

The empirical evidence on the magnitudes of the dynamic effects is far from being conclusive and mostly related to problems other than economic integration. For example, there are some indications of a substantial increase in labor productivity in individual firms where dynamic efficiency measures were introduced such as plant layout reorganization, simple technical alterations, waste control, workers training and supervision, etc.⁽⁶⁵⁾ Among the factors which affect the rate of growth; i.e. dynamic efficiency, Harberger has singled out technical advance to be the most important. «If there is any key factor at all for achieving rapid development, I believe it is technical advance.⁽⁶⁶⁾

Very few writers, even among those who realize the importance of dynamic effects, have really analyzed these effects systematically. Some confine their analysis within static assumptions.⁽⁶⁷⁾ Therefore, the analysis of dynamic aspects of economic integration among LDC's requires not only some empirical studies, but also a systematic theoretical treatment.

65) *Ibid.*, p. 400.

66) *op. cit.*, p. 143.

67) See, for example, Bhambri, *op. cit.* p. 241; and Cooper and Massell, *op. cit.*, p. 463.

TABLE 1.
 Static Gains of Economic Integration : Empirical Evidence

<i>Study</i>	<i>Case</i>	<i>Gain % of GNP</i>
1. Scitovsky, T. Economic Theory and Western European Integration. Stanford : Stanford Univ. Press, 1958, pp. 64-70.	Effects on the pattern of trade of a customs union among EEC countries, Scandinavian countries, and Britain, based upon their 1952 trade matrix.	0.005 of GNP matched by equal loss to the rest of the world due to trade diversion.
2. Johnson, H. G. «The Gains from Free Trade with Europe : An Estimate,» Manchester School , (September, 1958), pp. 247-55.	Effect on the value of British trade from joining EFTA, estimates for 1970.	About £ 225 million, which is about 0.01 of British GNP.
3. Wemelsfelder, J. «The Short-Term Effect of the lowering of import Duties in Germany,» Economic Journal , (March, 1960), pp. 94-104.	Effects of lowering German tariffs during 1956-57 by more than 50 percent.	DM 375 million or 0.0018.
4. Singh, A. in Leibenstein, H. «Allocative efficiency» Vs. «X-Efficiency», « American Economic Review ,» (June, 1966), pp. 392-b15.	Gains from trade among LAF-TA countries, using Scitovsky method.	0.000075.

Meier has pointed out that it is «unlikely that the establishment of a customs union will lead to any pronounced increase in intra-West Indian trade — whether of a trade creating or trade diverting character.»⁽⁶²⁾

The relative insignificance of the static effects on welfare (or static efficiency) has been generalized to include not only eliminating tariffs in an economic integration scheme, but also eliminating monopoly, taxes and inflation.⁽⁶³⁾ This insignificance should not be surprising because «allocational inefficiency involves only the net marginal effects. The basic assumption is that every firm purchases and utilizes all of its inputs «efficiently». Thus, what is left is simply the consequences of price and quantity distortions.»⁽⁶⁴⁾

62) *op. cit.*, p. 33.

63) A. C. Harberger, «Using the Resources at Hand More Effectively,» *American Economic Review, Papers and Proceedings*, (May, 1959), pp. 134 - 46 and H. Leibenstein, «Allocation Efficiency Vs. «X-Efficiency»,» *American Economic Review*, (June, 1966), pp. 392 - 415.

64) Leibenstein, *Ibid.*, p. 397.

In the meantime, there is an impression expressed by many writers that dynamic effects of economic integration are far more important than static effects.⁽⁵⁸⁾ It is thought that a larger gain would come if economic integration results in eliminating the inefficiency of producing inside the given production possibilities curve and in shifting the production possibilities curve upwards. However, most of these impressions are based on a *priori* judgement rather than on concrete empirical studies.

