THE RELEVANCE OF THE TRADITIONAL STATIC ANALYSIS TO THE EVALUATION OF REGIONAL INTEGRATION SCHEMES BETWEEN LESS DEVELOPED COUNTRIES

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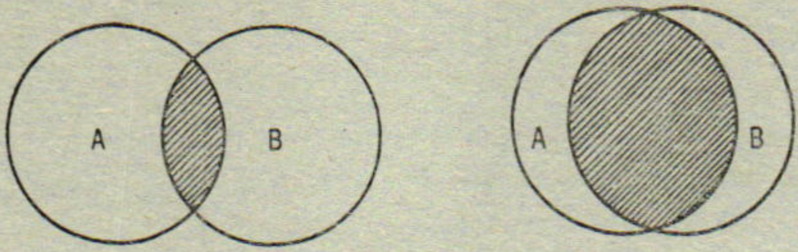
Lipsey has defined the theory of customs union as that branch of tariff theory which deals with the effects of geographically discriminatory changes in trade barriers. The earliest customs union theory was largely embodied in the oral tradition and had been viewed favorably. The reasoning was: Free trade maximizes world welfare; a customs union reduces tariffs and is a movement towards free trade; a customs union will therefore, increase world welfare even if it does not maximize it (Lipsey, p. 262).

Viner showed this argument to be incorrect. He introduced the now familiar concepts of trade creation and trade diversion. His analysis suggests that if a customs union leads to trade creation, it will lead to an increase in welfare; and if it gives rise to trade diversion, it will decrease the world's welfare.

The implication of this analysis is that customs unions will lead to detrimental effects if the countries are complementary in their production. If, on the other hand the group of commodities that both countries produce under tariff protection is large, the scope for positive welfare effects is large. The below figures show the complementarity (a) and overlapping (b) production structures of countries And B (Södersten, p. 432).



(a) (b)

A customs union is more likely to lead to an increase in welfare if the union partners are actually competitive but potentially complementary. The larger the cost differentials between the countries of the union in goods they both produce, the larger is the scope for gains. The higher the initial tariffs between the union partners, the greater is the scope for an increase in welfare. The lower the tariffs to the outside world, the smaller are the losses on trade diversion The larger the part of trade originally covered by trade between union partners, the greater is the scope for gains from the union (Södersten, pp. 442-3).

Viner's analysis assumes; constancy in terms of trade, constancy of production costs, and zero demand elasticities for products, that is commodities are consumed in some fixed proportion and there is no substitution between them (Vaitsos, p. 751).

These assumptions were later relaxed. For instance, by incorporating the substitution among commodities in consumption Gehler has shown that it is possible for a country to form a trade diverting customs union and yet gain an increase in its welfare. Gehler concluded that his anlysis established a general presumption in favour of gains from union rather than losses (Lipsey, p. 436).

Viner's analysis is an example of what Lancaster and Lipsey called «The General Theory of Second Best». That is, if it is impossible to satisfy all the optimum conditions, then a change which brings about the satisfaction of some of the optimum conditions may make things better or worse (Lipsey, p. 263). Customs union theory is, also, of a comperative-static nature. It starts from an eguilibrium with a given tariff structure. Then a discriminatory change in this structure is made, and the effects on economic welfare are estimated.

The tools of analysis and assumptions as well as its emphasis on competition and gains from trade are a mix of the Ricardian comperative advantage theory and the neo-classical theoretical formulations. It is of a neo-classical type because it assumes that the countries involved are fully employed both before and after the formation of the union (Södersten, p. 431).

The most important consequence of static analysis is that; countries heavilu, dependenton each other in theirtrade should From custams union with each other. There are no gains to be had by forming unions with countries that are only marginal importance.

The postulates drawn from traditional theory lead to the conclusion that developing countries ought to From customs unions, if at all, with some of the industrialized countries (Vaitsos, p. 751). That is because, their trade is not with one another but with developed countries.

The theory of customs union has been confined mainly to a study of the effects on welfare rather than, for example, on the level of economic activity, the balance of payments or the rate of inflation. One could argue that there are other effects of a «dynamic» or perhaps institutional kind that are more important. One such dynamic effect is the presence of unutilised economies of scale, the other is the enforced competition (Södersten, p. 441).

