EU countries into two categories—the wealthiest and the less advanced nations—Baldwin and Krugman did not find that the average corporate tax rate between the two subgroups followed a race to the bottom. Instead, since the mid-1980s, tax rates of the less wealthy countries have been converging upward, toward those rates prevailing in the richest countries of the European Union.

does not mean special treatment: foreign investors should not be exempted from domestic laws governing corporate and individual behavior, nor should the authority or domestic courts, tribunals and regulatory authorities over foreign investors and their enterprises be curtailed. . . . The wrong way (to attract foreign direct investment) is to hand out tax concessions or erode domestic social or environmental standards."

A second policy recommendation is that focusing excessively on the matter of corporate taxation as a way to attract international capital may distract from reforms in other areas, such as improved bankruptcy laws, efficient judicial systems, and enforcement of the rule of law and contracts, that might be more important to attract and retain foreign direct investment. A third recommendation is that given the long list of problems facing developing countries in optimizing their tax structure, modifications to the corporate tax system should not be made in a vacuum but with consideration for all the other components of the tax structure.