There are several empirical studies aiming at measuring the static gains of economic integration. Results of some of these studies are summarized in Table 1.⁽⁵⁹⁾ It is obvious that all these results show the static gains to be extremely small. These gains are taken from the viewpoint of an individual country or area. The consideration of static effects on the rest of the world shows, as in the first case, a very insignificant gain or loss. Even if a margin is allowed for error and inadequacy of estimates, a basic implication of these studies is that they provide no economic support for the case of economic integration. «It certainly seems that the textbook example of the benefit from increased trade and specialization is very unimportant indeed in the case of Western Europe».⁽⁶⁰⁾

There are some indications that static gains from economic integration among LDC's tend to be even more insignificant than for DC's. The case for LAFTA in Table 1 confirms this point. However, this can be explained by the relatively small percentage of intra-regional trade, the inflexibility or delay in responsiveness of the economic structure to undertake necessary adjustments and the greater degree of imperfection in the market.⁽⁶¹⁾ In evaluating economic integration in the West Indies

58) See, for example, Kitamura, *op. cit.*, pp. 55 - 56; Mikesell, *op. cit.* p. 206; Demas, *Ibid.*, pp. 86 - 87; Scitovsky, *op. cit.*, p. 68 and Hazlewood, *op. cit.*, p. 8.

59) For a survey of such empirical studies see Bela Balassa, «Trade Creation and Trade Diversion in the European Common Market», *Economic Journal*, (March, 1967), pp. 1 - 5.

60) Scitovsky, *op. cit.*, p. 68.

61) Kitamura, *op. cit.*, p. 54.

Thus generalizations of the traditional theory of economic integration have limited, if any, applicability, for evaluating the desirability of economic integration among LDC's.⁽⁵⁴⁾ This has led some writers to think that «the possibility of a universal theory of customs unions and economic development is automatically ruled out.»⁽⁵⁵⁾ Others have suggested a specific approach to deal with economic integration of LDC's which «accepts industrialization as a legitimate policy goal and considers how membership in a CU may enable a less developed country to achieve more economically the ends served by protection.»⁽⁵⁶⁾

It is the objective of this study to show that the evaluation of economic integration among LDC's should be based upon : 1) an understanding of economic integration as an approach to regional economic development, and 2) the evaluation of the dynamic effects of integration such as economies of scale, external economies, and differences in the level of economic development,

(C) The Relative Insignificance of Static Effects :

Static effects of economic integration are concerned with changes in production mix on a **given** production possibilities curve and changes in its value in terms of foreign goods which will result in a consumption point at a higher or lower community indifference curve. The traditional theory of economic integration relies «heavily on the neo-classical assumptions of full employment, perfect competition, constant returns to scale, perfect internal mobility of factors of production, and the equality of private and social costs.»⁽⁵⁷⁾ Accordingly, its analysis is mostly confined to static effects as was pointed out previously.

54) Other writers have reached the same conclusion. See Balassa, *Economic Development and Integration*, op. cit., p. 35; and Mikesell, op. cit., p. 213.

55) Linder, «Customs Unions and Economic Development», op. cit., 32.

56) C. A. Cooper and B. F. Massell, «Toward a General Theory of Customs Unions for Developing Countries», *Journal of Political Economy*, (October, 1965), p. 462.

57) Demas, *The Economics of Development in Small Countries With Special Reference to the Caribbean*, op. cit., pp. 85 - 86.

trictions, e) lack of knowledge and inadequate marketing skills, f) the historical ties of colonial economic integration, g) negative attitudes of nationalism, and h) the absence of standardized specifications.⁽⁴⁸⁾

Removal of some or all of these obstacles appear to result in an increase of intra-regional trade. Some examples are given by the relatively high percentage of trade among East African Common Market members (16 percent); the relative increase in trade among Central American Common Market members where «nearly two-thirds of the total volume of [their] trade... consists of manufactured products.»⁽⁴⁹⁾ Trade between Egypt and Syria after their unity of 1958 showed a relatively larger increase than among any other two Arab countries.⁽⁵⁰⁾

6. Finally, the traditional theory suggests that «a customs union is more likely to raise welfare the lower is the total volume of foreign trade»⁽⁵¹⁾ as a percentage of GNP of member countries. It is concluded then that for LDC's, economic integration does not promise a significant gain in welfare.⁽⁵²⁾ However, the relative importance of foreign trade depends upon the size more than the level of economic development. Moreover, the relatively large volume of foreign trade represents a potential for dynamic production and income effects.⁽⁵³⁾

48) See V. L. Urquidi, **Free Trade and Economic Integration in Latin America** (Los Angeles : University of California Press, 1964), pp. 13 - 16; Balassa, **Economic Development and Integration**, op. cit., pp. 32 - 34; and Bhambri, op. cit., pp. 237 - 38.

