

## **The Impact of Regional Integration on Economic Growth of East African Community (EAC)**

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### **Abstract:**

*This study sought to examine the effects and gains of regional integration (EAC) on economic growth in Kenya. Despite the long existence of the East African Community, its contribution to financial integration, trade integration and effect of past per capita GDP on current output levels in EAC, its output has hardly been quantified. This study hence explored the efficacy of the East Africa Regional Integration on Economic growth, mainly looking at the role of financial integration, trade integration and the effects of past Per capita income on economic growth and development in the region. The Harrod-Domar growth model and Solow-Swan model were the key theories anchoring this study. Panel data time series analysis method was used in the in testing of the study objectives. The findings indicated that Financial integration in East African Community (EAC) has not impacted substantially on economic growth in the region. The hypothesis was tested at 5% level of significance which translates into t-statistic value of 1.96 based on the total observation of 154 observations. Thus, if the computed t –statistic is more than 1.96 or the probability value is less than 0.05 (5%), the study hence rejects the null hypothesis. It was also noted that Trade integration in East African Community has no influence on output produced in the region. The critical t-statistic and the probability corresponding to the t-statistic are 1.96 and 0.05, respectively. Since the computed t-statistic and the probability are: 2.596 and 0.0096, these values clearly indicate that trade integration stimulates output in East African Community significantly. Thus, this study could not accept the null hypothesis. Finally, the past per capita GDP had no effect on output produced in East African Community. The critical t-statistic and the probability corresponding to the t-statistic are 1.96 and 0.05, respectively. Since the computed t-statistic and the probability are: 1.9225 and 0.0548, these values clearly indicate that past per capita GDP has no influence on output produced in East African Community significantly. Thus, this study cannot reject the null hypothesis.*

**Key Word:** *Free Trade area (FTA) Preferential Trade Arrangement (PTA), East Africa Community (EAC), Most favoured nations (MFN)*

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### **I. Introduction**

Kato Sophal and Piseth (1998) have defined economic integration as comprising of legal arrangements among the nations for economic transactions and activities across their boundaries. In economic integration, a set of nations within a certain geographical region form a potential arrangement where they agree to lift trade restrictions among their members. De Melo and Panagariya (1993) have classified integration into broad categories ;(i) Modest regional integration; and (ii)deep regional integration. Modest economic integration seeks only to give preferential trade arrangements (PTA) or free trade area (FTA) to their members. In the case of PTA, lower Tariff are imposed on goods and services from member countries than imports from the rest of the other countries. Regarding FTA, De Melo and Panagariya (1993) explained that it is one step ahead of PTA in the sense that tariff on imports from member countries are reduced to nil, while those from non-member remain at a pre – agreement level. Deep economic integration therefore envisages either a Customs Union in which members set a common market where free movements across national boundaries is established for members' factors of production (capital, labour, services and finance, in addition to trade of goods and services.

Kato Sophal and Piseth (1998) argue that the economic integration can be arranged beyond regional levels, and that it can be organised even at a global level. They argue that multilateral trade agreements which were negotiated and agreed by the General Agreements on Trade and Tariffs (GATT), which evolved into the World Trade Organization (WTO)as an example of economic integration.

The general principle of GATT and WTO is that of non-discrimination, which is stated in two clauses: (i) Most favoured nations (MFN); and (ii) National treatment (NT).WTO asserts that in MFN, there should be no discrimination against imports compared with goods which are domestically produced .In a nutshell, WTO (1995) states that countries should adopt trade openness in order to encourage competition among countries and competition between domestically produced goods and foreign made goods .

Kato Sophal and Piseth (1998) have argued that it may appear that regional trading arrangements which involve a discriminatory element against non-members might have contradicted the non-discriminatory principle of MFN treatment. In GATT and WTO at first sight but this is not the case for the reason that closer economic integration within regional countries is expected to promote freer trade. However, regional trade arrangements are required to treat non-members in no more restrictive manner than before the regional trading arrangement.

Economic growth has been defined by Perkins Radalet, Lindauer and Block (2013) as a persistent rise in the national or per capita income. This means that a continuous increase in the gross domestic product (GDP) of a country can be seen as economic growth. The same authors (Perkins et al) following Kuznets, also define economic growth from the modern perspective or current economic Epoch, which is still evolving and so its features are not yet clear, as application of signs to application science to problem of economic production which can led to organization, industrialization even explosive increase in population.

### **STATEMENT OF THE RESEARCH PROBLEM**

The East African Community regional integration is currently working on its modalities to enter into monetary union protocol despite receiving a caution from Christine Madeleine Odette Lagarde in January 2014 of immense shocks on fast pace of regional integration especially on monetary union (Kimeu, 2020). Despite the African continent having numerous regional integrations, many of them have not been able to achieve their desired and anticipated growth levels. The East African Community collapsed in 1977 owing to the political and ideological differences between Heads of member states, after being established in 1967. In spite of its revival on 7th July 2000 its objectives of achieving economic and financial development among its member states could not be quantified leading to questions of whether there was need and justification to proceed to the monetary union stage. This study would then seek to quantify whether financial and trade integration in the East African Community has significantly influenced economic growth in the region. This study would further query whether the past per capita incomes was of assistance in any way to EAC on its current out level in region.