On the other hand, traditional theory does not address itself to the major issues of development, namely how the process of integration will dynamically change the structural conditions of production and technology, the process of inter-commodity and inter-activity (rather than simply of inter-country) substitution, the dynamics of resource diversification going beyond the question of specialisation, the composition of investments and expectations, the capacity for absorbing externalities, etc. (Vaitsos, p. 751).

The principal objective of economic integration between less developed countries, surely, is to foster industrial development and to guide such development along more economic lines. With this objective in mind, Cooper and Massell have shown that, either trade creation or trade diversion can be gosd and either can be bad. With a trade diversion case, each oconomy expands its industrial produciton to supply the other's market. While this may reduce each economiy's national income, industrial production is expanded. Without knowing more abouth the countries indifference curves, one cannot say whether this raises or lowers walfare. Similarly consider trade creation. Say that North is a lower-cost producer than South for industrial products, so that with a customs union, production shifts from South to North. Although South now pays less for its industrial goods, its industrial sector has been lost in the bargain. Is South necessarily better off? Again, one cannot answer without some knowledge of South's preference (Cooper and Massell, p. 475).

In analytical terms there are important differences between European integration and customs union among developing countries. While in the first case, economic researchers have been mainly concerned with the effect on welfare of the world, the impact of, say the Central American Common Market on international trafe flows is rather insignificant. The main concern in the later case is with the effect of integration on the integrating countries themselves, and in that respect, trade creation as well as trade diversion may be beneficial. In Europe, trade diversion is considered harmful because it implies misallocation of fully employed resources from more efficient to less efficient pursuits. But in developing countries, the domestic labour drawn into trade-diverting activities may have been formerly unemployed or underemployed, so taht its opportunity cost is at or near zero (Kreinin, p. 374).

The argument that trade diversion is undesirable ignores two basic facts: First, because of potential economies of scale, the creation of local jobs, and the circular flow of income within the integrated region, static trade diversion may turn out to be dynamic trade creation. This is simply a variant of the standard «infant industry» argument for protection with the more likely possibility that the infant will grow up as a result of the larger market in which it operates. Second, if in the absence of integration each member state were to protect its local import-substituting industry against cheaper foreign suppliers, the common external tariff of member states causes no more trade diversion than would have happened anyway. But if there are scale economies the possibility of dynamic trade creation can emerge. This static but useful concepts like trade creation and trade diversion must be analysed in the dynamic context of growth and development based on the realities of current commercial policies of Third World nations rather than in the theoretical vacuum of traditional free trade models (Todaro, p. 334).

The first dynamic rational for the integration of LDCs is that integration provides the opportunity for industries which have not yet been established as well as for those that have to take advantage of the economies of large-scale production .Integration, therefore, needs to be viewed as a mechanizm to encourage a rational division of labour among a group of countries, each of which is too small to benefit from such a division of labour. The second dynamic rational is by removing barriers to trade among member states the possibility of co-ordinated industrial planning is created, especially in those industries where economies of scale are likely to exist (Todaro, p. 333).

CONSLUSION

The most cogent political argument, the prima facie justification for economic cooperation among LDCs, is the desire to enable the participating countries jointly to establish a broader and more effictient industrial base. The phenomenon of integration should be viewed in a dynamic context and in the light of a factor endowment which changes as a result of the integration process itself and gradual assimilation of technology (Salgado, p. 167).

The theory which is more relavant to South-South economic integration originates not from trade analysis but from development and programming theory interested in structural change of the productive and technological structure and from the literature which explores the dependence relations of developing countries with the rest of the world. The disillusionment with traditional integration theory led to some new formulations, as an extention or a branch of development theory rather than that of international trade. The basic premises of this development analysis are two : (a) inputs are variable and their composition as well as their effectiveness are not given but bound by the character of production; (b) the actual trade flows are to a large extent irrelavant to the opportunities of regional cooperation since the former do not adequately represent the potentialities of the latter. «Purely static propositions are mostly irrelevant if not actually misleading». Trade diversion might be a source of gain rather than of loss in less developed countries integration (Vaitsos, p. 752).

The scope for industrical growth can be greatly strengthend by economic co-operation among various less developed countries. Instead of trying to compete with one another for access to heavily protected developed country manufactured goods markets, Third World nations may stand a better long-run change to diversify their economies successfully by trading with one another behind the protective barrier of a common tariff (Todaro, p. 335).

Finally, trade diversion may help poor countries as a whole at the expence of the richer ones if the terms of trade improve the gains from trade more losses from misallocation of resources hurt (Kindleberger and Herrick, p. 329).

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