49) ECLA, **Economic Survey of Latin America** (New York, 1965), p. 47.

50) T. M. Abdel Jaber, «Jordan's Position in Arab Economic Integration» (unpublished Master's thesis, University of Southern California, Los Angeles, 1968), p. 32.

51) Lipsey, «The Theory of Customs Union : A General Survey», op. cit., p. 273.

52) Bhambri, op. cit., p. 237.

53) A. J. Brown, «Common Market Criteria and Experience», **The Three Banks Review**, (March, 1963), p. 7.

sential to permit the coordination of national policies prior to their amalgamation.»⁽⁴³⁾

Some writers imply that the external common tariff might have to be higher than national tariffs of partners.⁽⁴⁴⁾ This will conflict with the GATT rules according to which the external common tariff must not be higher than the initial national tariff of partners. However, this might be justified during the early period of an economic integration among LDC's. It could be shown that a successful economic integration would enable partner countries to lower the external common tariff due to real cost reductions.

5. According to the traditional theory of economic integration, it can be generalized that «a customs union is more likely to raise welfare the higher is the proportion of trade with the country's union partner and the lower the proportion with the outside world.»⁽⁴⁵⁾ It is recognized that intra-regional trade of LDC's is small, it does not exceed 12 percent of their total trade (except in South-East Asia), while it is more than 30 per cent among EEC countries.⁽⁴⁶⁾ This implies that welfare gains from static effects will be small in economic integration of LDC's.

Though this implication appears feasible in the static case, it should not be accepted on face. Recognition should be given to the several factors which limit intra-regional trade of LDC's. Most important of these factors are a) low level of economic development, b) inadequacy of transport facilities, c) overvalued currencies which cancel out significant cases of comparative advantage,⁽⁴⁷⁾ d) foreign exchange control and other import res-

43) A. Marchal, «The European Economic Community and the Developing Countries», *Annals of Public and Co-operative Economy*, (January-March, 1965), p. 52.

44) Sidney Dell, *Trade Blocs and Common Markets* (New York: Knopf, 1963), pp. 242 - 50.

45) Lipsey, «The Theory of Customs Union : A General Survey». *op. cit.*, p. 273.

46) Bhambri, *op. cit.* p. 236.

47) Vanek, *op. cit.*, pp. 187 - 91.

3. Transportation cost tends to limit the gain from economic integration among LDC's. Thus, «the removal of tariffs between Kenya and Ethiopia, for instance, would not add significantly to the market for industry established in either country... The reason is that there is virtually no means of surface transport between the two countries.»⁽³⁹⁾ In evaluating economic integration of the West Indies, Demas has pointed out that «without the development of cheap and regular interisland air and sea transport, customs union can have no meaning.»⁽⁴⁰⁾

In most cases, however, transport facilities do exist, but they «were developed in the past with an eye to encourage the export of primary products to the industrial countries of Western Europe and North America.»⁽⁴¹⁾ Thus, there are examples where transportation costs of a commodity between two neighbouring LDC's is higher than between one of them and a remote DC.⁽⁴²⁾ Nevertheless, transport facilities should not be taken as a parameter, rather, their improvement should be included in economic integration schemes of LDC's.

4. The higher the initial tariff rates and the lower the external common tariff, the larger the welfare gain of economic integration. Tariff rates in most LDC's are quite high either for revenue or protection purposes. This tends to increase the welfare gain. However, economic integration among LDC's is not expected to end up with a low external common tariff because a) the protective policy will be extended to the region, where partners tend to reach agreement faster if protection is increased. b) it is argued that «customs protection [even in the case of EEC] is the only effective means of securing the conditions es-

39) Arthur Hazlewood, «Problems of Integration Among African States? Hazlewood (ed.), *African Integration and Disintegration* New York: Oxford, 1967), p. 10.

