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Economic Integration among Developing Countries

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(continued on inside back cover)
In the early postwar period, economic integration among developing countries was considered primarily as a way of extending the policy of import substitution on a regional scale. This approach is subject to serious limitations since even regional markets will often not permit the establishment of efficient-size firms, much less competition among several such firms. Thus, regional integration oriented towards import substitution may lead to the establishment of inefficient plants and of an inefficient industrial structure, thereby postponing the time—and increasing the difficulties—of a reorientation of policies once the limits of import substitution have been reached.

A different approach is taken in this paper. Economic integration will be considered as one of the policy options available to developing countries and as part of their overall strategy for economic development. Broadly speaking, there are four possible policy options that may be adopted singly or in combination: development in a national framework, regional economic integration, increased trade with developing countries in other regions, and participation in the international division of labour.

I. ECONOMIC INTEGRATION THROUGH THE LIBERALIZATION OF TRADE

Import Substitution in National Markets
In the postwar period, a number of developing countries adopted a policy of import substitution in the framework of national markets. This choice reflected the view prevalent at the time that exportation, whether of primary goods or manufactured products, does not represent a viable alternative. It was assumed that the prospects for primary exports were unfavourable because of the slow growth of
demand on the part of developed nations, and that high import barriers as well as the inability of the developing countries to produce competitively foreclosed the possibilities for exporting manufactured products.

Views expressed as regards prospects for exporting manufactured products have proved to be overly pessimistic. Exports of manufactures from developing countries rose four-fold during the 1960s, with exports reaching $10 billion in 1970 as against the $4 billion predicted by the United Nations and their rapid expansion continued in the 1970s. Also, while demand is rising at a slow rate for tropical beverages and fruits of which developing countries are the only suppliers, the growth of import demand for most other primary products exceeds that of consumption in developed nations which face limitations of domestic supply. In fact, the slow expansion of the exports of these commodities from developing countries has often been due to their own policies, resulting in a loss in their world market shares.

At the same time, the opportunities for economical import substitution in the national framework are limited by the size of domestic markets. The smaller the market, the more restricted are the possibilities of establishing industries which cater exclusively to domestic demand and the higher are the costs of production. In the manufacturing of intermediate products and durable goods in particular, efficient operations require large-scale production, with unit costs rising substantially at lower output levels. The size of the domestic market also limits the extent of product specialization in individual firms and restricts the possibilities for process specialization through manufacturing parts, components and accessories on an efficient scale. Furthermore, the sheltering of national markets reduces the extent of competition and lessens the incentive for technological improvements.

An often-used measure of the size of national markets is the value of the gross national product. Among the non-European developing countries listed in the World Bank Atlas, 62 had a GNP of less than $1 billion, 40 between $1 and $5 billion, 15 between $5 and $10 billion, three between $10 and $25 billion in 1971. But, from the point of view of the exploitation of economies of scale and domestic competition, the market for manufactured goods is relevant. No developing country has a domestic market for manufactured goods as large as that of the Netherlands, Sweden, or Belgium among the smaller developed countries, which have entered into integration schemes in order to escape the limitations imposed by their national markets.
Since possibilities for economic growth through import substitution are limited by the extent of a country's domestic market, countries of different size will need to have recourse to exports at different levels of industrial development in order to ensure the continued expansion of their manufacturing industries. In some small African countries where the consumption of manufactured goods does not exceed $100 million a year, the domestic market is not sufficiently large even for the production of relatively simple manufactured goods.

At the other end of the scale, India and Brazil established a diversified industrial structure serving domestic needs, but have encountered market limitations in a number of their industries and are now attempting to expand their exports. The shift in strategy is the most apparent in Brazil that has increasingly focused on the promotion of agricultural and manufacturing exports. In this, Brazil is following the example of countries, such as Korea and Taiwan, which have attained high rates of economic growth applying a strategy of export promotion.

Exports and Economic Integration
Exports of manufactured goods may be oriented towards the markets of countries in the same region, to developing countries in other regions, or to developed nations. Providing incentives to exports would benefit sales in all foreign markets; regional integration would boost exports to countries in the same geographical area; and preferential schemes extending to other regions would stimulate exports to developing countries in those regions. But, as with import substitution, export promotion can be carried too far; this will be the case if excessive incentives are provided. Accordingly, an appropriate objective of development strategy may be seen in providing for the establishment of efficient export and import-substituting activities. Participation in the international division of labour through similar incentives to exports and import substitution and avoiding overly high protection of manufacturing industries can contribute to this goal.

