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**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Bahadir, Sefik Alp (1978) : Problems of integration theory in relation to the developing countries, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 13, Iss. 7/8, pp. 174-178,  
<https://doi.org/10.1007/BF02929189>

This Version is available at:

<https://hdl.handle.net/10419/139552>

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# Problems of Integration Theory in Relation to the Developing Countries

by Sefik Alp Bahadir, Berlin \*

**The opportunities for the integration of developing countries and the limitations to such integration have not received enough attention in the scientific discussion on the reform of the international economic order, with the result that a considerable research backlog has been accumulating in this field. The following article shows that the established integration theory which has been evolved primarily with the problems of the European integration movement in mind is not able to evolve adequate criteria for decisions on integrations of developing countries.**

The economic relations between the industrialized countries and the Third World have in the last few years moved into the focus of international politics. The demand of the developing countries for a New International Economic Order in particular has been the dominant topic at a number of international conferences since the Third Conference on Trade and Development (UNCTAD III) in 1972<sup>1</sup>. The view that a New International Economic Order alone can ensure the break-through to the desired economic progress in the Third World seems to be gaining general acceptance.

The scientific research into the problems of the developing countries consequently concentrated in recent years chiefly on the relations between industrialized and developing countries. But as regards the problems involved in the reorganization of the economic relations between developing countries a considerable research backlog has been allowed to accumulate. The question of the opportunities for economic cooperation and integration of developing countries amongst themselves and the limitations to such cooperation and integration in particular has not yet received due attention in the scientific discussion on the reform

of the international economic order. That the developing countries realize the need to lessen the narrowness and confinement of their national economies and to achieve cooperation and integration in the economic sphere across and beyond their borders is clearly reflected by their demands for a New International Economic Order. The "Declaration on the Establishment of a New International Economic Order" adopted at the Special Conference on Raw Materials of the United Nations in 1974 therefore included an important demand for the "Strengthening — through individual and collective actions — of mutual economic, trade, financial and technical cooperation among the developing countries mainly on a preferential basis"<sup>2</sup>.

### Lack of Interest in Research

Economic cooperation and integration of developing countries is generally regarded as an especially suitable instrument to assist the break-through of their industrialization efforts in particular. At the Second General Conference of UNIDO in 1975 for instance, which had the task of drawing up principles for the industrialization of the developing countries, the states of Asia, Africa and Latin America were urged to attach more importance to the independence of their development efforts and to their measures relating to the full utilization of their human and natural resources and to take in this connection suitable joint political steps for increased economic and technical cooperation amongst themselves<sup>3</sup>. The General Conference devoted Part II of its "Plan of Action" to the subject of "Cooperation among

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<sup>1</sup> At the sixth special session of the UN in the spring of 1974 the developing countries used their majority to get a "Declaration on the Establishment of a New World Economic Order" (UN, Resolution of the General Assembly at its Sixth Special Session, April 9 — May 2, 1974, Resolution 3201) and a "Program of Action on the Establishment of a New International Economic Order" (Resolution 3202) passed. The UN General Assembly followed this up with the adoption in December 1974 against a few oppositional votes of the "Charter of Economic Rights and Duties of States" (UN, Resolution of the General Assembly at its Twenty-Ninth Regular Session, September 17 — December 18, 1974, Resolution 3281). Next came the Conference on Raw Materials at Dakar in February 1975 and soon afterwards the "Declaration of Lima on Industrial Development and Cooperation" (UNIDO, Second General Conference of UNIDO, Lima, Peru, March 12–26, 1975, ID/Conf. 3/31, 9.5.1975). As distinct from earlier declarations of this kind — e.g. the UNCTAD conferences — these statements did not only lay stress on inequalities and injustices in international economic relations but raised, in a categorical form, a number of concrete demands.

<sup>2</sup> Art. 4 s of the Resolution, quoted from: Bundesministerium für wirtschaftliche Zusammenarbeit (Federal Ministry for Economic Cooperation), (Ed.), *Entwicklungspolitik (Development Policy) Materials* No. 45, Bonn, May 1974, p. 21.