40) Demas, «The Economics of West Indies Customs Union,» *op. cit.*, p. 13.

41) Bhambri, *op. cit.*, p. 338.

42) Balassa, *Economic Development and Integration*, *op. cit.*, p. 31.

due to the fact that most LDC exports of primary products are oriented to DC markets, and accordingly, economic integration among LDC's would not bring a sizable expansion of their intra-trade. However, the category of primary products is too broad, and once it is disaggregated, potential expansion would appear quite likely.

Indeed, the criterion of competitiveness and complementarity is not relevant at all to LDC's unless it is given a different sense.⁽³⁵⁾ It presumes a developed economic structure which, when integrated, would read just through a «creative destruction» process that ends up by the survival of the most efficient producer. These economic structures are not established in LDC's by definition, and even if they were, the «creative destruction» process would not be given a free play.

For LDC's, the welfare gain or loss from these effects is to be taken with reference to manufactured goods and local food-stuffs rather than to traditional exports of primary products.⁽³⁶⁾ Moreover, LDC's should purposefully develop a potential complementarity and minimize the cost of adjustment. In other words, «as industrialization proceeds, they [LDC's] are going to be more competitive; but what [they]... should strive for is a pattern of investment which will introduce a substantial degree of complementarity for the future.»⁽³⁷⁾

2. The traditional theory of economic integration concludes that the larger the size of the customs union, the larger the gains in welfare. Taking the economic size in terms of GNP, one implication is that the gain from economic integration among LDC's is small or even negligible. This seems to be obvious, however, a small absolute gain might be, in relative sense quite important for LDC's. Moreover, the gain does not depend only on the given size of the union but also on the rate at which it increases.⁽³⁸⁾

35) Balassa, *Economic Development and Integration*, op. cit., p. 25.

36) Demas, «The Economics of West Indies Customs Union,» op. cit., p. 21.

37) Mikesell, op. cit., p. 212.

38) Balassa, *The Theory of Economic Integration*, op. cit., p. 38.

(B) **Limitations of the Factors Affecting the Desirability of Economic Integration.**

The net static effect of economic integration, especially of the production effects, depends upon a number of factors which the traditional theory has discussed in the context of DC's.⁽³⁰⁾ Based on these factors, some generalizations are reached to judge the desirability of economic integration. Some writers take these generalizations to apply to DC's and LDC's alike. Of this view is Allen who suggested that «although these criteria were designed specifically for integration among industrialized countries, they are appropriate for application to less developed areas as well.»⁽³¹⁾ However, the following discussion will attempt to demonstrate the limited relevance of these generalizations to economic integration among LDC's when looked at from a dynamic viewpoint.

1: **Competitiveness and complementarity :**

Viner suggested that the more the partners are competitive (complementary) in the sense of producing similar (dissimilar) products, the more (less) favorable economic integration would be. Makower and Morton added that the larger the cost differences among partners, the larger the gain from economic integration.⁽³²⁾

Being specialized in primary products, LDC's tend to be more competitive in the Vinerian sense.⁽³³⁾ Nevertheless, this general stage of competitiveness is thought to limit the welfare gain of economic integration among LDC's. This is a correct implication, though it appears to be self-contradictory.⁽³⁴⁾ It is

30) For a summary of these factors, see Bela Balassa, *The Theory of Economic Integration* (Homewood, Ill. : Irwin, 1961), pp. 29 - 48; Meade, *op. cit.*, pp. 107 - 15; Allen, *op. cit.*, p. 319; and Johnson, *op. cit.*, p. 57.

31) Allen, *op. cit.*, p. 319.

32) Makower and Morton, *op. cit.*, p. 35.

33) Mikesell, *op. cit.*, p. 212.

34) S. El Naggar, «The Economic Union Between Developing Countries,» *L'Égypte Contemporaine*, (October, 1964), pp. 13 - 14. (In Arabic).