### **Objectives of the Study**

This study aimed at achieving the following objectives;

- a) To ascertain if financial integration of East African Community has impacted significantly on east African economic growth
- b) To establish if trade integration of EAC has stimulated economic growth.
- c) To assess the effect of past per capital GDP on current output level in EAC.

### **Study Hypothesis**

This study tested the following research hypotheses;

H1<sub>A</sub>: Financial integration in East African Community (EAC) has not impacted substantially on economic growth in the region

H2<sub>A</sub>: Trade integration in East African Community has no influence on output produced in the region.

H3<sub>A</sub>: Past per capital GDP has no effect on output produced in East African Community

## **II. Economic Growth Models**

There are three main Economic growth models which have emerged since the middle of 1950's. Perkins Radalet, Lindauer and Block (2013) have listed these models as Harrod - Domar model, the Solow – Swan model and the Romer -Lucas –Rebelo inspired endogenous growth model. After the publication of the Keynes (1936) general theory of employment, interest and money, two economist Harrod (1939, 1948) and Domar (1946, 1947) adopted Keynes short term analysis and applied it to obtain long run economic growth model. In their theory Harrod –Domar emphasised the effects of investment in the productive capacity of the economy.

The assumptions of the Harrod –Domar model is that there is fixed capital labour ratio (K/L), technology is given, the economy is closed and there is no government intervention in the free functioning of the economy. Based on these assumptions Perkins Radalet, Lindauer and Block (2013) give the fundamental Harrod Domar equation as:

$$g = \frac{s}{v} - \delta \quad 2.1$$

Where: g, s, v, and  $\delta$  are growth rate of the economy, saving rate, capital-output ratio (COR) and depreciation rate, respectively. Equation 2.1 states that the growth rate of the Economies is depending positively on the savings rate, intensively on capital output ratio and negatively on the depreciation rate.

Economists can use this frame work to predict growth rate or to calculate the amount of savings required to achieve target growth rate. The 1<sup>st</sup> step is to estimate the capital output ratio (V) and depreciation rate ( $\delta$ ). With this model once the target growth is decided along with the estimated depreciation and capital output ratio, rate of savings that is needed to achieve growth can easily estimate Perkins Radalet, Lindauer and Block (2013).

The model could not walk in the practice as the frame work tends to portray. The reason for this are many. Bhagwati (1993) argue that the Harrod- Domar model has taken the productivity of investment as fixed and this is not realistic. Another reason is that the assumption of zero substitution between capital and labour is not realistic. The model also assured wrongly that the economy doesn't interact with outside world and the public sector does not exist. All these defects make the model not to work in practice as predicted which led King and Levine (1994) and Easterly (2003) to describe the model as fetish, leading economist to the wrong path in their quest to achieve accelerated economic growth.

Dissatisfied with the Harrod-Domar model economist Solow (1956) and Swan (1956) developed a neo-classical growth model which assumes the following: (i) the economy has only one productive sector that produces capital and consumer goods; (ii) there is no government; (iii) all savings are invested; (iv) the economy is always at full employment equilibrium ; and (v) the technology is given .On the Basis of these assumptions the Solow Swan model concentrates on establishing the interaction between three variables of the production function ,consumption function and the capital accumulation process. This interaction gives us the following Solow – Swan model;

$$Sf(k^*) = (n + \delta)k^* \quad 2.2$$

Where s, f, ( $k^*$ ), n,  $\delta$  and  $k^*$  are the steady state saving function. growth rate of the population, depreciation rate and steady state capital growth rate.

Equation 2.2 states that the steadily state savings rate is dependent on the growth rate of the population, depreciation rate; and the steady state capital growth rate. The model further postulates that at the steady state the savings function, the growth rate in output per head is equal to the growth rate of the population and this is equal to the growth rate in capital stock. This is the golden rule of capital accumulation Solow (1956).Mankiw (2003) and Solow (2002 ) have given the following credit to the Solow and Swan model ; in the long run the economy will gradually approach its own steady state growth is dependent on the population and the technological progress ;the steady state growth rate of the population and output ;and the model has postulated that poorer countries will grow faster than rich countries and in the long run all countries in the world would converge to grow at the same rate.

The model of Solow-Swan has been credited for making the following predictions (see Mankiw, 2003; and Solow, 2002): (i) in the long-run the economy gradually approaches its stationary state; (ii) the steady state growth rate depends on population growth, and technological progress; (iii) in the steady state balance growth, the rate of growth of output per worker is dependent on technical progress; (iv) the steady state growth rate of capital equals the growth rate of output; (v) the effect of saving on increasing output is temporary; and (vi) the model has convergence characteristics which state that poorer countries tends to grow faster than richer countries.