While adopting such a policy would affect a country's overall trade, the establishment of the European Common Market and the European Free Trade Association indicates that even industrial countries with relatively large domestic markets derive advantages from regional integration. There are various reasons for this, several of which apply to developing countries as well.

First of all, a country participating in a regional integration scheme benefits from the elimination of barriers to its exports on the
part of the partner countries. This is of special importance for developing countries whose exports of manufactured goods often suffer discrimination in developed country markets. We observe that tariffs in developed nations tend to rise with the degree of fabrication, thereby discouraging the importation of foods and raw materials in a processed form. Also, tariffs are generally higher on simple manufactures than on products requiring a high level of technical sophistication developing countries do not possess. Finally, quantitative restrictions tend to be applied mostly to products originating in the developing nations, as in the case of textiles, clothing and shoes.

Considerations of risk and uncertainty favour regional integration schemes. There is more information on prices and costs in neighbouring countries than in faraway nations, thereby lessening uncertainty as regards the effects of trade liberalization on domestic industry. Uncertainty in intraregional trade is further reduced if commitments are taken to refrain from reimposing restrictions on imports or subsidies to exports. This is of special interest since developed countries have repeatedly imposed restrictions once the imports of manufactures from less developed areas have increased substantially. Also, in a regional union, it will generally be easier to reach—and to police—agreements to forego the use of measures which provide indirect benefits to domestic industry at the expense of their competitors in the partner countries.

In the EEC, an additional consideration has been to create large markets for highly sophisticated industries, such as aircraft, computers and electronics, where national markets of the member countries are too small for efficient operations, while protecting these industries from US competition. This argument applies a fortiori to developing economies which need protection for their infant industries. In a regional union, the cost of infant protection will be lower than in individual countries, since a wider market permits the establishment of larger plants, greater specialization, as well as more competition. At the same time, the markets of the partner countries can serve as a training ground for exporting elsewhere. We may then speak of infant export activities that need to learn quality control as well as marketing techniques.

But regional integration schemes have disadvantages of their own. Integration involves a cost in the form of higher prices paid for imports from the partner countries. Also, the establishment of new industries in a regional framework may give rise to monopoly positions and inefficient, high-cost production. This will occur if excessive protection is granted to regional industries that permits high-cost operations and provides little incentive for technological
improvements. At the same time, the establishment of firms oriented towards the markets of the partner countries may draw away resources, such as capital and entrepreneurship, from exporting to world markets, where they could be put to better uses. It may also be necessary to undertake costly investments in transportation to permit a substantial expansion of intraregional trade.

Furthermore, involved negotiations on economic integration impinge on scarce decision-making capacity in developing countries and limit the attention given to other policy options. On a different plane, economic integration will involve a cost through the diminution of national sovereignty as agreements on the liberalization of intra-area trade and on the policy coordination necessary for the success of the integration schemes reduce the scope of action by national authorities.

The balance of the benefits and costs of regional integration in a particular case will depend on the circumstances of the situation, including market size, resource endowment, geographical location and access to developed country markets, as well as on the policies applied. In the following, attention will be given to policies that may be used to increase the benefits of integration through the liberalization of intra-area trade and to contribute to the equitable distribution of these benefits among the participating countries. Subsequently, the possibilities of preferential tariff reductions on trade among developing countries located in different areas will be examined.

The Scope of Integration Schemes
There is a case for extending the range of industries covered by integration schemes that involve the liberalization of intraregional trade. In this way, one may allow for compensating changes in various industries, lessen the power of special interests, increase competition, and reduce investment requirements. Compensating changes will smoothen the path of adjustment and it may be easier to surmount opposition from special interests than if trade liberalization was limited to a few industries. Also, apart from the case of integration among countries at different levels of development to be discussed below, the exposure of domestic firms to competition from the partner countries would have beneficial effects in the form of improvements in the distribution of incomes through lowering excess profits and incentives for technical progress. Finally, the expansion of intra-area trade may lead to a higher degree of capacity utilization, thereby reducing the need for new investments.