Finally, trade creation, similar to trade diversion, should be taken in dynamic terms. The dynamic trade creating effect results from the increase in income of the integrated area and through the foreign trade multiplier.⁽²⁷⁾ Some writers argue that this effect would be large enough to outweigh dynamic trade diversion of economic integration among LDC's.

The income effects, so far as trade with the outside world is concerned, will clearly tend to increase considerably the scope for beneficial exchange of goods with third countries, and this secondary trade expansion may very well more than offset the possible initial reduction of this particular type of trade.⁽²⁸⁾

To summarize : there are several arguments which show the limited relevance of the application of production effects, as defined by the traditional theory, to problems of LDC's economic integration schemes. These arguments suggest, though do not prove, that the dynamic production effects are favorable to the welfare of LDC's and possibly to the world's welfare. When economic integration is looked at from the viewpoint of LDC's alone, the case for their economic integration becomes substantially stronger.

The traditional theory of economic integration attempts to answer two main questions: 1) What is the probable effect of a customs union on the world's welfare ? and 2) What are the factors which affect the desirability of a customs union ?⁽²⁹⁾ Thus far, the limitations of the answer to the first question have been discussed. The next section will deal with the limitations of the answer to the second question.

27) See M. E. Kreinin, «On the Dynamic Effects of a Customs Union», *Journal of Political Economy*, (April, 1964), pp. 193 - 95; and Scitovsky, *op. cit.*, p. 69.

28) Kitamura, *op. cit.*, p. 53.

29) H. Makower and G. Morton, «A Contribution Towards a Theory of Customs Unions», *Economic Journal*, (March, 1953), p. 33.

Another version of this argument which has been already referred to, is based on the assumption that one of the important factors determining LDC's actual imports is the availability of foreign exchange. It is implied that LDC's tend to utilize whatever foreign exchange available for imports. It is argued that trade diversion in consumer goods would release more foreign exchange which then can be directed to pay for the increasing requirements of capital goods from the rest of the world.⁽²⁴⁾ On balance, total imports of an integrated LDC's might not be reduced; it might increase depending on the rate of economic growth.

Fourthly, some writers argue that economic integration among LDC's should aim at trade diversion from DC's.⁽²⁵⁾ The effectiveness of such economic integration then is to be indicated by the success of the trade diversion process. Though this argument is expressed in stronger terms, the reasoning behind it is basically similar if not the same as in previous one. This reasoning is provided as follows :

It is... reasonable to suggest that trade diversion will be doubly beneficial. Firstly, by enlarging the size of market for manufactures in both countries, increase trade will help to reduce costs in industries where scale economies are important. Secondly, import substitution over a wider area will enable the region as a whole to spend a higher proportion of its foreign exchange on imports of capital goods and raw materials and help to increase the rate of investment and economic growth.⁽²⁶⁾

24) See Kitamura, *op. cit.*, p. 50; Mikesell, *op. cit.*, p. 209; and J. Vanek, «Payments Unions Among the Less Developed Countries and their Economic Integration,» *Journal of Common Market Studies*, (December, 1966), p. 191.

25) See S. B. Linder, *Trade and Trade Policy for Development* (New York: Praeger, 1967), p. 127; S. B. Linder, «Customs Union and Economic Development,» M. S. Wionczek, (ed.), *Latin American Economic Integration* (New York : Praeger, 1966), pp. 39 - 40; and Bhambri, *op. cit.*, pp. 244 - 45.

26) Bhambri, *op. cit.*, p. 245.

gain in welfare.⁽²⁰⁾ In case of unemployment, this gain in welfare becomes more obvious. This point is put clearly by Demas with reference to economic integration in the West Indies.

In underdeveloped countries such as the West Indies, it cannot be too often emphasized that while the money cost of the new trade-diverting production may be quite high, its real social opportunity cost may be very low, or even possibly zero. What is therefore required in the case of countries with surplus labour is an economic calculus which would set against the loss in economic efficiency arising from trade diversion the increase in the net social product arising from the creation of new and/or more productive employment.⁽²¹⁾

Therefore, the evaluation of economic integration among LDC's should not be confined to production and consumption effects. Of considerable importance are income and employment effects which should be included as well.