Mankiw (1995) also explains that many of the predictions from the Solow-Swan model are consistent with real world settings. The first observation is that the growth rates in rich OECD countries have been relatively low when compared to the high growth rates in initially low-income countries. There is no evidence of convergence across countries that are not homogeneous (Romer,1989; De Long, 1988) but there is significant evidence in support of conditional convergence from data set (Barro, 1991, 1997). The Solow model is at variance with Asian Tigers' growth which is explained by factor accumulation. The model has the capacity to explain the impressive growth of Japan and Germany after post world war 1945 growth and the faster growth of Italy and France in their transitional dynamics to stationary state (Snowdon and Vane, 2005). Growth in the long-run can be achieved through technological progress. However, the model takes technological progress as an exogenous variable that is available to all countries equally. This is considered by Romer (1986) as unsatisfactory as the model explains everything but not the long-run growth, which is a crucial factor affecting growth.

Some economists like Romer (1986), Lucas (1988) and Barro (1990) who were not satisfied with the exogenous growth model work towards making the model endogenous. They construct long-run growth model in which economic long-run growth is determined by investment decisions rather than technical progress. crafts (1996) has noted that the term investment as used in this context is a broad term which implies investment in broad capital which include physical capital accumulation, human capital and expenditure on research and development by government and individual firms. The implication of this broad definition of capital is that it is able to solve the problem of diminishing marginal productivity of capital (MPC). The returns to broad capital

invested exhibits constant returns to capital. The economy itself shows increasing returns to scale (Snowdon and Vane, 2005).

There are two versions of endogenous growth models. The first version is the one developed by Romer (1986), Lucas (1988) and Rebelo (1986). In this model, output is seen as a function of capital, labour and the economy wide stock of knowledge which can be clearly shown in equation form as:

$$Y = F(k, L, A) \quad 2.3$$

Where: Y, F, K, L, and A are: output function; function of; capital; labour; and stock of knowledge, respectively.

In this version of endogenous growth model, the stock of knowledge is assumed to be determined by rate of capital accumulation which deepens knowledge and fosters technology acquisition and spillover which raises the marginal productivity of capital in the whole economy (Romer, 1986). Romer postulates that any increase in K will improve the value of A and increase productivity of inputs. Spillover of knowledge among firms leads to learning externalities. The greater is the level of capital stock in the economy, the higher is the productivity of firms, by means of the process of learning by doing, in the country.

The second version of endogenous growth model is Romer's (1990) who was discontented with his early approach and go ahead to develop another thread of endogenous growth model. The newer model is known as endogenous innovative model (See Snowdon and Vane, 2005), embraces a neo-Schumpeterian framework of endogenous technological change that is based on three premises: growth is determined by technological advancement as in Solow (1956); growth is based on endogenous actions of economic agents which are determined by financial incentives; and once a new set of guidelines has been created by incurring cost, it can be used over and over without additional cost (Crafts, 1996; Aghion and Howitt, 1998). Therefore, ideas are non-rival and so their utilization by one economic agent does not shrink their use by another economic agent. Romer (1990) has argued that ideas are partially excludable, where excludable is defined as ability of an economic agent to prevent somebody from using an idea without payment. Romer (1990) has postulated that excludability of ideas is a function of technology and the legal system. Given the second hypothesis that ideas are generated for self interest of economic agents, improvement in technology must bring benefit to economic agent that is at least partially excludable, protected by say patent right laws.

Snowdon and Vane (2005) have argued that Romer has challenged the long-established neoclassical growth model on the view that technology is exogenous and so it is freely obtainable widespread wise. Romer (1995) rejects this view that technology is a public good and insists that there are laws shielding intellectual property rights which restrain the use of new technology. Romer (1995) also rejects the neoclassical view that per capita income gaps between advanced industrialized countries and less developed countries can be accounted for on the basis of capital accumulation. Mankiw (1995) believes that per capita income gaps can be accounted for on the basis of both physical capital accumulation and human capital accumulation, while Romer (1995) has insisted that per income gaps between LDCs and DCs is to be accounted for mainly by technological (idea) gaps.

Romer's position has been supported by Parente and Prescott (1994, 1992, 1999, 2000) who have also attributed differences in international per capital income gaps to technological gaps. This was based on their research works. Romer's position has also received the backing from the research work of Easterly and Levine (2001) who find that residual factor rather than factor accumulation accounts for large scale variations in per income and growth differences between low- and high-income countries.

## **2. 1 Economic Integration and Growth: Relationship**

The first systematic descriptive investigation of the effects of economic integration on output was carried out by Balassa (1961). Balassa (1961) has postulated that the dynamic effects of economic integration on output are rooted in the internal and external economies of scale which are primary due to technological improvement resulting from research and development (R & D), enhanced competition, reduced uncertainty, reduction in the cost of capital and creation of a more favourable environment for economic activities. After his contribution in the 1960s, further contribution on this topic could not come as a result of the fact that economist was pre-occupied with studying changes in business cycles and not the problem of long run economic growth.

The revival of interest in the long run problem of economic growth in the mid-1980s led to a more formal re-construction of the mechanism of how economic integration stimulates economic growth (Badinger, 2001). It is important to define conceptual issues at the onset. In analysing the role of economic integration on economic growth it's important to make a distinction between permanent growth effects with engenders steady state growth rate, resulting in steeper growth path of the economy and temporary growth effects which causes an upward shift in the growth path while leaving the long run path unchanged and after sometimes growth rate falls back to its steady state growth level. In line in Baldwin, (1993) has argued that the temporary growth effects can

be further be subdivided static effects which lead to more output from the same number of inputs and the dynamic effects that influence the accumulation of factor inputs. The channels through which economic integration influence growth were further divided by Badwin and Seghezza (1996) into integration –induced technology -led growth and technology –induced investment- led growth. Both temporary growth effects of level effects and permanent growth effects are classified into above two channels.