<sup>3</sup> Declaration of Lima on Industrial Development and Cooperation, op. cit., Art. 49.

Developing Countries" and demanded, *inter alia*, "Measures . . . to support the present processes of economic integration and search for new forms of economic cooperation with a view to contributing to a steady growth of the world economy and to the acceleration of the development of the developing countries . . ." <sup>4</sup>.

One of the reasons for the lack of interest in the problems of economic cooperation and integration of developing countries on the part of research workers is the hitherto relative unimportance of the economic relations among the developing countries in comparison with their relations with industrialized countries in the past. Another reason is that the experience gained from past integration efforts by developing countries has not been very encouraging and that these efforts were overshadowed in every respect by corresponding processes among the industrialized countries including in particular the European associations. One of the consequences of the research backlog in this field bears on the theory of economic cooperation and integration itself: The established economic integration theory which has been evolved primarily with the problems of the European integration movement in mind is not able to provide immediate answers to the questions arising in the course of integration efforts by developing countries. In regard to the developing countries it has so far been unable to develop adequate criteria for decisions on the question whether a particular integration project is desirable or not. On the question of the concrete content and forms of integration it has failed completely to provide adequate answers.

### Neo-classical Genesis of the Established Theory

The question whether regional associations are desirable has, it will be known, been generally answered positively by the neo-classic theory of the foreign trade: Regional free trade was assumed to be a step on the road to global free trade and thus a move towards optimization of trade and maximization of production and prosperity. The assumptions on which this train of argument rested were the usual axioms of neo-classic theory: Full employment of all production factors in the individual member states prior to the formation of an integration; unlimited competition in all goods and factor markets; stationary exogenous parameters for economic activities such as constant technology, incomes distribution — from which all welfare reasoning must start —, etc.

The economic integration theory does not set out to overturn these restrictive assumptions of the neo-classic foreign trade theory but only its faith in the prosperity-raising effect of all regional free trade. *Viner* introduced the concept of "trade

creation — trade diversion" <sup>5</sup> in order to show that this need not always be the case. The basic idea underlying this distinction is well enough known:

The international division of labour within a customs union is assisted by the removal of discriminatory measures in the trade between the members of the union, namely,

□ by the lowering of tariffs which allows the comparative cost advantages of the individual producer countries to operate to better effect. That part of the domestic production of a country which had been competitive only because of the tariff protection is replaced by production at more favourable costs in other member countries;

□ by the abolition of quotas and import and export embargos which makes it possible to engage in international trade in certain goods inside the customs union or to extend this trade beyond the limits set by quotas.

The usual result is an increase in trade with positive effects on the incomes (and thus the prosperity) inside the customs union.

As a common external tariff remains in existence or is established if it does not yet exist, it is possible to divert trade relations of the member countries with third countries which existed before the creation of the customs union to other countries in the union. New instances of discrimination will, for example, arise between the member countries and third countries if a producer who survived in the past only thanks to national protective duties after the introduction of common external duties supplies the whole integrated area, and in consequence displaces third country producers with more favourable costs. This trade-diverting effect of the customs union always involves a certain loss of income (and thus of prosperity) for the third countries concerned. The effect of the trade diversion on the customs union as a whole may in an individual case be either positive — when the "gains" of the new country of supply outweigh the "losses" of the recipient country — or negative — in the opposite case.

While the neo-classical theory of foreign trade looks solely at the trade-creating effects of a customs union and incidentally declares it to be generally desirable, the established integration theory extends this thesis by taking its trade-diverting effects into consideration and advocating the creation of a customs union only in cases in which it is likely to result in more trade creation than trade diversion. The argument about the relationship of trade creation and trade diversion based

<sup>4</sup> Plan of Action . . ., op. cit., Art. 60 e.