Thirdly, when imports of LDC's from DC's are disaggregated, trade diversion appears to occur only in nondurable, and to a less extent in durable, manufactured consumer goods. In a static situation, no trade diversion or creation is likely to occur in their imports of capital goods which account for about 40 per cent of total imports.⁽²²⁾ In a dynamic situation, it is argued that a higher rate of growth conceived by an economic integration scheme would require a larger investment. Since a large portion of this investment is imported as capital goods, the level of imports of integrated LDC's might then increase. In any case, the long-run impact of a regional trading arrangement is not to decrease trade with the rest of the world but rather to change its pattern and possible to enlarge it.»⁽²³⁾

20) Demas, *op. cit.*, p. 87. However this is not a first-best policy.

21) William G. Demas, «The Economics of West Indies Customs Union,» *Social and Economic Studies*, (March, 1960), p. 16.

22) Balassa, *Economic Development and Integration*, *op. cit.*, p. 25.

23) Mikesell, *op. cit.*, p. 209.

diversion is bad are no longer valid.⁽¹⁶⁾ However, more serious limitations appear once we look at it from the viewpoint of LDC's and in a dynamic setting.⁽¹⁷⁾

Firstly, it is noticed that trade diversion is basically taking place on the individual country's level through import-substituting industrialization. The choice then is between trade diversion in favor of the domestic producer at any cost and trade diversion in favor of the most efficient producer in the region. In general, «there seems little doubt that a pattern of industrialization based on greater specialization within the region will be more economical than one based on production by each country for its own domestic market.»⁽¹⁸⁾

Another version of this argument is concerned with the length of time required to assure optimum capacity of output. The rate of growth of domestic demand for small LDC's individually does not allow for a large volume of quantity demanded which could enable domestic firms to achieve real cost reductions over a reasonable period of time. This is more obvious in case of durable manufactured goods. Economic integration among LDC's would make this process of trade diversion more efficient in terms of reducing real costs over a shorter period.⁽¹⁹⁾

Secondly, in most LDC's there exists a situation of general low productivity, and in some sectors, productivity might approach zero. Unemployment exists also especially in densely-populated LDC's. If trade diversion would move labor from low-productivity to more productive activities, it will bring about a

16) R. G. Lipsey, «The Theory of Customs Unions : Trade Diversion and Welfare,» *Economica*, (February, 1957), p. 41.

17) R. F. Mikesell, «The Theory of Common Markets As Applied to Regional Arrangements Among Developing Countries,» Harrod and Hague (eds.), *International Trade Theory in A Developing World* (New York : St. Martin's Press, 1965), pp. 205 - 29.

18) *Ibid.*, pp. 209 - 10.

19) R. S. Bhambri, «Customs Unions and Underdeveloped Countries,» *Economia Internazionale*, (May, 1962), p. 245.

However, this alternative which was raised in UNCTAD of 1964, and advocated by Gunnar Myrdal requires a new type of morality in international economic relations. Other alternatives appear to be more controllable by each LDC. Nurkse's model of balanced growth offers an alternative which is virtually identical with the nationalistic protective model. However, this alternative does not solve the foreign-exchange gap once consumer goods are produced domestically. Balanced growth might induce investment, but the efficiency of these investments might stay low due to the still limited size of the market. As suggested by Demas, balanced growth :

“can hardly be applied to very small countries where economies of scale and lack of variety of resources will preclude the simultaneous establishment of a large number of industries all producing for the domestic market... [However, this doctrine] can be of some applicability to small underdeveloped countries only in the context of economic integration”.

Therefore, economic integration on a regional basis is suggested as the best alternative for LDC's in general, and small LDC's in particular, in their development process. Economic planning, investment, and import substitution will be considered in a regional context.⁽¹⁴⁾ A higher rate of growth is to be achieved through the working of dynamic effects.

(A) Limitations of the Production Effects

Viner considers trade diversion a negative production effect which reduces welfare necessarily. This idea was criticized even in the context of the traditional theory of economic integration. Lipsey pointed out that «when consumption effects are allowed for, the simple conclusions that trade creation is good and trade

14) William G. Demas, *The Economics of Development in Small Countries with Special Reference to the Caribbean* (Montreal : McGill University Press, 1965).

