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### Problems of LDC-Collaboration

by Professor Gerald M. Meier, Stanford

**T**he case for regional integration is receiving increasing attention in terms of how various degrees of integration might contribute to a relaxation of the foreign exchange constraint. Advocates of a free trade area or customs union believe that its formation will directly or indirectly ease the foreign exchange bottleneck and accelerate the development of the member countries by

- ☐ stimulating the establishment and expansion of manufacturing industries on a more rational basis within the developing countries;
- ☐ increasing the gains from trade for the developing countries;
- ☐ providing dynamic benefits from intensified competition within the member countries' economies.

#### The Case for Integration

By the time of UNCTAD I it was generally acknowledged that the "easy stage" of import substitution had been exhausted. From now on it would be more difficult to pursue import replacement down through the production process beyond the final assembling of finished goods to the production of intermediate inputs and capital goods. At the same time, it had become apparent that import substitutes were produced at an excessively high cost, that resources used per unit of foreign exchange saved were unnecessarily high compared with resources used per unit of foreign exchange earned through exports, and that the problems of development were actually being aggravated by having the import-substitution policies react negatively on agriculture and on exports.

To reach an efficient scale of output, a modern manufacturing plant may have to produce a larger output than the low level of home demand in a

single underdeveloped country can absorb<sup>1</sup>. By pooling markets through the removal of internal trade barriers, a free-trade union might thus provide a sufficiently wide export market to make economies of scale realisable. Within a union, secondary industry can become more efficient as specialisation occurs in the member country that acquires a comparative advantage. At the same time, the other constituent countries may now replace their imported manufactures from outside the union and thereby be able to spend a higher proportion of their foreign exchange on outside imports that are essential but cannot be produced efficiently within the union. A more rational pattern of production and trade within the region may therefore be an important result of integration.

#### Trade Effects

An expansion of trade among the member countries is also expected to result from the removal of trade barriers. If this takes the form of replacing high-cost producers within the region by lower-cost producers, the effect is one of "trade creation"<sup>2</sup>. The gains from trade are then increased since the international division of labor is improved as resources shift into more efficient production. On the other hand, some of the intra-union trade may merely replace trade that formerly occurred between members and non-members. When the formation of an economic union has this "trade-diverting" effect, the international division of labor will be worsened if the outside

<sup>1</sup> The remainder of this section is more fully discussed in the author's *Leading Issues in Economic Development*, Oxford University Press (Second edition, 1970), Chapter VIII.

<sup>2</sup> Jacob Viner, *The Customs Union Issue*, New York, 1950, pp. 48-62. Consumption effects as well as production effects are considered by R. G. Lipsey, "The Theory of Customs Union: Trade Diversion and Welfare", *Economica*, February 1957, p. 41.

source of supply is actually a low-cost source, and its product now becomes higher priced within the union because of the external tariff. In this case, there is an uneconomic diversion of output from the low-cost outside source to the high-cost supplier within the union, and the gains from trade are diminished.

The formation of a free-trade union might also result in an improvement—or at least the forestalling of a deterioration—in the region's commodity terms of trade. But unless the members of the union are the chief suppliers on the world market or constitute a large part of the world market for their imports, they are unlikely to be able to exercise sufficient monopolistic or monopsonistic power to influence their terms of trade by raising duties on their trade with the outside world or by inducing outsiders to supply their goods more cheaply.

### Poor Market Conditions

In practice, however, the proposals for regional integration have encountered serious obstacles in actual negotiations. As is true for a union even among advanced countries, political problems are encountered at the very outset when nations guard against a sacrifice of their sovereignty. These problems are especially acute for emergent countries that have only recently gained their political independence. The public administration of a union may also be extremely complex, and the administrative requirements may overtax the present administrative capacity of nations that give priority to administrative activities as demanded by national interests and needs.

It would, however, be too simple to explain past failures at regional integration in terms of only political and administrative difficulties. There are several economic objections that may be even more telling.

To begin with, it may be argued that the case for an economic union is in reality weak when the constituent countries have not yet established many industries. Limitations on the supply side may be more of a deterrent to the creation of an industry than is the narrow market on the side of demand. If production conditions do not also improve, the mere extension of the consumer market will not be sufficient to create industries. Moreover, when manufacturing industry is only at a rudimentary stage in the member countries, there is not much scope for eliminating high-cost manufacturers within the region. Nor is there much scope for realising the benefits of increased competition when there are not yet similar ranges of rival products, produced under different cost conditions, in the several member nations.

### Small Immediate Gains

It has been pointed out that the case for a union is strongest among countries that have little foreign trade in proportion to their domestic production, but conduct a high proportion of their foreign trade with one another<sup>3</sup>. When these conditions prevail, there is less possibility for introducing, within each member country, a distortion of the price relation between goods from other member countries and goods from outside the union, and more of a possibility for eliminating any distortion that tariffs may cause in the price-relations between domestic goods and imports from other member countries. There is therefore greater likelihood that the union will improve the use of resources and raise real income.