Nevertheless, integration in existing industries has been opposed
on the grounds that it would create serious dislocations in the individual countries. The experience of the Central American Common Market does not lend support to this view. The creation of the Central American Common Market led to a rapid expansion of trade among the member countries, with the annual rate of increase averaging 22 per cent in the period 1953–61 and 32 per cent in 1961–68. This increase took place largely in manufactured goods, whose share in the total reached 86 per cent in 1968 and entailed intraindustry specialization through the greater exchange of products, such as textiles and shoes, thus permitting the exploitation of economies of scale without appreciable adverse effects on national industries.

Possibilities for economies of scale are even greater for machinery, consumer durables, and intermediate goods industries where, following the European Common Market, intraindustry specialization could be accomplished through narrowing product variety and the exchange of parts and components in developing countries at higher levels of industrialization. On the other hand, integration of countries at different levels of development would require more adjustment and it raises the problem of the distribution of benefits and costs to be discussed below.

It should be added that the cost of dislocation can be reduced if adequate time is provided for adjustment by the spacing of tariff reductions. This can be done by agreeing on a fixed timetable on reducing, and ultimately eliminating tariffs. This would have additional benefits in lessening uncertainty for the firm and providing inducements for adaptation to the conditions of a larger market. Moreover, in adopting a fixed time schedule for tariff reductions, there is less of a chance that the progress of integration will be blocked. This has happened in LAFTA where after initial progress the opposition of vested interests has practically blocked tariff reductions in the framework of annual multilateral negotiations.

**Tariff Policy in an Integrated Area**

There is further a case for establishing common tariffs on extra-area imports. This is because the maintenance of national tariffs leads to distortions in intra-area trade and affects distribution of the benefits and cost from integration. Countries with relatively low tariffs on imported raw materials and intermediate products will enjoy artificial cost advantages in intra-area trade in finished goods, and the extent of preferences granted to partner country suppliers will be greater the higher are national tariffs. With continuing differences in national tariffs and the possibilities for unilateral
changes in these tariffs, then, the progress of integration may be jeopardized.

In the event of a common tariff being adopted, there will be need to ensure that its height and structure are conducive to the establishment of efficient industries. There is a case for lowering duties if the level of national tariffs was excessive, and the creation of a common external tariff provides an opportunity for reduction and rationalization. More generally, for regional integration to contribute to efficient import substitution and exporting, it would have to be accompanied by a rationalization of the system of incentives in the participating countries.

Adoption of a common tariff on imports from nonmember countries and the harmonization of other measures affecting imports and exports will eliminate distortions in competitiveness among the partner countries provided that exchange rates are free to adjust. Distortions in competitiveness will occur, however, if the speed of inflation differs among countries and devaluation takes place only intermittently. This is because under- or over-compensation in exchange rates for price changes has the same effect as changes in tariffs and subsidies. At the same time, uncertainty is created as regards future changes in the domestic currency value of foreign exchange and the sale price of competing producers.

Variations in competitiveness due to price changes uncompensated by changes in exchange rates create obstacles to regional integration since countries do not wish to expose their producers to sudden and unforeseen changes in trade flows. To avoid these adverse consequences, it would be advisable for member countries to devalue *pari passu* with inflation. Apart from avoiding distortions in competitiveness, agreement on rules concerning exchange rate changes would also permit maintaining the independence of national monetary policies.

**Distribution of Benefits and Costs of Integration**

Further consideration needs to be given to the distribution of benefits and costs of integration among member countries. The presumed maldistribution of benefits and costs appears to be the single major reason for the limited success of integration efforts in less developed areas. In this connection, reference has often been made to imbalances in intra-area trade following regional integration and the unequal distribution of manufacturing industries.

Imbalances in intra-area trade may however be the result of influences other than regional integration, including differential trends in economic growth and inflation. And should integration
be responsible for the imbalance, it may have been accompanied by offsetting changes in extra-area trade, so that one needs to consider the global trade position of a country rather than trade with the partner countries only. In turn, global trade imbalances may be offset by a devaluation or revaluation of the currency. Imbalances in intra-area trade per se should not be regarded as an indication of the unequal distribution of benefits. But, there is reason for concern if the imbalance is concentrated in trade in manufactured goods, reflecting the acquired superiority of certain partner countries in manufacturing that may foreclose the development of industries elsewhere. In such instances, action would have to be taken to offset the advantages of countries that would otherwise benefit from their early start in industrialization through concessions to the lesser-developed countries. This would, in turn, require striking a balance between the interests of countries at higher and lower income levels. At the same time, the concessions need to be temporary in nature to avoid the perpetuation of inefficient industries.