15) Hiroshi Kitamura, «Economic Theory and the Economic Integration of Underdeveloped Regions», M. S. Wionczek, (ed.), *Latin American Economic Integration*, (New York : Praeger, 1966), pp. 59-63.

specialized in primary products. Nothing is wrong with specialization in primary products if the income of importing countries grows fast enough, their income elasticity of demand were sufficiently large, the economic surplus from the primary sector could be reinvested productively, and some measures were to be taken to alleviate the consequences of short-run fluctuations in export proceeds.

However, because these assumptions are far from reality, especially for certain commodities of some LDC's, exclusive specialization in producing and exporting primary products is not conceived to help LDC's develop. There is a chance for improvement within this line of specialization and it should be utilized, but it is in general quite close to being exhausted as a potential source of economic development and growth.

Thus, a policy of diversification and import substitution has been advocated after World War II. Many LDC's have adopted this policy though to a different extent. With high tariff protection being granted, import substitution moves gradually from simple to more sophisticated consumer goods. Imports of consumer goods have been absolutely or relatively restricted so as to permit growing imports of capital goods.

The squeeze of consumer goods imports reaches a limit beyond which more capital goods could be imported only by increasing export earnings. However, «the limited capacity of underdeveloped countries to export to developed countries» is a strong constraint which checks the development process. A foreign-exchange gap will develop.⁽¹²⁾ Since almost nothing can be done about the low price-and-income elasticity of demand for primary products, developed countries should help LDC's by reducing or eliminating unilaterally their protective measures against the latter's exports of manufactured goods.⁽¹³⁾

12) Bela Balassa, *Trade Prospects for Developing Countries*, (Homewood, Ill. : Richard D. Irwin, 1964).

13) Among other possible alternatives are devaluation and multiple exchange rate. These alternatives have some administrative as well as other limitations.

In the 1960's, increasing attention has been directed to problems of economic integration among LDC's. Some writers consider these problems with the traditional theory in mind, such as Allen⁽¹⁰⁾ and Meier.⁽¹¹⁾ However, most writers feel that the traditional theory of economic integration has limited relevance, if any, to LDC's. They point out several arguments which can be classified as follows :

1. Economic integration in case of LDC's should be treated as **approach to economic development** rather than as a tariff issue. Accordingly, it combines various aspects which could improve the international trade position as well as raise the level of economic development of LDC's.
2. The emphasis should be put on dynamic rather than static effects in evaluating the desirability of economic integration among LDC's. The present economic structure is not acceptable and each LDC is trying individually to introduce positive changes. These changes are not marginal but structural. Their net effect will not be felt over a short period of time. Accordingly, any evaluation of economic integration schemes should concentrate on potential or dynamic effects.

The following sections will attempt to analyze these basic points in detail.

II—ECONOMIC INTEGRATION AS AN APPROACH TO ECONOMIC DEVELOPMENT

In general, the case for economic integration as an approach to development is based upon the present economic situation of LDC's and the presumably favorable dynamic effects of their integration. A brief statement of the present economic situation of LDC's is presented here. It is noticed first that LDC's are

10) R. L. Allen, «Integration in Less Developed Areas», *Kyklos*, (Fasc. 3, 1961), pp. 315-36.

11) Gerald M. Meier, «Effects of A Customs Union on Economic Development», *Social and Economic Studies*, (March, 1960), pp. 29-36.

effect, like the production effect, can work either to raise or to lower welfare.»⁽⁴⁾

Other effects of economic integration have received little attention in the traditional theory.⁽⁵⁾ Scitovsky considered such effects as increased competition, economies of scale, change in the volume and location of investment, and terms of trade with regard to Western Europe.⁽⁶⁾ However, his approach still lies within the traditional theory of economic integration. Among the dynamic effects considered, «the main results of integration are shown to be various consequences of the increase in competition which the common market is almost certain to bring about.»⁽⁷⁾

The emphasis on the static effects in the traditional theory of economic integration is not surprising however. First, it is consistent with the static approach in international trade theory of which economic integration is conceived as «that branch of tariff theory which deals with the effects of geographically discriminatory changes in trade barriers.»⁽⁸⁾ Second, it is consistent with the relative importance of adjustments likely to occur once a group of developed countries decides to integrate. «The theoretical literature of economic integration dealt almost exclusively with customs unions of industrial economies.»⁽⁹⁾ whose problem is not primarily one of economic development but of relatively marginal adjustments in production and consumption patterns.