In order to analyse the consequences of economic integration on growth in a systematic manner ,two strands of theories have to be differentiated these new classical and endogenous growth models .in neo-classical growth theory, economic integration, institutional strategies and economic policy measure have no effects on the economic growth rates which is solely determined by the exogenous technical problems .The reason is the existence of diminishing returns to productive inputs whereby if capital or labour per worker increase , it can increase output only up to a point where the investment ratio is equal to depreciation plus the rate of technological progress ratio .The theory states that the growth of capital stock at the equilibrium .The theory therefore insists that institutional changes, increase , in efficiency and changes in investment ratio have only temporary effects on the rate of growth . This implies that after the transaction. The theory, therefore rejects the notion of permanent effect of economic integration on economic growth rate.

The theory, however, insists that both static and dynamic effect do occur. Static effects occur in three ways. These are: lower costs, increase in competition, and increase in competition and enhance factor mobility. This refers to increase in efficiency which leads to more output from the same number of inputs from the first round, static effects. But this is not the final result. Since there is a constant investment ratio, the increase in output will also lead to higher investment, higher investment will increase capital stock which in turn will increase output in the second round, a dynamic effect. The total effects include static plus dynamic effects. The neo –classical growth model predict that trade integration can stimulate static and dynamic level effects but it contradicts the hypothesis of permanent growth effects on output.

The endogenous growth theory has a different perspective of how economic integration impacts on economic growth. The theory states that permanent growth can occur under certain conditions. Badinger, 2001 analyses endogenous growth model using two approaches: The augmented -capital models (AK-models); and models with variable endogenously determined technological parameter. IN A-K models having constant returns to capital, Rebelo (1991) has argued that permanent growth effects can occur in the assumption that economic integration increases technological parameter or investment ratio. This is because capital stock and output grow at the same rate and there is higher rate of capital accumulation, making it possible for permanent investment increase to generate permanent increase in output. to Badinger (2001) has argued that the stable endogenous growth rate can only be realised if returns to accumulation of capital are constant or increasing returns to scale. In this case economic growth rate will be explosive but if the returns to scale is diminishing economic growth rate will refer (Solow,1994)

## **2.2 ECONOMIC INTEGRATION AND GROWTH: RELATIONSHIP**

Badinger (2001) has stated that among the endogenous models with variables endogenously determined technological progress; additional difference between with and without scale effects must be made. Endogenous growth models which exhibit scarce effects show that the steady- state growth depends on the size of the country. Prominent examples of endogenous determined scale effects models are Romer (1990), Grossman and Helpman (1991) and Aghion and Howitt (1992).

Using the augmented capital model based on cob-Douglas production function

$$y = AK^\alpha L^{1-\alpha} \quad 2.4$$

Where y, A,K ,L , $\alpha$  ,and  $1-\alpha$  are ;output knowledge ,capital ,technology, labour , $\alpha$  and  $1-\alpha$  measuring the degree of returns to scale .An essential component of these model is the scale factor which is AK model. Production function having R and D sector exhibiting increasing returns to scale to accumulate factor (A) .This means that the growth rate of knowledge (technological progress , $g_A$  is a function of the level of human capital , $H_A$ .

Bandinger (2001) has observed this feature is closely related to the predicted effects of economic integration. The reason is that in economic integration at least two very similar economies are linked together and this is seem as economic enlargement with the potential to expand the size of the market.

A formal analysis of two country version of the Romer (1990) model is carried out by the Ri Vera – Batiz and Romer (1991).In their model ,human capital is employed in two countries that are identical in an effort to generate knowledge .Assuming that knowledge can be generated internationally, integration stimulates scale effects in the R  $\propto$  D (Permanent technology led growth effects),on assumption that double invention are ruled out in a second round effect ,Rivera –Batiz and Romer (1991) demonstrated that economic integration made lead to intersectoral and international reallocation effects .Several extension of this analysis have been carried out. Rivera-Batiz and xie(1994)have extended this analysis to two countries with heterogeneous panel of 2 countries .Walz(1998) has investigated the effects of factor markets liberalization in- three country model .

### 2.3 EMPIRICAL LITERATURE REVIEW

Having reviewed literature on economic integration on and economic growth; it is important to review empirical literature to see how the two economic variables are inter-related based on the data that have been collected from the real-world settings.

One of the studies in the settings is the works of the Schularick and Steger (2007), who investigated the impact of capital markets on economic growth. The study was designed to provide answers to certain questions. Does financially open capital market perform better than closed capital market economies? Theoretically, there are good arguments for a strong positive effect of economic integration with global capital market especially for developing countries. By utilizing the pool of global saving capital-poor countries can free themselves from the binding lack of capital constrain and this can engender economic growth in the country Schularick and Steger ,(2007). Leveine (2001) has also argued that the global level of economic integration of the financial systems capable of encouraging efficient capital allocations stimulating higher investments and engendering higher output. At the global level, sharing of international financial risk and efficient capital allocation can promote output level and stimulate economic growth.