The experience of the European Common Market may be of interest in this connection. Upon entry, Ireland has received concessions in postponing the elimination of duties on intra-area imports while enjoying free entry for its own exports and will further benefit from investments by the European Investment Fund. Similar concessions have been provided by agreements with Greece, Turkey and Portugal.

**Trade Liberalization among Developing Countries Located in Different Regions**

Alternatively, one may suggest limiting the participants in an economic integration scheme to countries at similar levels of industrial development. As this condition is often not fulfilled in regional integration schemes, consideration needs to be given to the possibility of extending reciprocal reductions in trade barriers to all developing countries at similar levels of industrialization, regardless of their geographical location. While such a scheme would escape the difficulties due to integration among countries at different levels of industrial development, it has difficulties of its own. To begin with, the potential benefits are limited by high transportation costs while it would involve considerable risk and uncertainty. There is uncertainty as regards the balance of cost and benefits, because of limited information on production costs and on governmental policies in countries located on different continents. Also, in the absence of agreements on policies extending to external tariffs, quotas, licenses, export subsidies and indirect incentives, the balance
of advantages can be easily upset and trade will be subject to artificial distortions. At the same time, it is difficult to reach an agreement on policy coordination because the loss of sovereignty involved may not be compensated by the expected benefits. And not only do benefits promise to be larger in intraregional trade, but countries in a particular region, having similar history, customs, and even language, may possess the greater solidarity and common interests necessary for policy coordination than nations separated by great distances.

**Conclusion**

Regional economic integration should be regarded as one of the policy options available to developing countries in pursuing their strategy for economic development. Its potential benefits and costs should be weighted against those of other policy options, and in particular an export-oriented strategy. Regional integration benefits the member countries by ensuring access to the markets of their partners, lessening risk and uncertainty as regards the effects of trade liberalization on domestic industry, easing the task of policy coordination, and reducing the cost of infant industry protection. But it may also involve paying higher prices for regional imports, establishing monopoly positions in particular industries, drawing away resources from more productive uses, and neglecting other policy options.

The balance of benefits and costs of regional integration in a particular case will depend on market size, resource endowment, geographical location, and access to developed country markets, as well as on policies followed. There is a case for extending the scope of industries covered by integration schemes that involve liberalizing intraregional trade, unifying tariffs on extra-area imports, and coordinating trade and exchange rate policies. Also, one should avoid excessive protection against extra-area imports, and measures would have to be taken to ensure the equitable distribution of the benefits and costs of integration among the member countries.

Agreements on measures to be taken in favour of member countries at lower levels of development are, however, difficult to reach in part because of difficulties involved in evaluating the effects of these measures and because of their cost for the more developed countries. And, the loss of sovereignty involved in the elimination of barriers to intra-area trade and the coordination of trade and exchange rate policies represents a further obstacle to integration efforts. Furthermore, the benefits of greater competition may not be enjoyed if the combined demand of the member countries can sup-
port only one plant in a particular industry or if their markets are undeveloped. In such instances, recourse may be had to the project approach to integration that involves reaching agreement on the establishment and the operation of particular industries.

The project approach can be utilized in regard to new industries in conjunction with the application of a general trade liberalization scheme; its potential scope will be the greater the smaller the integrated area and the lower its level of industrial development. In the event that the conditions for implementing a trade liberalization scheme are not fulfilled, the project approach may be applied by itself, with provisions made for intraregional trade in the products involved. This approach will be discussed in Part II.

II. THE PROJECT APPROACH TO ECONOMIC INTEGRATION

Definitions and Concepts

One of the principal aims of integration schemes among developing countries is the establishment of projects which serve a wider than national market. Such projects may emerge either through the free operation of market forces in a region where trade barriers have been removed, or as a result of an explicit agreement between two or more countries which may or may not be part of a regional trade liberalization scheme. Projects of this nature will be referred to as integration projects.

