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# Integration and Economic Development

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# INTEGRATION AND ECONOMIC DEVELOPMENT

BY ROBERT L. BIRMINGHAM\*

IN THIS PAPER I shall attempt to evaluate the potential impact of economic association among underdeveloped countries. Attention is centered on gain achievable by participating states as a group: world welfare alteration appears devoid of normative implication to the national decision maker, while questions of internal distribution of union benefit are too complex for summary treatment. Conclusions of amalgamation efficacy rest jointly on abstract analysis and deduction from empirical economic parameters; discussion of trade and development theory is extended beyond that logically necessary for argument coherence to provide a brief introduction to relevant recent thought.

## I. DEVELOPMENT OPPORTUNITIES

### A. *International Inequalities*

A pressing international problem is the great disparity between real incomes in the North Atlantic Community and those in the less developed lands of Latin America, Africa, and Asia. In 1962 per capita gross domestic product unadjusted for inequalities in purchasing power averaged 2,975 dollars in the United States, but only 145 dollars in the poorer market economies comprising two-thirds of the population of the free world.<sup>1</sup>

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<sup>1</sup>U.S. Agency for International Development, *Selected Economic Data for the Less Developed Countries*, May 1964, p. 8 (Table 1). Other comparisons are equally revealing:

	United States	Backward Regions (Free World)
Power per capita (kilowatt hours per year)	5050	110
Miles of improved roads (per 1000 square miles)	1010	70
Literacy (per cent)	98	35
Life expectancy (years)	70	45
Daily caloric intake (per capita)	3220	2230
People per physician	740	4400

*Ibid.* See U.N. DEP'T OF ECONOMIC & SOCIAL AFFAIRS, *WORLD ECONOMIC SURVEY 1963* pt. i, 1 U.N. Doc. No. E/3908(ST/ECA/84) at 18-28 (1964); Patel, *The Economic*

"When . . . the national income in the United States increases by the modest figure of 2½ percent in a year, the average increase in income for each man, woman, and child is just about equal to the total annual income of the average citizen of India."<sup>2</sup> While income indices are by no means comprehensive measures of intercivilization welfare differentials,<sup>3</sup> widespread adoption of materialistic western ideologies has diminished the importance attached to the traditional value structures of non-European cultures.

Wealth disparity made manifest by increasing international contact represents a potent source of political tension. The abortive United Nations Conference on Trade and Development, held in Geneva in the spring of 1964, is best interpreted as a protest by the backward nations against their plight. In a joint declaration at the conclusion of negotiations, the poorer participants proclaimed: "The developing countries regard their own unity, the unity of the seventy-five, as the outstanding feature of this Conference. . . . The injustice and neglect of centuries need to be redressed. The developing countries are united in their resolve to continue the quest for such redress . . . ."<sup>4</sup> A South American businessman has asserted: "You

*Distance Between Nations: Its Origin, Measurement and Outlook*, 74 ECON. J. 119 (1964). See also Falk & Mendlovitz, *Towards a Warless World: One Legal Formula To Achieve Transition*, 73 YALE L.J. 399, 405 (1964). Some idea of the concern generated by the problem can be garnered from Köllner, *Entwicklungstheorie und Entwicklungswirklichkeit*, 15 JAHRBUCH FÜR SOZIALWISSENSCHAFT 35 (1964).

Income estimates are hardly reliable. For difficulties of calculation see Kuznets, *Quantitative Aspects of the Economic Growth of Nations*, 5 ECON. DEVELOPMENT & CULTURAL CHANGE 1 (1956). In particular, bias is introduced because indices of traded goods are generally used to compare price levels, and price differentials are greatest among nontraded items. See Balassa, *The Purchasing-Power Parity Doctrine: A Reappraisal*, 72 J. POL. ECON. 584 (1964).

<sup>2</sup> NEALE, *THE FLOW OF RESOURCES FROM RICH TO POOR* 4 (1961).

<sup>3</sup> "Progress is a much oversimplified notion. Only in the narrow area of material control and production are the West and the non-Western world properly conceived of as "more developed" and "less developed"—and only then by making an unrealistic abstraction of material wealth from the culture and society in which it subsists. In every other respect the West and the societies of the non-Western world are not more or less advanced on a single road. They are, and have been, proceeding in quite different directions of development. They are, and have been, advancing toward quite different human destinations. Only a Westerner obsessed with the universal validity of his own values is compelled to look upon the hypersubtle Arab East, say, as "less developed," and he does so not by consideration of its intentions and the native accomplishments of its civilization, the intensity and subtlety of its life, but by assuming that whatever the rest of the world's aberrations and hesitations, that world is necessarily fated to conform to Western norms."

STILLMAN & PFAFF, *THE POLITICS OF HYSTERIA* 39-40 (1964). For an argument that the current goals of economic development have been formulated in disregard of basic human needs see Weisskopf, *Economic Growth Versus Existential Balance*, 75 ETHICS 77 (1965). On the "culture-centric predicament" see Hoyt, *Choice as an Interdisciplinary Area*, 79 Q.J. ECON. 106, 107-08 (1965). See also Bergson, *National Income and Welfare* (Rand Corp. Paper P-3004, Oct. 1964).

<sup>4</sup> 1 U.N. CONFERENCE ON TRADE AND DEVELOPMENT, FINAL ACT AND REPORT, Annex

have inundated our market with consumer goods and you have not invested enough to create national industries here. You arouse our discontent by putting pretty things in our windows. Now we look to you to satisfy the needs that all people have a right to. When we see Americans with two cars we . . . want two.”<sup>5</sup> Myrdal argues: “Without a radical change in policy . . . the world is headed for an economic and political cataclysm.”<sup>6</sup>

Wealth differentials can be satisfactorily reduced only by maintenance of rapid rates of growth in underdeveloped regions. Between 1950 and 1960, however, output per person in these areas increased only 2.2 per cent per year, less than in the advanced economies. Although during this period gross domestic product in the poorer nations grew 4.4 per cent per year, 20 per cent faster than in industrialized lands, population expansion at a 2.2 per cent annual rate dissipated the advantage.<sup>7</sup> As Myrdal notes, “The

B, at 67-68 (1964). Section I of the Preamble of the Final Act of the Conference proclaims: “The States participating . . . are determined . . . to seek a better and more effective system of international economic co-operation, whereby the division of the world into areas of poverty and plenty may be banished and prosperity achieved by all. . . . [I]t is essential that the flows of world trade should help to eliminate the wide economic disparities among nations.” *Id.* at 3. General Principle Four adds: “[A]ll countries pledge themselves to pursue internal and external economic policies designed to accelerate economic growth throughout the world, and in particular to help promote, in developing countries, a rate of growth consistent with the need to bring about a substantial and steady increase in average income, in order to narrow the gap between the standard of living in developing countries and that in the developed countries.” *Id.* at 10. The United States was the only participant voting against adoption of this statement. *Id.* Annex A, at 18. See Weintraub, *After the U.N. Trade Conference: Lessons and Portents*, 43 FOREIGN AFF. 37 (1964).

<sup>5</sup> Quoted in Guzzardi, *The Crucial Middle Class*, Fortune, Feb. 1962, pp. 98, 212. See also RAPOPORT, STRATEGY AND CONSCIENCE 261-62 (1964).

“U.S. firms established in Latin America derive approximately 500 million dollars monthly from profits. In other words, while the U.S. Congress allocates 525 million dollars for the Alliance for Progress program next year, the United States in one year extracts from Latin America the sum of six billion dollars in profits through firms which U.S. capital has established in impoverished Latin American nations. As can be easily observed, Latin America has its own Alliances for Progress in favor of the United States, supplying six billion dollars annually toward contributing to the high living standard enjoyed by the North American people. While the U.S. debates on loans to be granted to Latin American nations for the construction of schools, hospitals, roads, and so forth, Latin America is contributing toward the economic potential of the most powerful country of the world. Considering the cited figures, which reveal the increasing poverty of Latin America, it is not strange that the disturbed American hemisphere continues to be jolted by great social upheavals.”

Radio Tribuna, Panama City, Dec. 18, 1963, quoted in Johnson, U.S. Private Investment in Latin America: Some Questions of National Policy 53 (Rand Corp. Memo. RM-4092-ISA, July 1964).

<sup>6</sup> Myrdal, *The Widening Gap*, Int'l Development Rev., Sept. 1963, p. 3. See COUNCIL ON WORLD TENSIONS, A STUDY OF WORLD TENSIONS AND DEVELOPMENT (1962).