However, arguments against economic financial integration also abound one financial integration is not capable of leading to higher output levels and welfare enhancing if there are other distortions such as trade barriers weak economic institution and information asymmetries Stiglitz (2000), Bhagwati (1998).

In order to carry out the empirical study, Schularicks and Steger (2007) assembled data for the period 1880 to 1914. The study also employs data set for the for the period of 1980 to 2002. The study uses the pre-world war 1 and post-world war 11 data sets. In view of the contrasting economic setting, it is argued that for the period 1880 -1914 financial integration are correlated with domestic investment but in the period of 1980's and above they are not co-related. The study employs econometric methods of generalised methods of moment's (GMM) in analysing the data collected. The study uses cross sectional regression method with robust standard errors which takes the form;

$$\Delta Y_i = \alpha + \beta IFI_i + Y'X_i + \varepsilon_i \quad 2.5$$

Where  $\Delta Y_i$ ,  $IFI_i$ ,  $X_i$  and  $\varepsilon_i$  are the dependent variable, the log of GDP, average capital inflows to GDP in the period under study; a vector of control variables; independently identically distributed (i.i.d) stochastic term, respectively. The vector of control variables includes the GDP per capita, the log of schooling the averages of inflation and budget deficit. The study uses three models. The above variables were employed in model (i). In model (ii), trade openness was added; and in model (iii) average population growth was added in model as in model (2.5).

The study deploys the system GMM estimation introduced by Arellano and Bover (1995) and Blundell and Bond (1993). These methods combine the standard set of equation in first differences with suitable lagged levels as instruments. The sources of data are world development indicators database inflows of portfolio and equity capital over GDP are taken from international monetary fund (IMF). Data on schooling are taken from Barro and Lee. The number of countries involved are 54 countries. The study establishes that before the world war 1 economic capital growth integration stimulated economic growth but after the post-world war 11 capital integration does not stimulate economic growth. The reason for this is that before the World War 1, opening up of for international capital market was tantamount to net inflows of foreign savings. The inflows of foreign savings into a country boosts investment and stimulates growth. In the current era, the influx of foreign capital and investments are not the same but dependent on certain factors and not just financial openness.

Kato, Sophal and Piseth (1998) seek to discuss the challenges economic integration pose to achievement of sustainable development in Cambodia. The paper was designed to assess the benefits Cambodia stands to gain if the country joins the Asian free trade area (AFTA). The study using data from 1995 to 1997 shows that AFTA was Cambodia largest trading partner. The study also shows that Cambodia's comparative advantage lie in agriculture and agro based industries.

The study was designed to discuss the challenges on converting the benefits of economic integration to sustainable development; Regional integration is seen as a means of raising the standards of living of Cambodia ultimate, the ultimate goal of sustainable development.

The first challenge Cambodia faces is to achieve high economic growth with equity. Cambodia's economic development and the benefits from integration will not be sustainable unless the benefits resulting from them are shared equitably and the poor have their share. A key policy for achieving equity is investment into human capital development particularly in universal education and in health. The study notes that there is a considerable gap in investment in human capital between Cambodia and its counterparts in AFTA. A major challenge the Cambodian faces is how to mobilize the limited resources to fill the existing gap in human capacity between Cambodia and other ASEAN countries.

The study identified the second challenge of Cambodia is how to promote agriculture and rural development. The study notes that the productivity of agriculture in Cambodia is below the best practice in the region. Cambodian farmers face serious constraint like lack of access to technology, access to finance, constraints like lack of access to agricultural inputs and access to necessary information. Because of these challenges Cambodia has not manifested its comparative advantage in agriculture by solving challenges Cambodia's comparative advantage can be manifested.

The Third challenge is relating to industrial service sector, those sectors are closely related to the other service sectors of the economy and developments in these areas can minimise the constraints in the development of other areas.

Pontes 2001 examines the impact of Horizontal multinational cooperation's in the contest of integration and economic growth. A non-comparative game theory with two firms who chooses to have one or two firms located in the two countries is used. Ponte (2001) has argued that economic integration has na ambiguous impact on foreign direct investment. on one hand it reduces the costs of and increases access to foreign markets for a country's output .it increases the size of the market and reduces multinationals fixed costs of production. Thus, trade integration enhances multinational cooperation entry into foreign countries.

A horizontal multinational has several plants which are determined by trade of between trade costs and the fixed cost of setting up a plant the fixed plant. A vertical plant is one that has headquarters that supplies specialized services without transports cost like R and D finance, and strategic planning. The study concentrates on horizontal multinational cooperation.

The study using the game theory establishes that foreign direct investment occurs if there are high trading costs and then there is low fixed cost of production. Thus, if the fixed costs are low, multinational cooperation will be willing to set plant in a small country. Thangavelu, and Chogvila ivan (2009) investigated the proliferation and the and the performance of free trade agreements (FTA) in the association of southern eastern nations (ASEAN). The study sought to identify factors that have led to emergence of ASEAN. The study established that ASEAN was set up to achieve the objective of enlarged markets, to enhance competition, to increase the flow by capital, thereby increasing the level of investment and ensures economic growth.