In discussing economic integration, it is useful to bear in mind that different classes of goods and services are not equally mobile. A well-known distinction is that between internationally tradable and non-tradable goods and services; in turn, Mennes, Tinbergen and Waardenburg distinguish among local, regional, national, continental and international or world goods and services.¹ Both classification schemes are based on a variety of economic and technical considerations, among which transportation costs are the most important. In the following, a distinction will be made among national, regional (i.e. multi-country) and international goods and services.

National goods and services, including perishables, construction, housing, retail trade, most government and private services, are normally not traded among countries. They can, therefore, be excluded from the discussion of integration projects. By contrast, regional and international goods and services both qualify as candidates for integration projects. Regional goods and services may be

provided on a national basis as well as jointly for a group of contiguous countries; they can not as a rule be imported from world markets. This class of goods and services may include electricity, railways, roads, irrigation, etc. International goods and services, in turn, may be procured on a national and regional basis as well as from world markets. They comprise most agricultural, mining and manufactured products.

The Scope for Integration Projects: regional goods and services
Integration projects in this category may be found in transportation and communications, public utilities, education and research, and a few other fields that are specified below. They bring economic benefits if production on a regional scale leads to cost savings compared to their production on a national scale, taking into account production as well as distribution costs. Cost savings may be achieved directly through large-scale operations, fuller utilization of existing capacity, greater specialization in production, joint management, and the coordinated use of jointly-owned resources. Benefits may also be reaped indirectly, e.g. by investments in infrastructure that are principally designed to promote trade within the region.

Transportation provides examples of direct and indirect benefits from integration projects. First, cost savings may be achieved through coordinated planning, construction and/or operation of transportation facilities (e.g. a joint airline, a regionally integrated railway network with identical railway gauges, regional shipping companies, and an integrated highway system). Second, coordinated investments in transportation may have beneficial effects of an indirect nature in promoting trade among the partner countries.

Cost savings and, in particular, quality improvements may also be achieved by the coordinated planning and operation of regional communications networks. This would require, among others, tariff agreements, as well as the rationalization of signalling systems in the case of telecommunications. Among public utilities, electric power production and the development and management of water resources offer scope for integration projects. Both types of projects supply output that is normally not internationally tradable unless distances are short. In such cases, integration projects may offer benefits by exploiting economies of scale through regional cooperation. In some instances, gains can also be obtained through utilizing those resources from within the region that lead to the lower production costs; the latter may occur if several possible sites exist within a region for hydro-electric power generation, but one site is more suitable than others.
In the category of water supply projects, the principal case for coordinated action is with respect to the development of international river basins. A number of schemes of this nature exist (e.g. the Lower Mekong Basin), with the major potential gains to be derived from improved flood control, and more intensive use of the water resources for irrigation purposes. In turn, projects located on international waters may cause problems of environmental pollution in other countries, making desirable the coordination of action.

Joint projects in the field of education and research can lead to cost savings due to the better utilization of indivisible factors such as teaching and research staff and equipment, and may result in qualitative improvements in education and research as well. Regional universities, and technical colleges, and research into area-specific problems, jointly financed and managed by the participating countries, come into this category. Integration projects in the category of research are not necessarily restricted to regional arrangements, and successful global undertakings exist, e.g. the International Rice Research Institute.

The list of categories of integration projects among regional goods and services given so far is by no means exhaustive, and a variety of other fields should be mentioned where scope for such projects exists. These include projects aiming at regional computer facilities, the promotion of tourism, the promotion of regional exports through regional trade promotion centres, the development of mineral resources, and the provision of meteorological services.

The Scope for Integration Projects: international goods and services
This category of projects consists chiefly of agricultural, mining and industrial activities; their principal characteristic is that they can be internationally traded so that their availability in the region is not contingent upon production within the region; if produced within the region, they can also be exported to overseas markets.