A union among underdeveloped countries, however, is unlikely to conform to these conditions. The ratio of foreign trade to domestic production is generally high for these countries, and the actual volume of intra-regional trade is normally only a small proportion of the region's total foreign trade. The gain from regional integration would therefore be small. The basic difficulty is that, with existing trade-patterns, the formation of a union is likely to cause a considerable amount of wasteful "trade diversion". Over the longer run, comparative costs and trade-patterns may change, and economies of scale may give rise to competitive advantages as development proceeds, so that the scope for "trade creation" will become greater within the union. But the immediate gain is small, and the longer run prospects for the creation of new trade are not likely to influence current decisions to join a union.

The case for regional preferential trading arrangements is therefore stronger than that for a general preference scheme (preferences granted by all developed countries in favor of all LDCs) if the regional arrangement allows the avoidance of trade diversion. Although GATT (Article XXIV) insists that tariffs among members of a customs union or free trade area must be reduced to zero, it can be demonstrated that in some cases less trade diversion will result if the members reduce their internal tariffs below the external tariff but not necessarily to zero<sup>4</sup>. In this respect, a partial preferential arrangement has merit.

### Strains From Uneven Development

Besides the possibility of "trade diversion", other undesirable consequences may result from a

<sup>3</sup> R. G. Lipsey, "The Theory of Customs Unions: A General Survey", *Economic Journal*, September 1960, pp. 507-9. This conclusion rests, however, on the assumption that there are no productive economies of large scale.

<sup>4</sup> Lipsey, *op. cit.*, pp. 506-507; W. M. Corden, *Recent Developments in the Theory of International Trade*, Princeton, 1965, p. 54.

union. Most important is the fact that the member countries are unlikely to benefit equally, and some members may believe that others are gaining at their expense. A country may have a strong comparative advantage in only primary products and will sell to other members only goods that it could as readily export to outside countries. At the same time, the more attractive manufacturing industries may become highly localised within one country in the union, and the other members may then contend that if they too had been able to adopt tariff protection against their partners, they would have also been able to attract industry. A non-industrialised member country may further complain that in buying from an industrialised partner, instead of importing from the outside, it is losing revenue equal to the duty on outside manufactures. And, with a common external tariff, member countries no longer have the discretionary power to use variations in the tariff for the purpose of adjusting their national revenues to their own requirements. The internal strains that arise from uneven development among the member countries—accentuated by the lack of complementarity among the members' economies and the limited mobility of factors of production—may thus make it extremely difficult to preserve a free-trade area. It may be possible for the union to correct some of the inequalities through a system of public finance transfers among members, a regional development bank, encouragement of free factor movements, regional policies for the location of industry, the pooling of overhead costs of public services, or coordination of development policies. But unless the union is strong enough to adopt these other measures and distribute the gains more evenly, its stability may be threatened.

Indeed, most attempts to establish regional trading arrangements have floundered on this problem of the distribution of benefits<sup>5</sup>. If there is to be future progress in integration, it will be necessary to understand more fully this entire problem of benefits: first, the nature and degree of the potential benefits; second, the distribution of these benefits among the LDC-members; third, the extent to which the developing countries benefit at the expense of rich countries or other developing countries; and finally, by what means can the disadvantaged member be compensated.

### Competition for Foreign Investment

Although it has been difficult to establish new measures of regional integration in an affirmative

<sup>5</sup> Cf. UNCTAD Secretariat, *Trade Expansion and Economic Integration Among Developing Countries*, New York, 1967, p. 21. For the acute forms of this problem in relation to integration in Latin America see M. S. Wionczek (editor), *Latin American Economic Integration*, New York, 1966, pp. 12-14; Inter American Development Bank, *Multinational Investment in the Economic Development and Integration of Latin America*, Bogota, April 1968, pp. 37-40, 47-48.

sense, efforts should now be made to remove at least the negative restraints on multinational collaboration among the developing countries, as represented by their competitive economic policies. The problems of international development entail not only the growth of rich countries vis à vis poor countries, but also the development of one poor country vis à vis another poor country. Insofar as poor countries compete against one another, the general course of development is impaired. This competition is especially evident in two policy areas — that of private foreign investment and import-substitution.

In an effort to attract special forms of private foreign investment that are particularly desirable to the developing country, many LDCs now have "investment encouragement laws" and offer special concessions by way of tax inducements, tariff remissions, provision of special domestic facilities, and other policies designed to make the location of the foreign investment particularly attractive in one country rather than another. But if the foreign investment is of the character that would be made in one country or another, regardless of concessions (such as investment for a raw material supply — say, bauxite), then the LDCs may simply compete among themselves for the investment by offering concession and counter-concession to the prospective investor. In so doing, the LDCs tend to over-concede, and this can be a waste. If the prospective recipient countries could instead agree upon a maximum amount of concessions and could harmonise the terms and conditions of foreign investment, then this problem of overconceding might be mitigated<sup>6</sup>.