<sup>7</sup> U.N. DEP'T OF ECONOMIC & SOCIAL AFFAIRS, *op. cit. supra* note 1, at 26. See Wittmann, *Wirtschaftliches Wachstum in reichem und armen Ländern*, 177 JAHRBÜCHER FÜR NATIONALÖKONOMIE UND STATISTIK 97 (1965).

income gap between the rich and the poor countries has . . . been increasing and not decreasing, not only absolutely but relatively.”<sup>8</sup> Seers argues that “Marx’s prophecy of the impoverishment of the poor may be fulfilled on the international plane.”<sup>9</sup> Extrapolation of environmental parameters suggests that if the underdeveloped market economies continue internal policies of the recent past they will by 1970 be unable to maintain even the modest 1950-1960 pace of output expansion without roughly 10 billion dollars of capital inflow annually from their more wealthy neighbors. Raising growth rates a single percentage point would almost double external assistance requirements.<sup>10</sup> Aspirations nevertheless remain high:

“Sheik Abeid Karume, the first Vice-President of the Republic of Tanganyika and Zanzibar, on June 6, 1964, promised the 320,000 people of Zanzibar that they ‘would all be earning £450 by 1966,’ an income £25 greater than the 1962 U.K. average. This remarkable objective is to be achieved by a three-year Zanzibar development plan prepared by the revolutionary government of Zanzibar. When I questioned an important figure in the revolutionary government about the feasibility of this promise, he replied, ‘If the Government says it will happen, it will,’ and eagerly dropped the subject. The Chinese People’s Republic has already promised Zanzibar an interest-free loan of £5 million, but this is, unfortunately, only about 1 per cent of the investment required to reach the promised per capita income level.”<sup>11</sup>

Oil export has thus far provided the only mechanism permitting rapid accumulation of wealth by non-Western societies. A World Bank survey reports: “Kuwait has reached the level of affluence where purely economic improvement, in the form of a higher per capita income for her people, need not be an overriding objective of national policy.”<sup>12</sup> Two decades ago Kuwait was a sparsely populated 6,000-square-mile wasteland at the northeast corner of the Persian Gulf. Per capita income was but 35 dollars; public revenues totaled only 290,000 dollars. Today annual imports of luxury goods amount to almost 300,000,000 dollars, or roughly 825 dollars for each of its 350,000 inhabitants. The cost of salaries of public officials is about 1,120 dollars per citizen. Each tree and bush along the streets requires 250 dollars per year in maintenance expenditures. The Kuwait Fund for the

<sup>8</sup> Myrdal, *supra* note 6, at 3, 11.

<sup>9</sup> Seers, *A Model of Comparative Rates of Growth in the World Economy*, 72 *Econ. J.* 45, 75 (1962).

<sup>10</sup> U.S. Agency for International Development, *Development Policies and Assistance Requirements*, Dec. 1964 (preliminary draft).

<sup>11</sup> Keegan, *Tanganyika’s Five-Year (1964-1969) Development Plan: Sober Realism or Buoyant Optimism?*, in *FINANCING AFRICAN DEVELOPMENT* 11, 12 n.3 (Farer ed. 1965).

<sup>12</sup> INT’L BANK FOR RECONSTRUCTION & DEVELOPMENT, *THE ECONOMIC DEVELOPMENT OF KUWAIT* 1 (1965).

Economic Development of the Arab Countries has capital resources of 840,000,000 dollars. Yet the unskilled laborer earns only 1.5 dollars per day. The 1957 census revealed an indigenous labor force of almost 24,000, of which over 19,000 had at best rudimentary training. Most of the remainder were designated "professionals and technologists," although they included only one chemist, one geologist, two doctors, two author-journalists, and eight accountants. Also in this category were 156 "clergymen."<sup>13</sup>

### B. Constraints Limiting Development Velocity

In pioneering studies of economic growth in the decade following the Second World War, attention was focused on the Harrod-Domar model, in which the assumption of fixed factor proportions dictated that given a plentiful labor supply and an invariant capital-output ratio, production would be directly proportional to the quantity of capital available.<sup>14</sup> Stimulation of increases in investment levels became the planner's primary goal: "In the literature on economic development and in public statements by leaders of underdeveloped countries, emphasis is always placed on the need for more and more capital."<sup>15</sup>

The introduction of the more realistic neo-classical model permitting substitution between capital and labor inputs demonstrated that such emphasis on a single variable was misplaced.<sup>16</sup> Extensions of this analysis have

<sup>13</sup> Shehab, *Kuwait: A Super-Affluent Society*, 42 FOREIGN AFF. 461 (1964). See also Schmidt, *Affluence in Kuwait*, N.Y. Times, Jan. 9, 1965, p. 5, col. 1. Contrast HIGGINS, ECONOMIC DEVELOPMENT 26-37 (1959), with Smith, *Wealth in Libya Flowing Like Oil*, N.Y. Times, Jan. 25, 1965, p. 47, col. 1. On national wealth as a possible inducement to political liberalism see Habachy, *A Study in Comparative Constitutional Law: Constitutional Government in Kuwait*, 3 COLUM. J. TRANSNAT'L L. 116 (1965). Note the difficulty of even approximately positioning the described government on the democratic-totalitarian continuum on the basis of supplied data.

<sup>14</sup> See HARROD, TOWARDS A DYNAMIC ECONOMICS (1948); DOMAR, ESSAYS IN THE THEORY OF ECONOMIC GROWTH (1957).

<sup>15</sup> Bruton, *Growth Models and Underdeveloped Economies*, 63 J. POL. ECON. 322, 335 (1955), reprinted in THE ECONOMICS OF UNDERDEVELOPMENT 219, 240 (Agarwala & Singh eds. 1958). "In recent years too much emphasis in the discussion of growth has been devoted to one of the factors concerned, namely investment." Clark, *The Fundamental Problems of Economic Growth*, 94 WELTWIRTSCHAFTLICHES ARCHIV 1 (1965).

<sup>16</sup> See Solow, *A Contribution to the Theory of Economic Growth*, 70 Q.J. ECON. 65 (1956). See also MEADE, A NEO-CLASSICAL THEORY OF ECONOMIC GROWTH (2d ed. 1962); SOLOW, CAPITAL THEORY AND THE RATE OF RETURN (1963); *Symposium on Production Functions and Economic Growth*, 29 REV. ECON. STUDIES 155-266 (1962). For critical comment see Riese, *Mittelfristiges wirtschaftliches Wachstum und neoklassische Wachstumstheorie*, 18 KYKLOS 80 (1965).

The current rage is the constant-elasticity-of-substitution (CES) production function, introduced in Arrow, Chenery, Minhas & Solow, *Capital-Labor Substitution and Economic Efficiency*, 43 REV. ECON. & STATISTICS 225 (1961). For a detailed discussion of its derivation and characteristics see Scheper, *Produktionsfunktionen mit konstanten Substitutionselastizitäten*, 177 JAHRBÜCHER FÜR NATIONALÖKONOMIE UND STATISTIK 1 (1965).

See generally Hahn & Matthews, *The Theory of Economic Growth: A Survey*, 74 ECON. J. 779 (1964). This 123-page review contains a 232-item bibliography.

illustrated the possibility that long-term consumption levels may be negatively influenced by policies encouraging a continuing massive investment effort. Over an indefinite time interval greatest possible total consumption will result if capital expansion is limited to the rate of profit; a steady investment flow exceeding this amount will boost the capital-output ratio to such an extent that the resulting rise in future income will be less than the increase in saving necessary to maintain the selected rate of growth of production. Once a certain level of development is attained, technical progress replaces capital accumulation as the major factor inducing advance in per capita income.<sup>17</sup>

Recent work has stressed social aspects of development: "Kapitalbildung [ist] nicht Impuls, sondern Erscheinung des Wachstums . . . Tiefer gefasst muss . . . alle wirtschaftliche Entwicklung auf den primären Faktor schlechthin zurückgeführt werden: auf *menschliche Leistungen*." <sup>18</sup> Traditional cul-

<sup>17</sup> If  $Y$ ,  $C$ ,  $I$ , and  $K$  represent income, consumption, investment, and capital stock respectively, we may write:

$$C = Y - I = Y - dK.$$

It follows that

$$C = Y - \frac{K}{K} dK.$$

If  $W_k$  represents  $\frac{dK}{K}$ , the rate of capital accumulation,

$$C = Y - W_k K.$$

Differentiating with respect to  $K$  and setting the result equal to 0 we obtain:

$$\frac{\partial C}{\partial K} = \frac{\partial Y}{\partial K} - W_k = 0$$

or

$$W_k = \frac{\partial Y}{\partial K}.$$

Riese, *Gleichgewichtswachstum und optimales Wachstum in der neoklassischen Wachstum Theorie*, 17 KYKLOS 31 (1964). See VON WEIZSÄCKER, *Wachstum, Zins und Optimale Investitionsquote* (1962); Bombach, *Optimales Wachstum und Gleichgewichtswachstum*, in HENN, BOMBACH & BÖVENTER, *Optimales Wachstum und Optimale Standortverteilung* 47 (1962); Krelle, *Investition und Wachstum*, 176 JAHRBÜCHER FÜR NATIONALÖKONOMIE UND STATISTIK 1 (1964); Richter, 'Harrod-Wachstum' und 'Solow-Wachstum', ein Vergleich, 121 ZEITSCHRIFT FÜR DIE GESAMTE STAATSWISSENSCHAFT 235 (1965). See also Samuelson, *A Catenary Turnpike Theorem Involving Consumption and the Golden Rule*, 55 AM. ECON. REV. 486 (1965). But see Sato, *Fiscal Policy in a Neo-Classical Growth Model: An Analysis of Time Required for Equilibrating Adjustment*, 30 REV. ECON. STUDIES 16 (1963).

<sup>18</sup> Paulson, *Sachkapital und Human Capital in der wirtschaftlichen Entwicklung*, 120 ZEITSCHRIFT FÜR DIE GESAMTE STAATSWISSENSCHAFT 577, 588 (1964). (Emphasis in original.) "While investment of capital is undoubtedly necessary for economic growth, it is certainly not the controlling or predominant factor. Economists are not yet in a position to analyse this matter fully, but we can say that the principal factors in economic growth are not physical—natural resources and invested capital—but human." Clark, *supra* note 15, at 2. See BOON, *Economic Choice of Human and Physical Factors in Production* (1964).



tural patterns generated in periods of economic stagnation frequently prove incompatible with the dynamic acquisitiveness necessary to material progress.<sup>19</sup> Capital equipment is of little value unless complemented by a skilled labor force:

"Among the preconditions of industrialization, therefore, I believe that the major difficulty lies in the absence of a population with sufficient experience in the use of money and credit and with inadequate skill on a large scale to manage or operate industrial enterprise. What this means is that the pace of industrialization is inexorably linked to the pace of adult training and education and the fostering of migration to the nation involved of persons already trained and capable of training others.