In agriculture, there are examples of countries agreeing to limit the expansion of production in order to improve their terms of trade (e.g. coffee). Such agreements are usually of a global nature; they are considered to be outside the scope of this study. There are also possibilities for agreements on specialization in agricultural production between countries with different resource endowments. However, since economies of scale in agricultural production can be exploited in the national framework, integration projects in agriculture are usually linked with processing.
If regional planning permits the identification and establishment of efficient facilities, for example to process cocoa, cotton, rubber, as well as forest products and livestock, such projects are properly classified as integration projects. To the extent such facilities are dependent on the supply of inputs from the region as a whole, agreements among the participating countries may be required to guarantee compatible agricultural produce. Often, a country can exploit its geographical location by processing the exports of a landlocked country, which are allowed duty-free into the country. If the landlocked country were to process its own agricultural produce for exports, the transit country could impose import duties on the processed product. This issue has arisen a few times in practice, for example in West Africa with respect to livestock produced in the inland states of Mali and Niger.

Many cooperative efforts among developing countries have as their main objective the promotion of industrial growth, and most existing integration agreements devote special attention to industrial development. This is primarily due to the belief that the widening of the domestic market through regional integration enables the capturing of economies of scale that characterize most industrial activities, leading to lower average costs of production.

Lower average costs of production can be the result of higher rates of capacity utilization in the case of already existing plants. In such instances, partner countries may be induced to forego investments in similar activities. Secondly, cost savings may be achieved by exploitation of economies of scale. The simplest form is one that leads to the establishment of production units of a larger scale than would have been possible on the basis of the domestic market alone. Moreover, the wider market may permit the exploitation of advantages associated with specialization, most of which are also related to economies of scale. Specialization can take place either at the product or the process level. Petrochemicals, fertilizer and machinery provide possibilities for product specialization, with countries producing different varieties within a product category. Process specialization occurs if a group of countries agree to specialize in different components for the manufacture of machinery or transport equipment.

Finally, it may be useful to point out that the project approach in the case of international goods need not be restricted to the markets of contiguous countries, and that a wider approach is feasible given the possibility of international trade. The extreme case is that of world-wide sectoral investment planning; an example of an appli-
cation of this approach was recently discussed in the Board. The major problem facing this particular approach is its implementation: if it is difficult to reach agreement among a few neighbouring countries on one or more integration projects, it may be expected to be even more so among a larger group of countries.

**The Measurement of Costs and Benefits**

In the preceding sections, we have described the scope for integration projects in the various sectors of the economy and the nature of the benefits that may be derived from such projects. In spite of the potential gains that can be associated with integration projects, few of such projects have in fact been established. In an attempt to identify the reasons for the limited success of the integration project approach, it appears useful to draw a distinction between two sets of problems, one related to the evaluation of the costs and benefits of integration projects, the other being associated with the establishment and operation of such projects. In this section, we shall discuss the evaluation problems.

The selection and appraisal of integration projects raises a number of complex technical problems. One of the main arguments in favour of integration projects is the exploitation of economies of scale that many activities exhibit. However, until recently, no efficient planning techniques were available to select optimal projects in the presence of economies of scale. Such a technique is now available in the form of mixed-integer programming, but its application requires technical expertise which is available in few developing countries.

In addition to technical problems associated with project planning in the presence of economies of scale, complications are introduced by the explicit recognition of risk and uncertainty in project analysis. The latter tends to weaken the case for large production units, even under economies of scale. As a plant designed to meet requirements for a regional market faces greater uncertainty than one that caters for a national market only, since regional cooperation may be discontinued, the expected benefits of an integration project are correspondingly lower.

2 IBRD, IFC, IDA, *Fertilizer Requirements of Developing Countries*, May 15, 1974.

3 A research project at the Development Research Center (RPO 224—Programming in the Manufacturing Sector) which is now in its final phase, has resulted in the formulation and solution of a number of mixed-integer programming models for specific industrial activities. These models are formulated such that they are easily applicable elsewhere, either for one country or for a group of countries. Moreover, the project has resulted in improved solution procedures for such models, reducing the cost of their use considerably.
Besides methodological problems of integration project selection and evaluation, a data problem exists. To make an adequate case for integration projects, detailed estimates of net benefits associated with them in comparison to alternative modes of production are required. To measure these net benefits, production cost data for various scales of production are required, as well as detailed information on the geographical dispersion of demand and transportation cost. Yet, statistical data are rarely collected on the basis of a group of countries, and most data collection efforts are geared toward the domestic economy. Differences in data coverage and classification often render the construction of regional data sets a difficult problem, further complicating the task of accurately measuring the costs and benefits of integration projects.