Davis, and Hashimoto (2014) have considered the role of monopoly power in relationship to two countries which are modelled based on endogenous growth model without a scale effect s. Firms locate their production in the lowest cost economies and trade cost and imperfect knowledge diffusion leads firms to partial concentration of production activities and carrying out innovation in larger countries.

If firms having strong monopoly power improved economic integration as a result of the fall in trade costs and or a rise in knowledge diffusion, it can accelerate growth while reducing product variety. On the other hand, a reduction in monopoly power a rise in industrial concentration that coincide with market interaction has a positive effect on product variety but is associated with less productivity growth. The study therefore demonstrated that when monopoly power exists, arise in economic integration can be led to increase output. However, when there is less concentration of industries a rise in economic integration can harm economic growth.

Naveh, Torosyan and jalee (2012) examined the impact of economic integration between Iran and northern states counterparts. The data used for analysis covered the period 1995 -2009.The study covered Iran, Armenia, Azerbaijan, Turkmenistan, and Russia. The data source was the world bank. The study employs GDP as the dependent variable; the explanatory variable are GDI to GDP, Debt to GDP, FDI to GDP and trade to GDP a proxy for trade liberalization. These variables reflect the role of integration extrovert policies and trade liberalization degree. The model employed in the study is;

$$GROWTH_{it} = \beta_0 + \beta_1 LOG GDP_{it} + \beta_2 \left( \frac{GDI_{it}}{GDP_{it}} \right) + \beta_3 \left( \frac{DEBT_{it}}{GDP_{it}} \right) + \beta_4 \left( \frac{FDI_{it}}{GDP_{it}} \right) + \beta_5 \left( \frac{TRADE_{it}}{GDP_{it}} \right) + \epsilon_{it}$$

2.6

Where: GDI, trade, Debt, GDP are: gross domestic investments, trade, debt, gross domestic production. while (i) represented the country (i) taking values of 1,2,3,4and 5 and (t) stands for the year ranging from 1995 to 2009.

The study establishes that gross domestic investments have positive and significant impact on economic growth in the panel of countries studied. Other finding are; debt have significant depressing effect on economic growth; trade exerts a substantial positive effect on growth and trade depresses growth significantly.

Ezaki and Nguyen 2008 have used computable general equilibrium to establish the impact of economic integration in East Asia consisting of ASEAN, NIES, China and Japan or the East Asian community (EAC). The analysis using the world CGE indicates that the East Asian (FTA'S) generally have positive effect on economic growth, improved income distribution and resulting to poverty reduction.

Bretschger and Steger (2004) have studied economic integration and its effect on growth through two channels; the scale effect channel and factor relocation channel. Both models were investigated within a unifying frame work. The scale effects increases long-run growth rate or balanced of long run growth path. The

effects of factor relocation or channel are ambiguous .it works to stimulate output under certain conditions but outside such conditions the result is not significant.

Mitsuo and Fei 2007 have investigated the impact of economic integration in Asia on economic growth in the region as well as the impact of economic integration on poverty reduction and promotion of income equality in china .in order to carry out the study; one employs the use of world computable general equilibrium (CGE) in carrying out the analysis.

The data used covers the period of 1990 to 2004. The study uses simulation method to assess the economic impact of poverty reduction and income inequality promoting the impact of economic integration in East Asia. The results of the study reveal that the smaller association of south eastern Asia nations (ASEAN) will almost benefit from all kinds of benefits expected from free trade area (FTA's) such as growth, poverty reduction and reduction in inequality. In china the poor people will benefit more than rich people. However, there was no evidence to suggest that inequality will be reduced in China.

Campos, Coricelli and Moretti (2013) examine growth and productivity effects from European integration .The study relies on the construction of credible counterfactuals in carrying out the analysis .The study presents estimates of the growth and productivity effects from integration of European based on counter synthetic factual method that is synthetic control methods for comparable inferences .The method id pioneered by Abadie and Gardeazabal (2003).The study is designed to answer the question stated below ,Do EU countries grow faster ?Can the EU growth rates experienced by EU members be associated with EU membership? Are the growth rates temporary or permanent?

In order to constraint counterfactuals benefits of being EU members, the study employ a simple method of binary or qualitative analysis based on (1) for being a member and (0) zero for being non-members. The method also uses the enlargement of the EU membership in the past four decades 1970, 1980, 1990 and 2000. The results of the analysis show that the impacts of EU on members vary a cross countries. However, EU member has accelerated growth in EU countries substantially. There is only one exception and this exception is Greece. Greece membership of EU has not stimulated growth in the country.

### **III. Research Methodology**

The research method used in this study is based on survey research design .it is designed to ascertain the course and effect relationship between economic integration and economic growth along with control variables of gross domestic product per capita. The variable representing measures of trade openness are gross domestic investment (GDID), trade openness and tariffs. The study uses per capita GDP as a control variable while GDP is the dependent variable.