"Everything else can be resolved by appropriate legal structures, but the problems of training and education cannot be resolved by fiat."<sup>20</sup>

In Africa "in 1960 less than 1 percent of the population had received a secondary education and less than 10 percent primary education."<sup>21</sup>

In general, growth speed can be restricted either by limited export earnings or by low domestic saving ratios: an industrializing state is de-

<sup>19</sup> "The widespread personal and social habits, attitudes and customs of large sectors of the Indian population—the caste system, the veneration of the cow, the reluctance to slaughter animals, the contemplative, uncurious and fatalistic outlook—have contributed in large measure to her backwardness, and unless they are modified or abandoned, capital investment cannot hope to be as productive of output and incomes as in western countries." Clark, *supra* note 15, at 5. See HAGEN, ON THE THEORY OF SOCIAL CHANGE: HOW ECONOMIC GROWTH BEGINS (1962); McCLELLAND, THE ACHIEVING SOCIETY (1961); Morgan, *The Achievement Motive and Economic Behavior*, 12 ECON. DEVELOPMENT & CULTURAL CHANGE 243 (1964); Nash, *Social Prerequisites to Economic Growth in Latin America and Southeast Asia*, 12 ECON. DEVELOPMENT & CULTURAL CHANGE 225 (1964); Reynaud, *Wirtschaftspsychologie und Entwicklungsforschung*, 91 WELTWIRTSCHAFTLICHES ARCHIV 231 (1963); Schatz, *n Achievement and Economic Growth: A Critique*, 79 Q.J. ECON. 234 (1965); McClelland, *Reply*, *id.* at 242; Schatz, *Rejoinder*, *id.* at 246. But see Hill, *Growth and Investment According to International Comparisons*, 74 ECON. J. 288 (1964).

<sup>20</sup> Mentschikoff, *Federalism and Economic Growth*, in *FEDERALISM AND THE NEW NATIONS OF AFRICA* 191, 196, 199 (Currie ed. 1964). Up to 40% of American national income growth between 1929 and 1956 has been attributed to investment in education. For a review of such estimates see Bowman, *Schultz, Denison, and the Contribution of "Eds" to National Income Growth*, 72 J. POL. ECON. 450 (1964). See also *Symposium: Investment in Human Beings*, 70 J. POL. ECON. 1-157 (Supp. 1962). "[T]he rate of return on investment in 'human capital,' however measured, may be at least as large as that on physical capital. . . . I am tempted to conclude: If I was given the economic dictatorship of a country, charged with the task of ensuring a maximum rate of growth, I would be prepared to risk my posthumous fame by betting heavily on education and research—under the motto: 'Mind over machine.'" Aukrust, *Factors of Economic Development: A Review of Recent Research*, 93 WELTWIRTSCHAFTLICHES ARCHIV 23, 41 (1964). (Footnote omitted.)

<sup>21</sup> Lewis, *A Review of Economic Development*, 55 AM. ECON. REV. PAPERS & PROC. 1, 7 (1965).

pendent upon importation of foreign capital equipment to provide a foundation for a manufacturing sector; a poor nation must use a very high proportion of what income it is able to generate to furnish its people with the basic necessities of life.<sup>22</sup> Albeit with some inconvenience, other purportedly independent constraints can frequently be incorporated into one of these dichotomous categories: a deficiency in worker skill, for example, must be remedied through import of trained labor or investment in human capital requiring saving undifferentiated from that needed to expand the stock of producer goods. Admittedly many social aspects of the revolution inherent in the process of industrialization can hardly be usefully delineated in quantitative terms; for purposes of initial orientation, nevertheless, it is convenient to abstract from distortions and discontinuities produced by institutional rigidities.

This posited bifurcation is itself not unobjectionable, although if applied as a tool of analysis the assertion that "the two approaches are complementary rather than competitive and, under proper definitions, they should give identical results"<sup>23</sup> misleadingly exaggerates their interrelationship. A proportion of export gains will be saved; and it is frequently possible partially to compensate for unavailability of needed foreign capital goods through increased levels of domestic investment, even though substitution

<sup>22</sup> "The ease with which people can procure food, the primary necessity, determines the amount of labor and other resources that they can devote to industry and culture. A population that must devote 95 percent of its resources to feeding itself will have fewer allocable resources for other pursuits than will one of equal size that must devote only 90 percent to procuring necessities. The latter society can grow twice as fast at the outset, and the resulting capital accumulation will constantly raise the proportion of resources which it can use for further development. After a time, therefore, the two populations will occupy entirely different economic and cultural levels. When one considers that many societies today spend practically their total resources in securing the barest necessities of life, while others spend less than 10 percent for needs of the same urgency, observed differences in the levels of development of the two groups are not surprising . . ."

TRAVIS, *THE THEORY OF TRADE AND PROTECTION* 243 (1964).

<sup>23</sup> Balassa, *The Capital Needs of Developing Countries*, 17 *KYKLOS* 197 (1964). The author justifies his statement through appeal to the familiar identities describing equilibrium in an open economy:

$$M - X = E - Y = I - S = I_r,$$

where

M = imports  
 X = exports  
 E = aggregate expenditures  
 Y = income  
 I = investment  
 S = saving  
 I<sub>r</sub> = net capital inflow

*Ibid.* The equalities, indisputably correct, are of some value used in the context of a discussion of the impact of foreign aid. They nevertheless depict only ex post relationships, and are thus incapable of indicating the dynamics of the adjustment process which produced them.

costs may be disproportionate or lengthy delay may be required.<sup>24</sup> The distinction nevertheless provides a convenient framework for exploration of the potential of alternative programs designed to overcome growth barriers.

### C. Parameters and Prospects

#### 1. Capital Transfer

The levels of constraints of both types can be raised by inflow of capital from industrial areas. While inadequate to support proposed ambitious growth programs, current resource transfers to backward regions are not insubstantial: in 1963, for example, they exceeded eight billion dollars. The United States alone provided 58 per cent of this sum. Grants by governments accounted for more than half of disbursements, and much of the remainder consisted of soft loans of public funds. Over two-thirds of the 1.5 billion dollars loaned by the United States to emerging nations in 1963 earns less than one per cent interest.<sup>25</sup> Private capital transfer, almost entirely in the form of direct investment, totaled 1.8 billion dollars.<sup>26</sup> In 1960, inflow of six billion dollars amounted to 3.5 per cent of national incomes of recipient states and was associated with a quarter of their total growth. A decade earlier only two billion dollars was provided. Capital receipts averaged four dollars per inhabitant throughout the poorer portion of the free world in 1958: Southeast Asians and Africans gained 2.3 and six dollars respectively, while the Latin American and Middle Eastern inflow

<sup>24</sup> If unlimited quantities of labor and raw materials are available and the supply of land is fixed, the assumption of rigid factor proportions would imply a production function of the Harrod-Domar type:

$$P = \min. (\alpha K_d, \beta K_f) \quad \alpha < 0, \beta > 0$$

Here  $P$ ,  $K_d$ , and  $K_f$  represent production, domestic capital goods, and imported capital goods respectively, and  $\alpha$  and  $\beta$  are parameters. Output growth is restricted by deficiencies in  $K_f$  or in  $K_d$  and  $K_f$  jointly, depending on whether foreign currency or investment funds generally are lacking. See McKinnon, *Foreign Aid Constraints in Economic Development and Efficient Aid Allocation*, 74 ECON. J. 388 (1964).

Substitution opportunities may be incorporated into the formulation through use of the CES production function:

$$P = \alpha [\delta K_d^{-\rho} + (1 - \delta) K_f^{-\rho}]^{-\frac{1}{\rho}} \quad \delta > 0, 1 - \delta > 0, \rho > -1$$

where  $\alpha$ ,  $\delta$ , and  $\rho$  are parameters. See McKinnon, *supra* at 405; Guha, *Scarcity of Specific Resources as a Limit to Output*, 30 REV. ECON. STUDIES 37 (1963). On problems of parameter estimation see Seers, *Normal Growth and Distortions: Some Techniques of Structural Analysis*, 16 OXFORD ECON. PAPERS 78 (1964).

<sup>25</sup> For a recent survey of the institutional framework of intergovernmental lending see House Comm. on Foreign Affairs, *Staff Memorandum on International Lending and Guarantee Programs*, 88th Cong., 2d Sess. (1964).

<sup>26</sup> ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *DEVELOPMENT ASSISTANCE EFFORTS AND POLICIES: 1964 REVIEW* 102-03, 108-09, 110. (Tables 1, 5, 6) (1964).

exceeded seven dollars per person. Between 1956 and 1959 these funds provided 14 per cent of transferee foreign exchange resources.<sup>27</sup>

Although the political nature of foreign aid decisions precludes confidence in projections of current trends, the possibility of dramatic increase in the availability to underdeveloped states of capital at noncommercial prices appears remote. Lewis states: "[T]he future of foreign aid is now critically in doubt, not only in the United States, but even in France, where aid has hitherto been sacrosanct."<sup>28</sup> Interest rates on private loans, which must reflect the uncertainties inherent in any long-term international transaction, are frequently prohibitively high. Nor is investment by nonnationals a panacea. The governments of backward countries often feel that unless closely regulated, participation in domestic ventures by the alien entrepreneur may be a more costly source of funds than borrowing:

"In such a sheltered market, almost every new industry has possibilities of a fourfold growth or so in ten years. Moreover, the dividend policy of Indian companies is to pay around 10 per cent per annum. This is necessary to maintain a good credit standing in the stock markets. Thus it is not unusual to derive a 400 per cent return in equity investment in ten years. This creates no difficulty for the planners and policy makers of India insofar as domestic equity investment is concerned, for with proper tax and other policies, consumption can be dissuaded and re-investment encouraged with respect to these high profits. But foreign equity investment presents another problem. It is India's policy, and one which she intends to maintain, to allow free remittance of profits and repatriation of capital, including capital gains, to foreign enterprise in India. In view of this policy, India feels it must be prepared to return in ten years \$5.00 for every dollar it allows as foreign equity investment. On the other hand, a ten-year loan at 6 per cent interest would require a foreign exchange repayments burden of only \$1.60 to \$1.00."<sup>29</sup>

A justified fear of expropriation raises demanded profit levels and limits

<sup>27</sup> WHITMAN, *GOVERNMENT RISK-SHARING IN FOREIGN INVESTMENT* (1965); Leduc, *International Aid and Growth*, in *PROBLEMS IN ECONOMIC DEVELOPMENT* 139, 156-57 (E. Robinson ed. 1965); Lewis, *A Review of Economic Development*, 55 *AM. ECON. REV. PAPERS & PROC.* 1, 2 (1965).