<sup>5</sup> Jacob *Viner*, *The Customs Union Issue*, Carnegie Endowment for International Peace, New York 1950, esp. chapter 4.

on the criterion of the effect on the prosperity in the countries of the customs union and the rest of the world is indeed the main content of the established integration theory.

Viner's analysis of the effects of customs unions has been developed further by Meade<sup>6</sup>, Lipsey<sup>7</sup> and Gehrels<sup>8</sup> in particular who supplemented the mentioned effects relating to the production by pointing out additional effects relating to consumption. The contemplation of the latter has given rise to further important theorems of the established integration theory, namely a number of statements by Meade and Gehrels, which are not being dealt with here, and the following two by Lipsey:

□ The positive beneficial effects of a customs union will be all the higher, the more extensive the trade of the future members of the union is already amongst themselves in relation to their trade with third countries; and

□ the smaller their foreign trade was in relation to their internal trade before the customs union was set up.

The dilemma of the established integration theory in its application to the developing countries here becomes evident: to go by the two above-mentioned criteria customs unions of developing countries cannot be expected to yield positive beneficial effects since developing countries normally engage in active trade relations with industrialised countries which exceed by far their foreign trade with other developing countries – and often also their internal trade. The choice for the established integration theory is therefore either to reject economic integrations of developing countries in general or to acknowledge its own irrelevance.

<sup>6</sup> James E. Meade, *Problems of Economic Union*, Chicago 1953, and the same author, *The Theory of Customs Unions*, Amsterdam 1955.

<sup>7</sup> Richard G. Lipsey, *The Theory of Customs Unions: Trade Diversion and Welfare*, in: *Economica*, N.S. Vol. 24 (1957), p. 40-46; the same author, *The Theory of Customs Unions: A General Survey*, in: *Economic Journal*, Vol. 70 (1960), p. 496-513; the same author, *The Theory of Customs Unions: A General Equilibrium Analysis*, London 1970.

<sup>8</sup> Franz Gehrels, *Customs Unions from a Single Country's Viewpoint*, in: *Review of Economic Studies*, Vol. 24 (1956/57), p. 61-64. Cf. the same author, *Optimal Restrictions on Foreign Trade and Investment*, in: *American Economic Review*, Vol. 61 (1971), p. 147-159.

<sup>9</sup> Robert L. Allen, *Integration in Less Developed Areas*, in: *Kyklos*, Vol. 14 (1961), p. 315-336.

<sup>10</sup> Gerald M. Meier, *Problems of Cooperation for Development*, London 1974. Cf. the same author, *Leading Issues in Development Economics*, New York 1964, and *The International Economics of Development, Theory and Policy, A Revised and expanded edition of International Trade and Development*, New York 1968.

<sup>11</sup> Raymond F. Mikesell, *The Theory of Common Market as Applied to Regional Arrangements Among Developing Countries*, in: Roy Harrod, Douglas Hague (Eds.), *International Trade in a Developing World*, London 1963, p. 203-240, quoted p. 213. Cf. the same author, *Liberalization of Inter-Latin American Trade*, Washington 1957, and *The Movement Toward Regional Trading Groups in Latin America*, in: Albert O. Hirschman (Ed.), *Latin American Issues: Essays and Comments*, New York 1961, p. 125-151.

A number of economists such as Allen<sup>9</sup>, Meier<sup>10</sup> and Mikesell<sup>11</sup> have chosen the second alternative while another group of economists are making the attempt of revising the established integration theory and to extend its area of validity to the developing countries. The latter school of thought is to be dealt with in the following passage.

### Synthesis of Integration and Development Theories

A revised integration theory adapted to the problems and particularities of the developing countries can certainly not be developed without recourse to an economic development theory. The beginnings in this field may therefore be interpreted also as attempts at a synthesis between the established integration theory and one particular variant of the theories of economic development. The state of research reached by now however still falls far short of a satisfactory synthesis, and such a synthesis remains unattainable as long as the neo-classical methodology of the established integration theory is retained – as it has been until now – and is merely augmented by individual elements of the theories of economic development.