#### **3.1 MODEL SPECIFICATIONS**

The study is based on the endogenous theoretical frame work. The reason is because economic integration can enhance long-run growth under this model unlike the net classical growth, where the impact of economic integration is temporary on output. Badinger (2001) and Naveh, Torosyan and Jalaee (2012),abait, with minor modifications .The model is based on the AK production function which capital is conceived to include physical capital, human capital and investment in  $R \propto D$  (Barro ,1990).Under this setting he production function exhibit constant returns to scale .The production AK production function employed can be specified as ;

Where GDP, GNI, TROPN, TAR, GDPP and  $\varepsilon$  are gross domestic product, gross national investment; trade openness, tariff rate, GDP per capita, and identically distributed random variable.  $\alpha, \beta_0, \beta_1, \beta_2 + \beta_3$  are estimated parameters for a constant, the change in GDP given a change in GNP given a change in TROPN, holding other variables constant and so on.

- (1) Represents the cross-sectional units taking the values (1) FOR Burundi,
- (2) For Kenya, 3 for Uganda, 4 for Tanzania, and 5 for Rwanda. while the t values stand for time series data starting 1980's, 1981 ....2013, respectively.

it is important to note that GDI is the variable measuring financial integration in the EAC. Trade openness (TROPEN) means trade integration in EAC; Tariff rate measures the extent of removing trade barriers among EAC. The gross domestic product (GDP)Per capita is a variable that is used as a control variable.

#### **3.2 ESTIMATION METHOD**

The data to be used in this study are time series data. As a result, the relevant statistical methods of analysis are time –series methods. These measures can be classified into univariate method into unit root test and multivariate time series methods of cointegration test and the vector-error correction methods (Gujarati and Porter, 2009), The Unit root test invest root test investigates the time series properties of the data.



The importance of carrying out unit root test is to avoid spurious regression analysis. if the data to be used in trending that is having unit, it has to before being combined to run regression using ordinary least squares (2002). However, there is an exception, if the series of trending data are used to run regression analysis and the residuals from the regression are stationary, such data are said to be co-integrated (2002).

This methods of unit root test used are Levin ,Lin and Chu (LLC ) which uses a common or homogenous unit root process and Im paseran and shin(IPS)which uses individual or heterogeneous unit roots processed .The reason for using more than one method is because of the fact that unit root tests method have lower values for tests .The test are biased towards finding of non-unit root (Gujarati and Paren (2009).The null hypothesis of unit root test is that there is no unit root test in the data . if the null hypothesis is not rejected, it means that the data is stationary at a level and no differentcity is required and the variables can be combined to ran regression at level without any fear of spurious regression (Gujarati and Porter,2009).

The second method of unit root test employed is the multivariate panel data cointegration .The method is employed in order to combine both the short-run and the long run relationship among the variables (Gujarati and Porter,2009).This theory was first developed by Granger 1981 and explained elaborately in Engle and Granger (1987).This method of Analysing Co integration order ILO ),the variables are co integrated .This is the principle on which Pedroni (1999;2004)and Kao (1999)invented the pool and panel data methods of carrying out autogressive vector model (VAR) model .The study applies Pedroni method Vector –error correction (VEC) model.

### 3.4 VARIABLE DESCRIPTION

This study is set out to assess the impact of economic integration on economic growth of East Africa Community. To carry out the analyses, the study uses GDP as the measure of economic growth, the explained variable, gross domestic investment (GDI), trade openness (TRAOPEN), and tariff as the explanatory variable, while using GDP per capita as the control variable. The above variable employed in this work are defined as (GDP)

- i. Gross domestic product; the GDP is concerned as the total output produced in each of the five EAC based on millions of USA dollar. The figures are obtained from united nations conference on trade and Development (UNCTAD 2014)
- ii. Gross domestic investment (GDI); This refers to the total investment coming in a country in millions of USA dollars. This GDI is used to measure the level of openness of financial investment. This method follows the pattern of Schularrick and Steger (2007) who used the same model to measure financial investment. This data is sourced from UNCTAD (2014)
- iii. Trade Openness (TRAOPN); This is defined as the ratio of export to the GDP (UNCTAD,2014). The figures of (TRAOPEN) are obtained from UNCTAD (2014) and it is measured in percentage of the GDP.
- iv. Per capita GDP (GDPP); This is defined as the total GDP Divided by the total population of the country Both figures for the GDP and the population are obtained from UNCTAD (2014).

## IV. Presentation Of Results And Analyses

**Table 1:** presents the Levin, Lin and Chu along with Im paseran and Shin tests as were presented.

Variable	Number of Integrations	Levin, Lin and Chu		Im, Pesaran, and Shin	
		Statistic	Probability	Statistic	Probability
GDP	At a Level	2.7587	0.9971	4.9348	1.0000
GDP	At 1 <sup>st</sup> Diff.	-3.3183	0.0005	-3.6640	0.0001
TRAOPN	At a Level	-2.173	0.7290	-0.6749	0.2499
TRAOPN	At 1 <sup>st</sup> Diff.	-4.9310	0.0000	-6.9856	0.0000
EXPT/GDP	At a Level	-1.0521	0.1464	-0.6749	0.62499
EXPT/GDP	At 1 <sup>st</sup> Diff.	-4.931	0.0000	-6.9856	0.0000
GDI	At a Level	-2.7888	0.0026	-1.6234	0.0523
GDI	At 1 <sup>st</sup> Diff.	-	-	8.160	0.0000

Note: Data is analysed with E-views 8.2

The table clearly shows that all the variables are stationary after the first differencing, except that gross domestic investment (GDI) is stationary at a level.