<sup>28</sup> *Id.* at 4. See Belair, *Foreign Aid: Program Faces Mounting Challenge at Home*, *N.Y. Times*, Feb. 7, 1965, § E, p. 3, col. 1.

<sup>29</sup> KUST, *FOREIGN ENTERPRISE IN INDIA* 55 (1964). A more traditional view is in disagreement: "Capital to be used for machinery acquisition will probably have to be available in hard currency. There are three sources of such capital. The best is from an export balance of trade because it is earned by the nation involved itself. The next best is investment or equity capital, since it need not be repaid. . . . The third is commercial lending, which has the disadvantage of requiring repayment. . . ." Mentschikoff, *supra* note 20, at 194. See Rothwell, *The Extra Borrowing Costs of Fixed-Return Over Equity Foreign Capital*, 11 *INDIAN ECON. J.* 311 (1964). See also Ball, *Capital Imports and Economic Development: Paradox or Orthodoxy?*, 15 *KYKLOS* 610 (1962); Kaizuka, *A Remark on Capital Imports and Economic Development*, 17 *KYKLOS* 483 (1964);

the magnitude of ventures undertaken.<sup>30</sup> Earnings are frequently less than is commonly supposed: "The average rate of return of U.S. manufacturing

Massell, *Exports, Capital Imports and Economic Growth*, 17 KYKLOS 627; Ball, *Capital Imports and Economic Growth: A Reply*, 18 KYKLOS 139 (1965).

At present the developing economies owe in excess of \$30 billion to their industrialized neighbors. In 1962 external public debt service costs in Argentina, Brazil, and Chile were 22.8, 24.2, and 27.6% of export receipts respectively; 30% of 1964 aid flows to poorer nations were offset by interest charges. Weintraub, *The Foreign-Exchange Gap of the Developing Countries* 18-19 (Princeton Univ. Essays in International Finance No. 48, Sept. 1965).

For a discussion of additional problems posed by the activities of foreign enterprise in backward countries see Johnson, *U.S. Private Investment in Latin America: Some Questions of National Policy* (Rand Corporation Memorandum RM-4092-ISA, July 1964). Distrust of the traditional capitalistic forms of market organization is common in emerging nations. See FRIEDLAND & ROSBERG, *AFRICAN SOCIALISM* (1964); NARAYAN, *SOCIALISM IN INDIAN PLANNING* (1964); Berg, *Socialism and Economic Development in Tropical Africa*, 78 Q.J. ECON. 549 (1964); Hazard, *Negritude, Socialism and the Law*, 65 COLUM. L. REV. 778 (1965). "Socialism is the road to social freedom . . . The path of the revolution, which is the path of socialism, is an inevitability dictated by historical reality and by the broad aspirations of the masses . . . Action to increase national wealth cannot be left to the improvisations of exploiting private capital and its mad whims which are motivated only by the selfish desire for profit." United Arab Republic Information Dep't, Declaration of Agreement for Federal Union of the United Arab Republic, Syria, and Iraq: Social and Economic Constituents, April 17, 1963, reprinted in 2 INT'L LEGAL MATERIALS 559, 565, 566 (1963).

<sup>30</sup> Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 84 Sup. Ct. 923, (1964). See Falk, *The Complexity of Sabbatino*, 58 AM. J. INT'L L. 935, 939-42, 943 (1964); Comment, *The Act of State Doctrine After Sabbatino*, 63 MICH. L. REV. 528, 534, 537-38 (1965). For an interesting example of an arrangement providing partial compensation see Switzerland-United Arab Republic Compensation Agreement for Nationalizations, June 20, 1964 (effective Nov. 1, 1964), 2 FEUILLE FÉDÉRALE 952 (Switzerland 1964), translated in 3 INT'L LEGAL MATERIALS 1125 (1964) (effective Nov. 1, 1964).

See FATOUROS, *GOVERNMENT GUARANTEES TO FOREIGN INVESTORS* (1962); WHITE, *NATIONALISATION OF FOREIGN PROPERTY* (1962); House Comm. on Foreign Affairs, *Expropriation of American-Owned Property by Foreign Governments in the Twentieth Century*, 88th Cong., 1st Sess. (Comm. Print 1963), reproduced in 2 INT'L LEGAL MATERIALS 1066 (1963). "Every country has the sovereign right . . . freely to dispose of its natural resources in the interest of the economic development and well-being of its own people." I U.N. CONFERENCE ON TRADE AND DEVELOPMENT, FINAL ACT AND REPORT 10 (1964) (General Principle Three). See Gess, *Permanent Sovereignty Over Natural Resources*, 13 INT'L & COMP. L.Q. 398 (1964); U.N. SECRETARIAT, *THE STATUS OF PERMANENT SOVEREIGNTY OVER NATIONAL WEALTH AND RESOURCES & REPORT OF THE COMMISSION ON PERMANENT SOVEREIGNTY OVER NATIONAL RESOURCES*, U.N. DOC. NOS. A/AC.97/5/Rev.2, E/3511, A/AC.97/13 (1962).

"International law does not consider the nature of property rights nor does it regulate property relations within a state. Under international law states are sovereign, therefore only municipal and not international law can regulate all matters connected with the acquisition, transfer and loss of ownership rights, including the loss of ownership under the terms of a nationalization law. This cannot become a subject for discussion by another state. The laws of the state carrying out the nationalization, and not international law, determine the conditions under which property is taken from private persons and in particular to whom the law extends, whether or not compensation shall be paid, etc., etc. This postulate applies equally to the property of aliens."

Vilkov, *Nationalization and International Law*, 1960 SOVIET YB. INT'L L. 58, 78 (English

industries in Latin America after depreciation was 3.6 per cent for 1962 compared with 8.8 per cent in the United States and 11.3 per cent in Western Europe. Over 1957-62, these average rates were 6.6 per cent, 8.7 per cent and 14.9 per cent, respectively."<sup>31</sup>

## 2. Sales Abroad

Export earnings of less-developed countries are expected to expand at an annual rate of between 3.7 and 4.9 per cent during the next five years.<sup>32</sup> Although promoting increase in these receipts would appear the obvious method of acquiring foreign exchange sufficient to permit import of capital equipment needed for accelerated domestic development, prospects are poor for rapid growth in this sector.

Demand for commodities produced at a comparative advantage in backward regions is generally both price and income inelastic.<sup>33</sup> Rapid expansion of output of many of these goods would merely cause price declines so extensive that total revenue would itself be lowered: in the coffee market, for example, a mere 10 per cent increase in supply with demand unchanged would induce a price fall of almost a third.<sup>34</sup> Here a policy advantageous to the individual nation is disastrous when adopted universally.

summary), quoted in Fatouros, *International Law and the Third World*, 50 VA. L. REV. 783, 808 (1964). See N.V. Vereinigde Deli-Maatschappijen v. Deutsch-Indonesische Tabak-Handelsgesellschaft m.b.h., Ct. App. Bremen, Aug. 21, 1959, 9 ARCHIV DES VÖLKERRECHTS 318 (1961), 28 Int'l L. Rep. 24, 35 (1963). The court maintained "that there should be no compensation in cases of nationalization of colonial investments." Friedmann, *Act of State: Sabbatino in the Courts and in Congress—Remarks*, 3 COLUM. J. TRANSNAT'L L. 103, 106 (1965). See also FRIEDMANN, *THE CHANGING STRUCTURE OF INTERNATIONAL LAW* 318-21 (1964).

On the impact of programs of creditor nations insuring investment in underdeveloped lands against expropriation see WHITMAN, *THE UNITED STATES INVESTMENT GUARANTY PROGRAM AND PRIVATE FOREIGN INVESTMENT* (1959); Johnson, *The Course of U.S. Private Investment in Latin America Since the Rise of Castro* 20-24 (Rand Corp. Memo. RM-4091-ISA, May 1964). For a discussion of the threat of deprivation of foreign aid as a deterrent against nationalization see Lillich, *The Protection of Foreign Investment and the Hickenlooper Amendment*, 112 U. PA. L. REV. 1116 (1964). In spite of impediments the extent of our private commitments in backward areas is striking: "in 1955 the export sales of U.S. owned enterprises accounted for about 30 per cent of total Latin American exports." Johnson, *supra* at 20-24.

<sup>31</sup> Hasson, Book Review, 55 AM. ECON. REV. 564, 565-66 (1965).

<sup>32</sup> U.S. Agency for International Development, *Development Policies and Assistance Requirements*, Dec. 1964, at II-5 (preliminary draft). For estimates of comparable magnitude with smaller range see BALASSA, *TRADE PROSPECTS FOR DEVELOPING COUNTRIES* 94 (1964). See also Pincus, *Commodity Policy and Economic Development* (Rand Corporation Memorandum RM-3887-ISA, Oct. 1963).