### Priority of Domestic Integration

Programs of industrialisation via import substitution have also led to keen competition among the developing countries themselves. Not only have LDCs imposed trade restrictions against developed countries, but they have also imposed similar restrictions against other LDCs. The volume of trade among the LDCs has accordingly been unduly small: in 1968, intra-trade among the developing countries was less than 3 p.c. of world exports. There should clearly be considerable potential for an expansion of trade among the LDCs. But this requires cessation of competitive trade policies.

Another notable consequence of policies to industrialise via import-substitution has been to accentuate the "dualism" of the LDC's economy and to exacerbate the competition between the modern-urban-industrial sector and the traditional-

<sup>6</sup> See Dudley Seers, "Big Companies and Small Countries", *Kyklos*, Vol. 16, Fasc. 4, pp. 599-607; Reginald H. Green and Ann Seidman, *Unity or Poverty? The Economics of Pan-Africanism*, Penguin African Library, 1968, pp. 99-131.

rural-agricultural sector within the developing country. The policies in support of import-replacement have in many countries increased the differentials between these two sectors. As a result, the cause of domestic integration—let alone regional integration—has suffered. Without prior integration of its domestic economy, an LDC cannot be expected to be able or willing to devote its policies to regional integration. There may now be more justification for optimism about the attainment of this objective as the emphasis shifts from import substitution policies to export promotion, and as more attention is given to the agricultural bottleneck.

### Less Trade Restrictions

Finally, we should recognise that although a comprehensive form of free trade area or full customs union may not yet be practicable for most of the developing countries, there are still substantial advantages that can be derived from more ad hoc functional types of multi-national collaboration short of comprehensive integration<sup>7</sup>.

At a level considerably less general than a customs union or free trade area, multinational collaboration may be directed toward the removal or reduction of trade restrictions on simply a selected list of commodities. Countries might identify individual products or specific sectors for which they could commit themselves to reduce trade barriers. Products that are not yet fabricated in any of the collaborating countries—that is, new products—might be singled out as especially feasible for such a commitment. Further, there is scope for preferential trading arrangements—sort of a customs union—as has previously been argued above. This is especially relevant for the future expansion of exports of manufactures and semi-manufactures among the LDCs as a group. Although there is now only a small volume of intra-trade among LDCs, it is significant that manufactured goods already play a relatively more important role in this trade than in the developing countries' total exports, accounting for almost one-quarter of the value of intra-trade.

### Multinational Cooperation

At another level of collaboration, developing countries might undertake the complementary development of specific industries through a multinational investment policy. An interesting proposal has thus been made for the creation of Latin American Multinational or Subregional Corporations — public companies with private participation that might be able to organise consortia of

national and foreign investors, be adequate instruments for implementing inter-industry and complementation agreements, and be able to carry out large projects beyond the capacity of presently existing single institutions, "maintaining throughout a 'Latin American presence' in decision making"<sup>8</sup>.

Another important area of multinational collaboration—and one that could be used to support other areas of cooperation—is that of channelling foreign aid through regional development banks or development corporations so as to promote regional investment and trade. The quality of the foreign aid relationship may itself be improved when the allocation of aid is explicitly based on regional or subregional considerations. The more this is done, the more effective might the regional institutions be in promoting the regional investment policies and regional trade liberalisation policies that are necessary to avoid uncoordinated duplicative national development policies.

Finally, the entire area of national development planning can be improved through multinational collaboration. There may at least be expected some partial coordination with respect to trade policy, monetary policy, or fiscal policy. The harmonisation of domestic policies may be slow in coming, and will never be as dramatic as the establishment of a customs union, but the potential value of multinational collaboration in these areas can be considerable.

### Conclusion

We may therefore conclude that while there are benefits to be derived from regional integration in the form of a free trade area or customs union, especially over the longer run, the immediate gains should not be overestimated, and due attention must be given to the possible undesirable consequences for some countries. The outstanding lesson from efforts at regional integration is that if an economic union is to be effective, it must be a strong one — and most proposals for regional integration have not yet shown this capacity for sufficient cohesion.

Until the risks of joining a free trade union are diminished, the less ambitious approach of lower degrees of multinational collaboration may be the most feasible alternative. Even though a customs union or full economic union may be the ultimate objective, there is still much to be done in the immediate future to secure the mutually supporting measures of trade liberalisation, multinational investment policies, and regional aid institutions.

<sup>7</sup> A distinction should be made between "integration" and "collaboration". Cf. Bela Balassa, "Toward a Theory of Economic Integration", in: Wionczek, op. cit., p. 24.

<sup>8</sup> Paul N. Rosenstein-Rodan, "Multinational Investment in the Framework of Latin American Integration", in: Inter American Development Bank, op. cit., p. 85.