**Table 2:** Co-integration Test

No. of co-integrating equations	Trace statistic	Probability	Max. eigen test	Probability
None	47.56	0.0000	35.45	0.0001
At most 1	20.66	0.0236	10.05	0.4365
At most 2	18.27	0.0505	11.0	0.3579
At most 3	26.41	0.0032	26.41	0.0032

Note: Computed using E-views 8.2

Columns 1, 2, 3 ,4, and 5 show the hypothesized number of co-integrating equations, the Fisher statistic from the trace statistic, the probability of the trace statistic, the Fisher statistic from maximum-eigen test and the probability associated with maximum-eigen values. Following the hypothesized number of co-integrating equations, the null hypothesis that there is none hypothesized co-integrating equated based on both trace and maximum eigen test. The hypotheses that there are 1, 2, and 3 co-integrating equations are: (i) unaccepted based on probability of trace statistic but it is not rejected on the basis of maximum-eigen value; (ii) not rejected on the basis of both trace and maximum-eigen value statistics; and (iii) not accepted on the grounds of trace statistic and maximum-eigen test. Thus, the hypothesis of no-co-integrating relationship among the variables cannot be accepted and on the basis of this, it is rational for this study to employ error correction model in estimating the relationship between economic growth (the dependent variable) and the variables representing economic integration (financial integration represented by investment and trade integration represented by trade openness) and the control variable of per capita income, which stands for welfare.

**Table 3: Vector Error Correction Model (GDP is the Dependent Variable)**

Variable	Coefficient	Standard Error	T-Statistics	Probability
Constant	443.28	104.10	4.2582	0.0000
ECM	-0.1039	0.0231	4.5035	0.0000
$\Delta$ GDP <sub>t-1</sub>	-0.1136	0.2014	-0.5641	0.5824
GDI <sub>t-1</sub>	4356.35	2824.47	1.5424	0.1236
TRAOPN <sub>t-1</sub>	8916.56	3434.76	2.5960	0.0096
GDPP <sub>t-1</sub>	8952.12	4656.44	1.9225	0.0548

Adjusted R<sup>2</sup> = 0.3344    F-Statistic = 16.9742

AIC = 16.598    SC = 16.713

Note: Computed using E-views 8.20

The result shows that the model explains over 33% of variations in output in the East African Community. The overall model is significant in explaining changes in output in the EAC. The reason is that the computed F- statistic is 16.713 while the critical F-statistic based on 6 degrees of freedom horizontally and 154 (160-6) degrees of freedom vertically is 2.099. Since the computed F-statistic is higher than the critical statistic, the study concludes that the overall model is significant in explaining changes in output produced in EAC.

#### 4.1 Test of Hypotheses

The hypotheses formulated in this study are tested in this section. The testing procedure involves recalling the hypothesis along the objective of the study and then stating the significance level for which the hypothesis is to be tested. The critical t-statistic or the critical probability value for accepting the hypothesis will be stated. On the basis of the critical t-statistic or its probability value, a decision will be made rejecting or accepting the hypothesis.

##### 4.1.1 Test of Hypothesis One

Financial integration in East African Community (EAC) has not impacted substantially on economic growth in the region. This hypothesis corresponds to the first objective of the study that the study is designed to ascertain if financial integration of East African Community has impacted significantly on east African economic growth. This hypothesis is tested at 5% level of significance which translates into t-statistic value of 1.96 based on the total observation of 154 observations. Thus, if the computed t –statistic is more than 1.96 or the probability value is less than 0.05 (5%), the study will reject the null hypothesis. From the above vector error correction (VEC) model, the computed t-statistic for financial integration is 1.5424 and its probability is 0.124. Since the computed t-statistic is less than the critical t-statistic or equivalently, the probability of the computed t-statistic is greater than 0.05, this study do not accept the null hypothesis and concludes that financial intermediation has no impact on output produced in EAC.

##### 4.1.2 Test of Hypothesis Two

Trade integration in East African Community has no influence on output produced in the region. This hypothesis is in tandem with the study’s objective to the effect that the study is organized to establish if trade integration of EAC has stimulated economic growth. The critical t-statistic and the probability corresponding to the t-statistic are 1.96 and 0.05, respectively. Since the computed t-statistic and the probability are: 2.596 and 0.0096, these values clearly indicate that trade integration stimulates output in East African Community significantly. Thus, this study cannot accept the null hypothesis.

### 4.1.3 Test of Hypothesis Three

Past per capital GDP has no effect on output produced in East African Community. This hypothesis is related with the objective study to assess the effect of past per capital GDP on current output level in EAC. The critical t-statistic and the probability corresponding to the t-statistic are 1.96 and 0.05, respectively. Since the computed t-statistic and the probability are: 1.9225 and 0.0548, these values clearly indicate that past per capital GDP has no influence on output produced in East African Community significantly. Thus, this study cannot reject the null hypothesis.

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