<sup>33</sup> See KRELLE, *PREISTHEORIE* 3-8 (1962).

<sup>34</sup> The calculation is based on an estimated price elasticity of  $-.25$ . Data from the United States, which alone accounts for  $\frac{1}{2}$  of world imports, yield an elasticity between  $-.2$  and  $-.3$ . BALASSA, *TRADE PROSPECTS FOR DEVELOPING COUNTRIES* 199; FAO, *THE WORLD COFFEE ECONOMY* 31 (1961). Equivalent figures have been obtained for Argentina, Canada, Finland, Sweden, Switzerland, and the Federal Republic of Germany. *Ibid.* See

As standards of living rise a smaller proportion of total income is spent on food and on other raw material intensive commodities: "[T]he total consumption of wheat in the United States has been fairly stable since the beginning of the twentieth century despite the tremendous expansion in population and increase in real per capita incomes during the period."<sup>35</sup> Technical progress may reduce raw material input by improving process efficiency or by allowing substitution of synthetics. In the United States in the first half of the present century the amount of coal required to generate one kilowatt-hour of electricity fell from 7.05 to 1.19 pounds.<sup>36</sup>

Politically necessary tariff and quota barriers in wealthier lands frequently preclude imports from backward regions even where substantial comparative advantage exists:

"[D]eveloped countries have their own domestic sources of supply of many primary commodities and the tendency has been for them to become more self-sufficient rather than less.

"It has been estimated, for example, that in the United States total consumption of twenty-six primary commodities excluding petroleum rose by 35 per cent from 1927-29 to 1955-57, while imports of the same commodities increased only 17 per cent. In Western Europe consumption of these commodities also advanced 35 per cent during this period, but the volume of imported supplies rose only 9 per cent—even less than in the United States."<sup>37</sup>

Farmer protection and subsidization permitted the United States, burdened with surpluses, to export agricultural products valued at 6.1 billion dollars

also Leibert, *Die Auswirkungen der Kaffeesteuer auf den Kaffeeverbrauch in der Bundesrepublik Deutschland*, 91 WELTWIRTSCHAFTLICHES ARCHIV 327 (1963), and studies cited therein. The absolute value of the ratio rises as per capita income falls and may be between  $-.5$  and  $-.7$  where earnings per person are as low as \$100 annually: approximations of  $-.61$  and  $-.40$  have been calculated for Italy and Greece respectively. FAO, *op. cit. supra* at 31 (1961).

<sup>35</sup> DELL, TRADE BLOCS AND COMMON MARKETS 176-77 (1963). Studies based on United States statistics yield coffee income elasticities between .2 and .3 or around .5, depending on periods selected and whether time series or budget data are used. FAO, *op. cit. supra* note 34, at 31-33 (1961). Three separate analyses reveal an approximately unitary West German proportion. Leibert, *supra* note 34, at 327. Figures of .77, .57, and .26 have been derived for Italy, Finland, and Sweden. Cross-country comparisons show income elasticity declining sharply as income rises: per capita earnings of \$400, \$500, \$750, and \$1000 per year are associated with elasticities of 3.0, 1.8, 1.1, and .8 respectively. FAO, *op. cit. supra* note 34, at 31-33 (1961).

The assertion that the demand for food products is income inelastic, formalized as Engel's law, may be countered in part by a reminder that agricultural production is subject to the law of diminishing returns because of the limited quantity of the input land. See Haberler, *An Assessment of the Current Relevance of the Theory of Comparative Advantage to Agricultural Production and Trade*, 4 INT'L J. AGRARIAN AFF. 130, 136-38 (1964).

<sup>36</sup> DELL, TRADE BLOCS AND COMMON MARKETS, 176, 177 (1963).

<sup>37</sup> *Id.* at 178.

in the fiscal year 1963-1964.<sup>38</sup> Competitive pressures in the labor-intensive<sup>39</sup> world textile industry recently led to a trade-restricting international agreement under GATT auspices.<sup>40</sup> Domestic measures supplement world constraints:

"The Federal Government has long subsidized cotton growers. Then, when exporters complained that the farmers' subsidy priced American cotton out of overseas markets, the U.S. started subsidizing exporters. And last year, after textile mill owners protested that the exporters' subsidy permitted foreign mills to buy U.S. cotton cheaper than American mills could, the Johnson Administration pushed through Congress a subsidy for the mills.

"So far, the textile industry has received a mouth-watering \$329 million in subsidies; payments have even gone to prisons whose convicts work at weaving. . . .

"The overall cotton program was advertised as costing \$448 million during its first year. Instead, it is now expected to amount to nearly \$800 million. . . . By last week the Commodity Credit Corp. owned a record 7,372,000 bales at a cost of \$1.2 billion, on which storage charges alone run another annual \$30 million." <sup>41</sup>

<sup>38</sup> U.S. Dep't of Agriculture, Economic Research Service, Foreign Agricultural Trade of the United States, July-Aug. 1964, p. 2. See also Janson, *Myrdal Sees Farm Surplus End With U.S. Producing for World*, N.Y. Times, March 16, 1965, p. 15, col. 1.

Economic theory posits that in general a country will export those commodities using most intensively the factors of production with which it is relatively well endowed. See OHLIN, *INTERREGIONAL AND INTERNATIONAL TRADE* (1933). Nevertheless a careful study has concluded that America, hardly obviously poor in capital, exports goods which are labor intensive relative to imports. Leontief, *Domestic Production and Foreign Trade: The American Capital Position Re-Examined*, 97 PROC. AM. PHILOSOPHICAL SOC'Y 332 (1953), reprinted in 7 *ECONOMIA INTERNAZIONALE* 9 (1954); Leontief, *Factor Proportions and the Structure of American Trade: Further Theoretical and Empirical Analysis*, 38 REV. ECON. & STATISTICS 386 (1956). Attempts to explain the "Leontief paradox" have recently been directed toward exploration of the possibility of reversals of the factor intensity rankings of commodity pairs under alternative factor endowment assumptions. See MINHAS, *AN INTERNATIONAL COMPARISON OF FACTOR COSTS AND FACTOR USE* (1963); Leontief, *An International Comparison of Factor Costs and Factor Use—A Review Article*, 54 AM. ECON. REV. 335 (1964); Robinson, *Factor Prices Not Equalized*, 78 Q.J. ECON. 202 (1964); Michaely, *Factor Proportions in International Trade: Current State of the Theory*, 17 KYKLOS 529 (1964). On the problem in general see especially TRAVIS, *THE THEORY OF TRADE AND PROTECTION* (1964). See also Clemhout, *Efficiency, the Heckscher-Ohlin Theorem and Patterns of International Trade as Exemplified by the Leontief Paradox*, 17 *ECONOMIA INTERNAZIONALE* 1 (1964); Ford, *The Ohlin-Heckscher Theory of the Basis of Commodity Trade*, 73 ECON. J. 458 (1963); Kreinin, *Comparative Labor Effectiveness and the Leontief Scarce-Factor Paradox*, 55 AM. ECON. REV. 131 (1965); Mathur, *Gains in Economic Growth From International Trade—A Theoretical Explanation of Leontief's Paradox*, 16 KYKLOS 609 (1963).

<sup>39</sup> See Bhalla, *Investment Allocation and Technical Choice—A Case of Cotton Spinning Techniques*, 74 ECON. J. 611 (1964).

<sup>40</sup> Long-Term Cotton Textiles Arrangement Enters Into Force on 1 October, Press Release GATT/711, Oct. 1, 1962.

<sup>41</sup> Time, March 5, 1965, pp. 21-22.



Barriers are not confined to a narrow range of goods: "The Americans encouraged us to diversify our industry and not concentrate on just a few items like textiles or toys or radios. We followed this advice, but now that we want to sell our new products to America the voices of the protectionists oppose us."<sup>42</sup>

Fluctuation in exchange earnings, intensified by extreme specialization in the export sectors, can render hazardous the initiation by developing economies of long-term investment projects even though expected receipt averages would be sufficient to permit completion. International guarantees against sharp falls in import-purchasing ability have been impeded by the desire of backward nations to obtain aid grants in the guise of insurance and by the unwillingness of the industrialized states to commit themselves to future assistance expenditures of uncertain magnitude.<sup>43</sup>

Coffee shipments account for roughly 7.5 per cent of purchases by the North Atlantic Community from underdeveloped states.<sup>44</sup> During the summer of 1962 representatives of the United States and 57 other countries, meeting in New York under the auspices of the United Nations, negotiated the International Coffee Agreement,<sup>45</sup> a treaty designed to permit control of the market for this commodity through regulation of its export. By April 6, 1964, the Agreement had been ratified or acceded to by 30 exporting countries representing 93.2 per cent of world coffee exports and 17 import-

<sup>42</sup> Statement by Japanese trade official, quoted in Sklarewitz, *Japan Grows Angrier With U.S. Over Curbs on Nippon Commerce*, Wall Street J., July 8, 1965, p. 1, col. 4 (Midwest ed.).

Where tariff rates on raw material imports are low, higher duties on products manufactured from these commodities impede processing prior to exportation. Balassa, *Tariff Protection in Industrial Countries: An Evaluation*, 73 J. POL. ECON. 573 (1965); Johnson, *The Theory of Tariff Structure, With Special Reference to World Trade and Development*, in JOHNSON & KENEN, *TRADE AND DEVELOPMENT* 9 (1965).