Measurement of costs and benefits of integration projects is more complicated in the case of projects in the category of international goods and services than for regional goods and services. For the latter, project analysis takes place in an environment which is fully controlled by the region itself, imports from outside the region being excluded by definition. As a result, fairly firm estimates can be made of the net gains or losses associated with any specific production structure. In contrast, for international goods, imports from world markets provide an alternative to production on national or regional scale; to estimate the gains and losses of an integration project in this category, a projection of import prices is required. Given the uncertainty associated with future world market prices, the assessment of potential costs and benefits of regional production becomes more complicated.

Reaching Agreement on Integration Projects
Perhaps the most important obstacle to agreements on integration projects is the bias prevalent in most countries in favour of national projects. This is reflected first of all in the orientation of the economic planning machinery in most countries which focuses primarily on the design and implementation of national investment programmes. If a regional bureaucracy exists, it is most often inadequately staffed, lacking both the political power and the financial resources to constitute an effective counterpart to nationally-oriented institutions.

Even if political will is there, integration project agreements are difficult to reach because of disputes concerning the distribution among countries of costs and benefits associated with a given project. Unless the location of a project is dictated by natural resource constraints, it is difficult to get countries to agree on the location of
an integration project. The more important a project, the more
difficult such negotiations may be, and it may either be impossible
to achieve agreement, or the allocation agreeable to all is so in-
efficient that the total net gain of integration projects is wiped out.
Judging by the experience of the last decade, problems of this nature
have arisen most frequently in the case of the 'foot-loose' industries.

Apart from the problem of which country provides the location
for a given integration project, it may be difficult to reach agree-
ment on what countries wish to distribute equitably, and in what
manner. Like any other project, an integration project generates
value added, employment, requires foreign exchange outlays and
domestic capital, may generate foreign exchange earnings, and pro-
vides opportunities for tax revenues; moreover, the project may have
important externalities. The distributional formula agreeable to
partner countries, therefore, contains many elements.

Disputes may furthermore arise over regional transfer prices of the
output of integration projects. This is closely related to the fact that
the approach to economic integration based on integration projects
frequently leads to the establishment of monopolies. If restrictions
are placed on competing imports, a privately managed integration
project will follow pricing and output policies that may not be
consistent with economic policy objectives in partner countries.
Without government interventions, therefore, there may be a trade-
off between the exploitation of economies of scale by establishing
relatively few productive units and an organization of supply that
results in the achievement of given policy objectives.

These difficulties are of especial importance in the case of inter-
national goods. As was explained before, the assessment of net gains
or losses for a project in this category is more difficult than for a
project in the category of regional goods and services because of the
uncertainty related to developments in the world market. This
problem may be particularly important if different countries have
different perceptions of the future.

Also, integration projects in the regional category may be more
stable over time than projects in the international category. In the
case of an integration project relating to a regional good or service,
the alternative of national production exists but can not be realized
instantly. Lengthy gestation periods are usually required to attain
full operation of a new project. However, in the case of integration
projects in the category of international goods and services, project
cooperation can be terminated at once, by activating the import
alternative. The above factors have in particular hampered the
establishment of integration projects in the industrial sector. Import
prices for industrial goods often vary by source and over time, while wide fluctuations in ocean shipping rates complicate c.i.f. import price projections even further. Under such conditions, it is extremely difficult to make plausible quantitative estimates of the potential net gains to be derived from integration projects in this sector, and countries have understandably been reluctant to agree to a production structure that may prove to be inefficient in the medium and long-term. If the latter occurs, one of two situations may obtain. First, the producing country may lose its regional market, and end up with an underutilized plant. Second, the regional market is maintained, but all participating countries suffer net losses because of relatively high-cost regional production. The former alternative is more likely to occur in practice and this distinguishes integration projects sharply from national projects. If a national project turns out to be based on an erroneous projection of c.i.f. imports prices, and is relatively high-cost, domestic pressures to prevent the shutdown of the project will be severe, usually resulting in higher protection from imports than originally envisaged. In the case of an integration project, such pressures from the project’s host country can be assumed to be less effective in the partner countries.