Common to all the "synthesis approaches" is that they reject the "trade rejection – trade diversion" concept as a criterion for decisions on the suitability of a certain integration project. The essential difference between them is that they replace the mentioned concept by a variety of other objectives borrowed from the development theory. Economic cooperation between, and integration of, developing countries is accordingly to be advocated insofar as they promise to help to achieve this particular objective.

The best-known variant sets out from the great importance of industrialization for economic-social progress and declares it to be the principal aspect of integration among developing countries. This way of approach which goes back, in the main, to Breton<sup>12</sup>, Cooper and Massell<sup>13</sup>, Hazlewood<sup>14</sup>, Johnson<sup>15</sup> and Urquidi<sup>16</sup> could be inter-

<sup>12</sup> Albert Breton, *The Economics of Nationalism*, in: *Journal of Political Economy*, Vol. 72 (1964), p. 376-386.

<sup>13</sup> Charles A. Cooper, Benton F. Massell, *Toward a General Theory of Customs Unions for Developing Countries*, in: *Journal of Political Economy*, Vol. 73 (1965), p. 461-476; the same authors, *A New Look at Customs Unions Theory*, in: *Economic Journal*, Vol. 75 (1965), p. 742-747.

<sup>14</sup> Cf. in particular the following studies of Arthur Hazlewood in the miscellany edited by him: *African Integration and Disintegration. Case Studies in Economic and Political Union*, London etc. 1967. *Problems of Integration Among African States* (p. 3-25) and *Economic Integration in East Africa* (p. 69-114).

<sup>15</sup> Harry G. Johnson, *The Economic Theory of Customs Unions*, in: *Pakistan Economic Journal*, Vol. 10 (1960), p. 14-32, reprinted in: the same author, *Money, Trade, and Economic Growth*, London 1962, p. 46-72. Cf. also the same author, *An Economic Theory of Protectionism. Tariff Bargaining, and the Formation of Customs Unions*, in: *Journal of Political Economy*, Vol. 73 (1965), p. 256-283.

<sup>16</sup> Victor L. Urquidi, *Free Trade and Economic Integration in Latin America: The Evolution of a Common Market Policy*, Berkeley 1962.

puted as follows: the variant takes one individual developing country as its starting point and assumes that it has a certain social preference for industrialization. As against the social "benefit" of the industrialization, which would mean the "development" of the country, there are social costs which consist of income losses arising when dearer domestic products take the place of cheaper imports. Assuming that the increase of industrial production will first extend to goods the producer prices of which show the smallest increase over the corresponding import prices, the "marginal social costs of industrialization" will – given a certain national income – from a certain moment in time advance along a rising curve reflecting the scissorlike widening gap between the producer and import prices of the industrial products to be made inside the country. If it is assumed further that – given a preference for industrialization at a certain moment in time – the curve indicating the "marginal social benefit" of industrialization declines, the point of intersection of the two curves indicates the volume of industrial production and the tariff rates required in order to protect it.

The line of argument pursued by the mentioned authors ultimately amounts to this that they construe, starting from such a one-country model, a so-called industrialization effect of the integration of developing countries which, they claim, arises because the "economies of scale", etc., achieved as a result of the customs union lead to a smaller rise of the curve of the "marginal social costs" and thereby to a high degree of industrialization in the integration area.

### No Meaningful Aid for Decision-Making

The work of *Bhambri*<sup>17</sup>, *Kitamura*<sup>18</sup>, *Linder*<sup>19</sup> and others follows in principle the same line of argument, with the difference that they substitute the "foreign exchange saving effect of import substitution" for the industrialization effect. *F. Andic*, *S. Andic* and *Dosser*<sup>20</sup> combined the two effects and thereby construed a "development creation" effect. It is obviously possible to deduce a number of possible important effects of integration on economic development, depend-

<sup>17</sup> R. S. Bhambri, Customs Unions and Under-Developed Countries, in: *Economica Internazionale*, Vol. 15 (1962), p. 235-258.