<sup>43</sup> See COPPOCK, *INTERNATIONAL ECONOMIC INSTABILITY* (1962); MICHAELY, *CONCENTRATION IN INTERNATIONAL TRADE* (1962); U.N. DEP'T OF ECONOMIC & SOCIAL AFFAIRS, *op. cit. supra* note 1, at 140-74; Bauer & Yamey, *Organized Commodity Stabilization With Voluntary Participation*, 16 OXFORD ECON. PAPERS 105 (1964); Hemmi, *International Commodity Agreements: Reality and the Future*, 2 DEVELOPING ECONOMIES 358 (1964); Kaldor, *Stabilizing the Terms of Trade of Under-Developed Countries*, Econ. Bull. Latin Am., March 1963, p. 1; MacBean, *The Short-Term Consequences of Export Instability to Underdeveloped Countries*, in MONTGOMERY & SMITHIES, *op. cit. supra* note 28, at 170; Massell, *Export Concentration and Fluctuations in Export Earnings: A Cross-Section Analysis*, 54 AM. ECON. REV. 47 (1964); Stern, *International Compensation for Fluctuations in Commodity Trade*, 77 Q.J. ECON. 258 (1963); *Symposium: The Quest for a Stabilization Policy in Primary Producing Countries*, 11 KYKLOS 139-243 (1958); *Symposium: Stabilization and Development of Primary Producing Countries*, 12 KYKLOS 271-401 (1959). For an extreme example of production variability see Bottomley, *Stability of Income and Employment in an Underdeveloped Desert Community*, 17 ECONOMIA INTERNAZIONALE 301 (1964).

<sup>44</sup> U.N. DEP'T OF ECONOMICS & SOCIAL AFFAIRS, *op. cit. supra* note 1, at 57, 66.

<sup>45</sup> International Coffee Agreement, Sept. 28, 1962, 14 U.S.T. & O.I.A. 1911, T.I.A.S. No. 5505 (1964) (effective Dec. 27, 1963). See U.N. Coffee Conference, Summary of Proceedings, U.N. Doc. No. E/CONF.42/7, 8 (1962).

ing countries representing 86.5 per cent of world coffee imports.<sup>46</sup> Implementing legislation assuring American participation was signed by President Johnson on May 24, 1965.<sup>47</sup>

### 3. *Import Substitution*

Whereas export earnings are often discouragingly unresponsive to domestic strategy, purchases abroad may be controlled by planners with relative ease. Reduction of imports of consumption commodities either by means of high duties restricting quantities demanded or through encouragement of creation of internal sources of supply permits a greater proportion of acquired foreign exchange to be employed to obtain products essential to the growth process. The new external tariff of the Central American Common Market will tax imported consumer goods at an average ad valorem level of 82.5 per cent, with individual rates as high as 150 per cent; in contrast, the levies on raw materials and machinery will average only 32 and 5 per cent respectively.<sup>48</sup> As development progresses, substitution will also be possible in the capital goods sector itself, and increasing autarky will diminish the impact of limited export potential. Import-competing industries are however a product of expansion: development difficulties include the problem of their establishment.<sup>49</sup>

### 4. *Domestic Saving*

Economic development has been characterized by Lewis as a "process by which a community which was previously saving and investing 4 or 5 per cent of its national income or less, converts itself into an economy where voluntary saving is running at about 12 to 15 per cent of national

<sup>46</sup> FAO, *FAO COMMODITY REVIEW* 1964, at 73 (1964).

<sup>47</sup> N.Y. Times, May 25, 1965, p. 57, col. 3.

<sup>48</sup> *Central American Customs Union*, Address by Edwin Alcantara, International Economic Relations Seminar, Harvard University, March 22, 1965.

"In general, low import duties, ranging from an equivalent of zero to 15 percent ad valorem, were fixed for raw materials and capital goods. For agricultural and industrial machinery, the maximum rates were not to exceed five percent ad valorem. For luxury products, and for consumption goods whose early production in Central America was deemed desirable, the duties were set in a range between 100 and 150 percent ad valorem. On the other hand, for those imported consumption items whose production by regional manufacturers was not possible, the limits were set at 25 to 50 percent ad valorem."

PINCUS, *THE CENTRAL AMERICAN COMMON MARKET* 78 (1962). For the advantages of replacement of tariff restrictions by protection through subsidization of domestic producers see Johnson, *Tariffs and Economic Development—Some Theoretical Issues*, 1 J. DEVELOPMENT ECON. 3 (1964).

<sup>49</sup> See MEIER, *LEADING ISSUES IN DEVELOPMENT ECONOMICS* 297-303 (1964); Economic Comm'n for Latin America (ECLA) and Banco Nacional do Desenvolvimento Econômico (BNDE) Joint Development Center, *The Growth and Decline of Import Substitution in Brazil*, Econ. Bull. Latin Am., March 1964, p. 1; Macario, *Protectionism and Industrialization in Latin America*, Econ. Bull. Latin Am., March 1964, p. 61.

income or more.”<sup>50</sup> Rostow's five-stage model isolates a “take-off” phase of rapidly accelerated growth during which “the proportion of net investment . . . rises . . . to over 10 per cent [of net national product (NNP)].”<sup>51</sup> Since marginal propensities to consume are substantially below average propensities, increases in per capita income will raise the level of the saving constraint. Growth at an accelerating rate will be possible unless precluded by unavailability of required foreign exchange or a rising capital-output ratio.<sup>52</sup>

In the past, internal acquisition of funds needed to commence this process has required oppression of the laboring classes by an elite to an extent incompatible with current American concepts of democratic equality.<sup>53</sup>

Under a totalitarian regime, the power of the administering group to raise saving levels is limited only by its ability to enforce its policies and by the need to maintain the productivity of workers and peasants: “Communism is a system for inducing people to produce more and eat less.”<sup>54</sup> In China

<sup>50</sup> Lewis, *Economic Development With Unlimited Supplies of Labour*, 22 MANCHESTER SCHOOL ECON. & SOCIAL STUDIES 139, 155 (1964), reprinted in *THE ECONOMICS OF UNDERDEVELOPMENT* 401, 416 (Agarwala & Singh eds. 1958).

<sup>51</sup> ROSTOW, *THE STAGES OF ECONOMIC GROWTH* 37 (1960). See also *THE ECONOMICS OF TAKE-OFF INTO SUSTAINED GROWTH* (Rostow ed. 1963); Berrill, *Historical Experience: The Problem of Economic “Take-Off,”* in *ECONOMIC DEVELOPMENT WITH SPECIAL REFERENCE TO EAST ASIA* 233 (Berrill ed. 1964); Fishlow, *Empty Economic Stages?*, 75 *ECON. J.* 112 (1965); Shrimali, *Professor Rostow's Leading Ideas in Economic Growth*, 11 *INDIAN ECON. J.* 427 (1964); Tsiang, *A Model of Economic Growth in Rostovian Stages*, 32 *ECONOMETRICA* 619 (1964).

<sup>52</sup> See Fei, *Per Capita Consumption and Growth*, 79 *Q.J. ECON.* 52 (1965).

<sup>53</sup> See de Schweinitz, *Free Enterprise in a Growth World*, 29 *So. ECON. J.* 103 (1962). Although the author argues that “economic freedom is a function not only of the structure of economic organization, but of economic growth as well,” *id.* at 110, critics have stated:

“His position is that economic growth at low levels of per capita income depends on increases in stocks of resources. These increases can be realized only by forcing the masses to save through coercive institutional changes. Under the usual conditions of economic backwardness, growth will occur only if a minority imbued with a growth perspective creates the institutions favorable to growth. From this reasoning he concludes: first, that doubt is cast upon the ability of the free enterprise system to initiate and sustain growth; and second, that growth must mean a temporary decrease in economic freedom for the masses.”

Laird & Wallace, *Free Enterprise in a Growth World: Comment*, 30 *So. ECON. J.* 268 (1964). See de Schweinitz, *Free Enterprise in a Growth World: Reply*, 30 *So. ECON. J.* 271 (1964). On the contradictory tendencies toward absolutism and pluralism created by the growth process see *SELF-GOVERNMENT IN MODERNIZING NATIONS* (Pennock ed. 1964); DE SCHWEINITZ, *INDUSTRIALIZATION AND DEMOCRACY* (1964); WITTFOGEL, *ORIENTAL DESPOTISM* (1957); Eisenstadt, *Breakdowns of Modernization*, 12 *ECON. DEVELOPMENT & CULTURAL CHANGE* 345 (1964).

<sup>54</sup> Wright, *Development of a General Theory of International Relations*, in *THE ROLE OF THEORY IN INTERNATIONAL RELATIONS* 15, 41 (Harrison ed. 1964). See Chapman, *Trends in Consumption in the Soviet Union* (Rand Corp. Paper P-2388, March 1964). “Es scheint wie ein Naturgesetz, daß Wirtschaftsplaner eine niedrigere Diskontrate als

in 1933 gross investment amounted to 5 per cent of domestic expenditure; in 1957 it totaled approximately 25 per cent, but per capita consumption was at least 10 per cent lower.<sup>55</sup>

Capitalism in Great Britain during its industrial revolution masked extreme economic inequities beneath a liberal institutional facade: here in 1880 fully 48 per cent of total personal income was received by only 5 per cent of the population; today this most prosperous segment obtains only 18 per cent.<sup>56</sup> The wage laborer does not enjoy the slave's protection of employer concern for preservation of his capital investment. The Sadler Committee appointed by Parliament in 1832 to examine working conditions recorded this testimony:

"Have you worked in a mill from your youth?—Yes, since I was 5 years of age.

"Were you hired for any length of time when you went?—Yes, my mother got 15s. for six years, I having my meat and clothes.

"What were your hours of labor, as you recollect, in the mill?—In the summer season we were very scarce of water.