The Package Approach

Some of the difficulties associated with reaching agreements on the individual integration project approach can be reduced by adopting the so-called package approach. This approach specifically and explicitly aims at facilitating the negotiation and enhancing the stability of an integration agreement by assuring that each participating country obtains at least one integration project from among a package of such projects. The condition that each country hosts at least one project aims at replacing complicated distributional formulas associated with individual project allocations among countries. Moreover, greater stability is achieved once an allocation of projects has been agreed upon because unilateral withdrawal from the regional scheme inflicts losses on the withdrawing country itself.

An important condition to be fulfilled for the successful application of the package approach is that the project planning exercise results in comprehensive information on the effects of alternative allocative schemes on partner countries. Some projects in the ‘package’ will usually be more efficient than others due to the region’s comparative advantage. Countries with efficient projects in the category of international goods and services may be better off
than countries with projects in the category of regional goods and services, as the latter can not, by definition, be exported outside the region. In general, it may be stated that the package approach is more likely to achieve its goal of stability in the regional market arrangement if the projects included are relatively efficient compared to national projects, in the case of regional goods and services, and compared to imports, for international goods and services. If high protective barriers are necessary for some or all of the projects included in the category of international goods and services, it is conceivable that the cost of trade diversion to a partner country is so high as to offset the loss associated with underutilization of the capacity of its integration projects following withdrawal from the scheme.

Even though it appears that the package approach poses less serious problems of distribution of costs and benefits than the individual project approach, several such problems remain. If an allocation of projects is decided upon, for example, it may not be the most efficient one from the point of view of the region as a whole. Special arrangements may need to be made to ensure that each project is implemented, to ensure that the ex ante allocation of projects materializes. This may be particularly important if a project is allocated in a relatively unattractive part of the regional market, and it turns out to be difficult to find capital and managerial talent to establish the project. However, basically, these problems are not more severe than they are in the case of individual projects.

A number of dynamic problems can be identified that are related more directly to the package approach. First, the original allocation of projects may have been agreeable to all partner countries, but while in operation some projects appear so inefficient that problems arise relating to the distribution of costs and benefits. Similarly, although the initial allocation of projects appeared acceptable, an incorrect projection of import prices, or demand, renders some projects less efficient than predicted. Finally, as demand for different products is likely to increase at different rates, some of the projects in the package may become independent of the regional market for efficient operation at an earlier stage than others, leading to instability over time.

One way in which these particular problems may be overcome is to consider joint financing of projects in the package by partner countries, in addition to outside financing. This would result in spreading the financial risk of the operation of integration projects among partner countries, which may result in greater solidarity.
among them in the face of unforeseen adverse circumstances affecting one or more integration projects.  

Conclusion

The integration project approach may offer substantial benefits to countries that are not yet able to compete in world markets, and wish to establish an efficient production structure in activities that are subject to economies of scale. In spite of its apparent advantages, however, this strategy has met with limited success, and very few integration projects have in fact been established. A number of reasons can be identified to explain this state of affairs.

First, there is a strong bias in favour of national projects and national development objectives; even if regional bureaucracies exist, they are usually powerless and without adequate resources. To remove this bias, one necessary condition to be fulfilled is that convincing quantitative estimates are made of the net benefits of integration projects to partner countries. Project planning techniques have now been developed for project selection and appraisal in the presence of economies of scale, and fairly detailed estimates can be made of the relative costs and benefits of alternative production structures.

Secondly, a major stumbling block during attempts at reaching an agreement on integration projects relates to the distribution of costs and benefits of such projects among partner countries. In the case of an individual integration project, discussions of this nature are often very difficult, and only if the net benefits of a specific integration project appear large to each participating country, may agreement be possible.

To alleviate some of the problems associated with the negotiation of integration project agreements, the package approach appears an attractive alternative. Although this approach does not provide a panacea for all problems associated with integration projects, it would appear that the fact that each participating country hosts at least one project facilitates not only the process of reaching an agreement on integration projects, but also increases its stability. Enhanced stability can be expected as any country that decides to withdraw from the integration scheme inflicts losses upon itself by losing access to the regional market for its integration project(s). For these reasons, the package approach—perhaps combined with some arrangement to provide for the joint financing of projects—may be recommended.

*For a specific proposal along these lines, see: I. M. D. Little, ‘Regional international companies as an approach to economic integration’, *Journal of Common Market Studies, Vol. 5, 1966.*
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