<sup>18</sup> Hiroshi Kitamura, Economic Theory and the Economic Integration of Underdeveloped Regions, in: Miguel S. Wionczek (Ed.), *Latin American Economic Integration: Experiences and Prospects*, New York 1966, p. 42-63.

<sup>19</sup> Staffan B. Linder, *Trade and Trade Policy for Development*, Praeger Series on International Economics and Development, New York 1967; the same author, *Customs Unions and Economic Development*, in: M. S. Wionczek (Ed.), *Latin American...*, op. cit., p. 32-41.

<sup>20</sup> Fuat Andic, Suphan Andic, Douglas Dosser, *A Theory of Economic Integration for Developing Countries*, illustrated by Caribbean Countries, London 1971, especially p. 41.

ing on the particular meaning given to "development" and the particular variant of the theories of economic development chosen.

It is true that these variants of the integration theory have shown convincingly that "trade creation and trade diversion are misleading terms in the context of less developed countries"<sup>21</sup> and that "trade diversion might be inevitable in a developing country, namely in those circumstances where there are no practicable alternatives to trade diverting production"<sup>22</sup>. They are however problematic because they remove the mentioned criterion for the beneficialness of concrete integration projects without putting anything in its place and are ultimately looking for arguments – improvement of the terms of trade, greater financial strength, etc., are often mentioned beside the economies of scale<sup>23</sup> – in support of the general desirability of integrations between developing countries. In the centre of interest are not the questions of the aims, prerequisites and methods of integration among developing countries but the question which role is to be assigned to it within the framework of certain development models. If applied consistently, this variant of the integration theory advocates and justifies every conceivable integration of developing countries and thereby relinquishes any claim that it might be of meaningful assistance for decisions on such projects.

### Of Limited Relevance

To sum up, there are three aspects in particular which greatly lessen the relevance of the established integration theory to the developing countries:

□ The problem of the worldwide incomes distribution receives no consideration. In other words, the welfare argument presented in support of the neo-classical integration theory does not question the existing incomes distribution and therefore demands for instance that the disadvantages to the industrialised countries debarred from the area of the customs union by its creation must not exceed the advantages accruing to the developing countries participating in the union. The "world benefit" is thus made the yardstick without, however, any consideration to its distribution. If validity for the developing countries is to be claimed for the integration theory,

<sup>21</sup> Op cit. (spaced out in original text). And further. "What a customs union of the style outlined here is maximizing is development creation not trade creation, and minimizing development diversion which means diverting development potential to an already developed country."

<sup>22</sup> F. Kahnert, P. Richards, E. Stoutjesdijk, P. Thomopoulos, *Economic Integration Among Developing Countries*, Development Centre of OECD 1969, p. 17.

<sup>23</sup> Cf. e.g. Peter Robson, *Economic Integration in Africa*, London 1968, p. 30 ff.

it must evolve a new welfare concept which allows a unit of income growth in a "poor" country to be attributed a higher value than the same growth in a "rich" country.

□ "Trade diversion" can be unavoidable and even desirable in a case of integration between developing countries<sup>24</sup> if there are no alternatives for trade-diverting production. The integration theory must fit in with the arguments which *Balassa* has formulated concisely: "The worldwide most efficient resource allocation does not necessarily correspond to optimal exploitation of growth potential."<sup>25</sup>

□ The established integration theory is a static or stationary reallocation theory and does not lend itself to dynamic-operational ways of thinking. In the case of the developing countries interest centres however not on the reallocation of existing resources but on the development of such resources itself and their incorporation in the social production process. In this connection it must be borne in mind that "the creation of a customs union or free trade area usually involves relatively long time-periods for fruition so that the initial impact, and the most important one, is on expectations regarding future market opportunities rather than on existing trade patterns . . .<sup>26</sup> *Balassa* stresses rightly that "even if the immediate effect of the union was, on balance, trade diverting, increased income in the union and other dynamic factors could benefit the world in the long run"<sup>27</sup>.