"But when you had sufficient water, how long did you work?— We began at 4-o'clock in the morning and worked till 10 or 11 at night; as long as we could stand on our feet.

"Were you kept on the premises constantly?—Constantly.

"Locked up?—Yes, locked up.

"Night and day?—Night and day; I never went home while I was at the mill.

"Do the children ever attempt to run away?—Very often.

"Were they pursued and brought back again?—Yes, the overseer pursued them and brought them back.

"Did you ever attempt to run away?—Yes, I ran away twice.

"And you were brought back?—Yes; and I was sent up to the master's loft, and thrashed with a whip for running away.

"Do you know whether the children were, in point of fact, compelled to stop during the whole time for which they were engaged?—Yes, they were.

die Konsumenten haben. Wenn die Planer fast unbeschränkte Möglichkeiten haben, die Konsumentenzielpräferenz durch ihre eigene zu ersetzen, wie in der Sowjetunion, so werden sie das Konsumniveau auf ein Minimum herunterdrücken, soweit es die Produktivität der Arbeit und die politische Stabilität erlauben." Gehrels, *Wachstum durch Investition in Wissenschaft und Bildung*, 94 WELTWIRTSCHAFTLICHES ARCHIV 215, 225-26 (1965).

<sup>55</sup> Klein, Book Review, 55 AM. ECON. REV. 575, 577 (1965). See Eckstein, *On the Economic Crisis in Communist China*, 42 FOREIGN AFF. 655 (1964); Perkins, *Centralization and Decentralization in Mainland China's Agriculture, 1949-1962*, 78 Q.J. ECON. 208 (1964).

<sup>56</sup> Ojha & Bhatt, *Pattern of Income Distribution in an Underdeveloped Economy: A Case Study of India*, 54 AM. ECON. REV. 711, 717 (1964). See 1 MARX, CAPITAL ch. 10 (1867).

"By law?—I cannot say by law; but they were compelled by the master; I never saw any law used there but the law of their own hands. . . ." <sup>57</sup>

Large internal income disparities in backward states allow some individuals in the community to save large proportions of their receipts. Our surprise on learning that domestic saving in the Congo has exceeded 20 per cent of national output <sup>58</sup> is mitigated on discovery of earnings distribution data: in 1950 the 11.5 million natives and 56,000 nonindigenous residents of the region had average per capita incomes of 23 and 2,946 dollars respectively. <sup>59</sup> In Latin America in 1962 the most prosperous 5 per cent of the population of the average country received 33 per cent of all income; in Europe between 1949 and 1955 and in the United States around 1961 the corresponding figures were 22 per cent and 20 per cent respectively. <sup>60</sup>

"In Guatemala, 516 farms (0.15 per cent of all farms) contain 41 per cent of the agricultural land; in Nicaragua, 362 owners control over one third; in Ecuador, 705 units (0.17 per cent) control 37 per cent. In Venezuela, 74 per cent of the farm acreage, comprising 6,800 units (1.69 per cent of all farms) is in holdings of over 1,000 hectares. In Brazil, half the farm land is in the hands of 1.6 per cent of the owners, while in Peru, 1.4 per cent of the landowners hold 62.8 per cent. In

<sup>57</sup> VOICES OF THE INDUSTRIAL REVOLUTION 86 (Bowditch & Ramsland eds. 1961). A factory overseer testified:

"Q. At what time in the morning, in the brisk time, did these girls go to the mills?

"A. In the brisk time, for about six weeks, they have gone at three o'clock in the morning and ended at ten or nearly half past at night.

"Q. What intervals were allowed for rest and refreshment during those nineteen hours of labor?

"A. Breakfast a quarter of an hour, and dinner half an hour, and drinking a quarter of an hour.

"Q. Was any of that time taken up in cleaning the machinery?

"A. They generally had to do what they call dry down; sometimes this took the whole time at breakfast or drinking.

"Q. Had you not great difficulty awakening your children to the excessive labor?

"A. Yes, in the early time we had to take them up asleep and shake them.

"Q. Had any of them any accident in consequence of this labor?

"A. Yes, my eldest daughter . . . the cog caught her forefinger nail and screwed it off below the knuckle.

"Q. Has she lost that finger?

"A. It is cut off at the second joint.

"Q. Were her wages paid during that time?

"A. As soon as the accident happened the wages were totally stopped."

ENGLISH ECONOMIC HISTORY—SELECTED DOCUMENTS 510 (Tawney, Bland & Brown eds. 1914). For a contrasting view see CAPITALISM AND THE HISTORIANS (Hayek ed. 1954).

<sup>58</sup> A. Robinson, *Introduction*, in ECONOMIC DEVELOPMENT FOR AFRICA SOUTH OF THE SAHARA at ix, xii (A. Robinson ed. 1963).

<sup>59</sup> Bezy, *Belgian Congo*, in ECONOMIC DEVELOPMENT 184, 211 (Pepelasis, Mears & Adelman eds. 1961).

<sup>60</sup> U.N., THE ECONOMIC DEVELOPMENT OF LATIN AMERICA IN THE POST-WAR PERIOD, U.N. Doc. No. E/CN.12/659/Rev.1 (1964).

Chile, some 3,000 farms of 1,000 or more hectares occupy almost 75 per cent of the farm land."<sup>61</sup>

In Panama in 1959, "twenty taxpayers accounted for 65 per cent of total income tax collections."<sup>62</sup> Exchange controls and assurances of domestic entrepreneurial opportunities can divert this wealth from Swiss accounts to development programs.<sup>63</sup>

Although primitive conditions render systems of taxation both economically disruptive and costly to administer, public revenues must remain an important source of investment funds. Duties on exports are popular because collection poses few difficulties; levies on imports combine equal ease of enforcement with favorable balance of payments effects. Heavy excise taxation of luxury goods, such as automobiles, may reduce expenditures of the rich without seriously damaging incentives through prevention of conspicuous consumption: the prestige value of a Rolls-Royce is determined not by its cost of manufacture but by its selling price. Finally, saving may be forced at the cost of the dislocations of inflation simply by printing the money needed for public investment purchases.<sup>64</sup>

#### D. Reactions

The poor prospects for dramatic economic advance by less-developed nations through autonomous action and the limited quantities of assistance available from industrialized states have combined with a recent sharp shift in terms of trade<sup>65</sup> in favor of manufactured products to induce widespread

<sup>61</sup> NEHEMKIS, *LATIN AMERICA: MYTH AND REALITY* 159 (1964). See Karst, *Latin-American Land Reform: The Uses of Confiscation*, 63 MICH. L. REV. 327 (1964).

<sup>62</sup> Maxwell, Book Review, 55 AM. ECON. REV. 601 (1965).

<sup>63</sup> See IMF, FIFTEENTH ANNUAL REPORT ON EXCHANGE RESTRICTIONS (1964); Marshall, *Exchange Controls and Economic Development*, in *ECONOMIC DEVELOPMENT FOR LATIN AMERICA* 430 (Ellis ed. 1961).

<sup>64</sup> See MEIER, *LEADING ISSUES IN DEVELOPMENT ECONOMICS* 169-228 (1964); INFLATION AND GROWTH IN LATIN AMERICA (Baer & Kerstenetzky eds. 1964); Ellis, *Price Stability: The Conflict Between Growth and the Control of Inflation*, in *ECONOMIC DEVELOPMENT WITH SPECIAL REFERENCE TO EAST ASIA* 255 (Berrill ed. 1964); Mamalakis, "Forced Saving" in *Underdeveloped Countries. A Rediscovery or a Misapplication of a Concept?*, 17 *ECONOMIA INTERNAZIONALE* 403 (1964); Mueller, *Structural Inflation and the Mexican Experience*, 5 *YALE ECON. ESSAYS* 145 (1965); Seers, *Inflation and Growth: A Summary of Experience in Latin America*, *Econ. Bull. Latin Am.*, Feb. 1962, p. 23.

<sup>65</sup> See Haberler, *Terms of Trade and Economic Development*, in *ECONOMIC DEVELOPMENT FOR LATIN AMERICA* 275 (Ellis ed. 1961); Morgan, *Trends in Terms of Trade, and Their Repercussions on Primary Producers*, in *INTERNATIONAL TRADE THEORY IN A DEVELOPING WORLD* 52 (Harrod & Hague eds. 1963); Schultz, *Economic Prospects of Primary Products*, in *ECONOMIC DEVELOPMENT FOR LATIN AMERICA* 308 (Ellis ed. 1961).

This general term masks a profusion of measurement formulae. Most popular because of ease of calculation is the commodity terms of trade ratio, simply

$$\frac{P_x}{P_m},$$

where P represents price and the subscripts x and m refer to exports and imports

rejection of the tenets of traditional trade theory.<sup>66</sup> In their place have been substituted models of exploitation and progressive immiseration<sup>67</sup> which promise redemption through industrialization: "What alchemy was to the Middle Ages, industrialization is to the underdeveloped world of this century—the magic elixir that can transform feudal societies."<sup>68</sup> Thus Prebisch differentiates a "center" of industrial lands from a "periphery" of retarded regions and argues obscurely that monopolistic labor unions and disparities in "technological density" concentrate the benefits of production advances in the former areas.<sup>69</sup> Myrdal has similarly used the inherently unobjection-

respectively. The gross barter terms of trade, today little used, may be defined as

$$\frac{Q_x}{Q_m},$$

where Q stands for quantity. The income terms of trade, an expression of the value of exports in terms of imports which has been frequently employed by the United Nations Economic Commission for Latin America, is

$$\frac{P_x Q_x}{P_m}.$$

Single and double factorial indices, written

$$\frac{\pi_x P_x}{P_m}$$

and

$$\frac{\pi_x P_x}{\pi_m P_m}$$

respectively, incorporate productivity alterations; although they provide a useful guide to welfare changes, data permitting computation are frequently unobtainable. See HABERLER, A SURVEY OF INTERNATIONAL TRADE THEORY 24-29 (1961).