4) R. G. Lipsey, «Mr. Gehrels on Customs Unions,» *Review of Economic Studies*, (1956-57), p. 211. See also Meade, *op. cit.*, pp. 44-52; and H.G. Johnson, *Money, Trade and Economic Growth* (Cambridge: Harvard University Press, 1967), pp. 53-54.

5) R. G. Lipsey, «The Theory of Customs Union : A General Survey» *Economic Journal*, (September, 1960), pp. 261-62.

6) Tibor Scitovsky, *Economic Theory and Western European Integration* (Stanford: Stanford University Press, 1958).

7) *Ibid.*, p. 10.

8) Lipsey, «The Theory of Customs Union : A General Survey», *op. cit.*, p. 261.

9) Bela Balassa, *Economic Development and Integration* (Mexico : Centro De Estudios Monetarios Latino Americanos, 1965). p. 16.

refers to the cumulative worsening of the relative, or absolute, economic position of a member country or some regions in the integrated area due to concentrated trade creation or attractiveness of labor and capital ; d) the effect on the volume and location of investment ; and, e) the effect on economic efficiency and smoothness of trade transactions due to change in the degree of competition and change in uncertainty and unilaterality of trade policies of individual countries.

The main concern of the traditional theory of economic integration is to evaluate the desirability of a customs union from the world's welfare viewpoint and using static effects as criteria.⁽¹⁾ The pioneer work of Viner distinguishes between two effects : trade diversion and trade creation. A customs union raises the world's welfare if its trade creation effect outweighs its trade diversion effect. Meade suggested that these two effects should not be measured in terms of the size of trade diverted only. A better method is to compare the product of trade diverted multiplied by the rise in its cost, and the product of trade created multiplied by the fall in its cost.⁽²⁾

More important is that Viner confined his analysis to production effects only, assuming demand curves of zero elasticity and supply curves of infinite elasticity. Gehrels brought up the consumption effects of a customs union as « the response of consumers to the drop in import prices caused by the tariff removal.»⁽³⁾ He conceived of positive consumption effects only which should be added to trade creation effect in evaluating the gains or losses of a customs union. This point was criticized by Lipsey who suggested, correctly, that «in general, the consumption

1) Yu-Min Chou, «Economic Integration in Less Developed Countries: The Case of Small Countries,» *Journal of Development Studies*, (July, 1967), p. 19.

2) J. E. Meade, *The Theory of Customs Union*, (Amsterdam: North-Holland Publishing Company, 1955).

3) Franz Gehrels, «Customs Union from a Single-Country Viewpoint», *Review of Economic Studies*, (1956-57), p. 61.

**THE RELEVANCE OF THE
TRADITIONAL THEORY OF ECONOMIC INTEGRATION
TO LESS DEVELOPED COUNTRIES**

Dr. TAYSEER A. JABER*

**I—INTRODUCTION : EFFECTS OF ECONOMIC
INTEGRATION**

The establishment of an economic integration scheme between two or more countries has several consequences which can be classified under two headings.

1. Static effects which refer to the welfare gains or losses from a marginal reallocation of production and consumption patterns, under given assumptions. They include : a) the production effect or intercountry substitution of trade (this effect is also divided into trade creation and trade diversion); b) consumption effect or intercommodity substitution due to changes in relative prices; and c) the terms of trade effect which might result from trade diversion or the increase in the bargaining power of the partner countries.

2. Dynamic effects which refer to the various possible ways which economic integration affects the rate of growth of GNP of participating countries. They include ; a) the economies of scale brought about by the enlargement of the size of the market for firms producing below optimum capacity prior to integration ; b) the external economies which shift specific or general cost curves downward; c) the polarization effect which

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