It has been impossible to resolve the dilemma of the established integration theory – of either rejecting all approaches to integration among developing countries or having to declare itself irrelevant in regard to this field – by the so far available variants aiming at a synthesis of the integration and development theories. These variants of the theory make allowance for the second aspect mentioned above but do not go beyond the methodological framework of the established integration theory as far as the aspects mentioned under 1 and 3 are concerned. The neo-classical character of the integration theory is thus implicitly accepted and therefore comes up against another dilemma when the attempt is made to evade the dilemma which has just been pointed out: by advocating and justifying all conceivable approaches to integration among developing countries it refutes its own relevance and ceases

<sup>24</sup> Thus *Linder* even asks explicitly for a concept of "efficient trade diversion" for developing countries. (Customs Unions . . . , op. cit., p. 40.)

<sup>25</sup> *Bela Balassa*, Towards a Theory of Economic Integration, in: *Kyklos*, Vol. 14 (1961), p. 1-17, particularly p. 12. The same author, *The Theory of Economic Integration*, Homewood, Ill., 1961, and *Economic Development and Integration*, Mexico 1965.

<sup>26</sup> *E. Mikesell*, *The Theory of Common Markets . . .*, op. cit., p. 205 ff.

<sup>27</sup> *Bela Balassa*, *Towards a Theory . . .*, op. cit., p. 13.

to be of assistance for decisions on economic cooperation and integration among developing countries.

The principal problem of the integration theory stems from its neo-classical genesis. It is a stationary allocation theory which cannot cope methodologically with economic development – that means, with the main problem of the less developed countries: for in considering the effects of resource allocation on the volume and quality of these resources (on the development of productive power), on the production sphere and even on the structure of the human requirements we are facing a multiple cumulative process. The forces making for constant change must in this context be regarded as endogenous; but this kind of approach shatters the methodological framework of the neo-classical integration theory which analyses the allocation sphere without recourse to the developments in the production sphere and to the development of productive forces. The established allocation theory is therefore of no relevance to the treatment of allocation problems in the context of economic development. At best it is of help for the contemplation of short-term problems where the framework of the social organization and the distribution of the bulk of available resources – capital equipment and trained or semi-skilled labour – can be considered a legacy from the past and the effects of present allocational decisions on future developments are being ignored<sup>28</sup>.

These methodological constraints of the established integration theory do not raise problems in regard to the developing countries alone<sup>29</sup> but the problems in the developing countries are especially grave. A solution can be found by axiomatic underpinning of the integration theory giving it more universal validity than the established neo-classical theory. This in turn requires as a first step the empirical observation, description and analysis of integration processes including in particular those among developing countries<sup>30</sup>.

<sup>28</sup> Cf. *Sefik Alp Bahadır*, Allokation der Produktivkräfte und gesamtwirtschaftliche Stabilität. Ein Beitrag zur Analyse ihrer Zusammenhänge (Allocation of productive forces and overall economic stability. A contribution to the analysis of its relations), Berlin 1978, particularly p. 121 ff.

<sup>29</sup> Cf. *Hermann Priebe*, Lehren aus der europäischen Wirtschafts-Integration für die Entwicklungsländer (Lessons from the European economic integration for the developing countries), in: *Wilfried Guth* (Ed.), Probleme der Wirtschaftspolitik in Entwicklungsländern. Beiträge zu Fragen der Entwicklungsplanung und regionalen Integration (Economic policy problems in developing countries. Contributions to problems of development planning and regional integration), Berlin 1967, p. 58-75.

<sup>30</sup> Cf. particularly *Hans-Jürgen Harborth*, Anforderungen an eine revidierte Integrationstheorie für Entwicklungsländer (Demands on a revised integration theory for developing countries), in: *Winfried von Urff* (Ed.), Integration der Entwicklungsländer in eine instabile Weltwirtschaft. Probleme, Chancen, Gefahren (Integration of developing countries into an unstable world economy. Problems, chances and risks), Berlin 1976, p. 65-88, particularly p. 74 ff.