<sup>66</sup> For an introduction to the attacked dogma see KINDLEBERGER, INTERNATIONAL ECONOMICS (3d ed. 1963). Three further texts, listed in order of increasing complexity, are ROSE, THEORIE DER AUSSENWIRTSCHAFT (1964); VAN EK, INTERNATIONAL TRADE: THEORY AND ECONOMIC POLICY (1962); KEMP, THE PURE THEORY OF INTERNATIONAL TRADE (1964). See also CAVES, TRADE AND ECONOMIC STRUCTURE (1960); CORDEN, RECENT DEVELOPMENTS IN THE THEORY OF INTERNATIONAL TRADE (1965); HABERLER, *op. cit. supra* note 65; MEADE, THE THEORY OF INTERNATIONAL ECONOMIC POLICY (1951 & 1955); BHAGWATI, *The Pure Theory of International Trade*, 74 ECON. J. 1 (1964).

For a discussion of free trade doctrines as propaganda designed to render acceptable to all advantages accruing to economically dominant nations as a result of unregulated international intercourse see J. ROBINSON, ECONOMIC PHILOSOPHY 62-66 (1963). "The hard-headed Classics made no bones about it. . . . [T]hey were in favor of Free Trade because it was good for Great Britain, not because it was good for the world." *Id.* at 124.

<sup>67</sup> See BHAGWATI, *Immiserizing Growth: A Geometrical Note*, 25 REV. ECON. STUDIES 201 (1958).

<sup>68</sup> NEHEMKIS, *op. cit. supra* note 61, at 185. See *id.* at 185-204.

<sup>69</sup> See FLANDERS, *Prebisch on Protectionism: An Evaluation*, 74 ECON. J. 305 (1964). See also BAER, *The Economics of Prebisch and ECLA*, 10 ECON. DEVELOPMENT & CULTURAL CHANGE 169 (1962); FLANDERS, *The Economics of Prebisch and ECLA: A Comment*, 12 ECON. DEVELOPMENT & CULTURAL CHANGE 312 (1964); BAER, *Reply*, 12 ECON. DEVELOPMENT & CULTURAL CHANGE 315 (1964); HYDE, *A Critique of the Prebisch Thesis*, 16 ECONOMIA INTERNAZIONALE 463 (1963). See Prebisch, *Commercial Policy in the Underdeveloped Countries*, 49 AM. ECON. REV. 251 (Supp. 1959); Prebisch, *The*

able<sup>70</sup> "vicious circle" concept so successfully employed in his study of the American Negro<sup>71</sup> as a basis for poorly substantiated condemnation of the present world economic structure.<sup>72</sup> Most nevertheless reject autarky: "As we see nowadays in South-East Asia or the Caribbean, the misery of being exploited by capitalists is nothing compared to the misery of not being exploited at all."<sup>73</sup>

The intemperate embrace of iconoclastic ideologies is reminiscent of the blind enthusiasm evoked by religious movements generated by vanquishment in intercultural strife. On a lower level the most fascinating manifestation of uncomprehending despair produced by interaction between primitive communities and the technologically advanced West is the cargo cult. In many parts of Melanesia large followings have been obtained by prophets predicting the arrival of supplies of presently unobtainable manufactured products which will be distributed at no cost to the indigenous populations. "Those in the coastal villages have built wharves out into the sea, ready for the ships to tie up, and those in land villages have constructed airstrips out of the jungle for the planes to land. And they have waited in expectancy for the . . . Coming of the Cargoes."<sup>74</sup>

Traditional international trade analysis posits a system of static balance; while the logic of its theorems is impeccable, they have in general little relevance to the dynamic problems of development.<sup>75</sup> Chenery asserts:

"Growth theory contains at least four basic assumptions about under-developed economies that differ sharply from those underlying the comparative cost doctrine: (1) factor prices do not necessarily reflect opportunity costs with any accuracy; (2) the quantity and quality of factors of production may change substantially over time, in part as a result of the production process itself; (3) economies of scale relative to the size of existing markets are important in a number of sectors of

*Economic Development of Latin America and Its Principal Problems*, Econ. Bull. Latin Am., Feb. 1962, p. 1. "Industrialization became the new religion of Latin America. Its latter-day high priest is the distinguished Argentine Raúl Prebisch." NEHEMKIS, *op. cit. supra* note 61, at 186.

<sup>70</sup> For a clever study of equilibrium at unacceptable levels see LEIBENSTEIN, *ECONOMIC BACKWARDNESS AND ECONOMIC GROWTH* (1957).

<sup>71</sup> MYRDAL, *AN AMERICAN DILEMMA—THE NEGRO PROBLEM AND MODERN DEMOCRACY* (1944).

<sup>72</sup> MYRDAL, *ECONOMIC THEORY AND UNDER-DEVELOPED REGIONS* (1957).

<sup>73</sup> J. ROBINSON, *op. cit. supra* note 66, at 45.

<sup>74</sup> FIRTH, *ELEMENTS OF SOCIAL ORGANIZATION* 112 (1951), quoted in HIRSCHMAN, *THE STRATEGY OF ECONOMIC DEVELOPMENT* 94 (1958). See LANTERNARI, *THE RELIGIONS OF THE OPPRESSED* 161-90 (1963); LAWRENCE, *ROAD BELONG CARGO* (1964).

<sup>75</sup> "[B]oth static neo-classical analysis of the allocation of given resources between various uses, and Keynesian short-period analysis of how given resources are employed, appear quite inadequate. A dynamic long-run analysis of how resources can be increased in now what we require." J. ROBINSON, *op. cit. supra* note 66, at 100.



production; (4) complementarity among commodities is dominant in both producer and consumer demand.”<sup>76</sup>

Esoteric doctrines are however not required to highlight the difficulties confronting emerging nations. So long as marginal propensities to import of these states remain above those of advanced countries equilibrium in international development requires continuation of wealth divergence.<sup>77</sup> Among the five members of the Central American Common Market, for example, the income elasticity of import demand averages 1.7: for every dollar increase in national income, an additional 1.7 dollars is expended on foreign merchandise.<sup>78</sup> Further rapid expansion of the world output of primary commodities can only lead to price declines, falling terms of trade, and diminished productivity levels.

Viner has claimed: “The real problem in poor countries is not agriculture as such, or the absence of manufactures as such, but poverty and backwardness, poor agriculture, or poor agriculture and poor manufacturing. . . . In many countries, the most promising field for rapid economic development lies in agriculture . . . .”<sup>79</sup> Elkan nevertheless supports a preference for development of manufacturing capacity over stimulation of primary commodity output with the following arguments:

“(1) In primary production increasing quantities of capital and labour are usually combined with a stock of natural resources which is fixed or grows at a slower rate. This leads to diminishing marginal physical product (diminishing returns) per unit of additional capital and/or labour.

“(2) Manufacturing not only escapes diminishing returns to any noticeable extent but also offers significantly increasing returns to scale.

<sup>76</sup> Chenery, *Comparative Advantage and Development Policy*, 51 AM. ECON. REV. 18, 20-21 (1961). For comment on this position see Haberler, *An Assessment of the Current Relevance of the Theory of Comparative Advantage to Agricultural Production and Trade*, 4 INT'L J. AGRARIAN AFF. 130, 145-48 (1964); Rodwin, *Choosing Regions for Development*, in FRIEDRICH & HARRIS, PUBLIC POLICY 141, 145-49 (Grad. School of Pub. Admin., Harvard Univ. No. 12, 1963), reprinted in REGIONAL DEVELOPMENT AND PLANNING 37, 41-45 (Friedman & Alonso eds. 1964). Two recent monographs dealing with the relationship between trade and growth are LINDER, AN ESSAY ON TRADE AND TRANSFORMATION (1961); MEIER, INTERNATIONAL TRADE AND DEVELOPMENT (1963). See INTERNATIONAL TRADE THEORY IN A DEVELOPING WORLD (Haitrod & Hague eds. 1963); Haring, *Dynamic Trade Theory and Growth in Poor Countries*, 16 KYKLOS 371 (1963); Nurfse, *International Trade and Development Policy*, in ECONOMIC DEVELOPMENT FOR LATIN AMERICA 234 (Ellis ed. 1961).

<sup>77</sup> See LUTZ, THE PROBLEM OF INTERNATIONAL ECONOMIC EQUILIBRIUM (1962); Johnson, *Economic Expansion and International Trade*, 23 MANCHESTER SCHOOL ECON. & SOCIAL STUDIES 95 (1955), reprinted in JOHNSON, INTERNATIONAL TRADE AND ECONOMIC GROWTH 65 (1958); Johnson, *Equilibrium Growth in an International Economy*, 19 CANADIAN J. ECON. & POL. SCI. 478 (1953), reprinted in JOHNSON, *supra* at 120; Takayama, *Economic Growth and International Trade*, 31 REV. ECON. STUDIES 207 (1964).

<sup>78</sup> Alcantara, *supra* note 48.

<sup>79</sup> VINER, INTERNATIONAL TRADE AND ECONOMIC DEVELOPMENT 71-72 (1952).

"(3) In manufacturing technical progress tends to be faster and more pervasive than in primary production. The primary sector itself is technically more progressive in industrialised or industrialising countries.

"(4) Manufacturing is typically associated with a higher rate of capital formation and of skill formation than primary production.

"(5) Manufacturing activities generate more and stronger 'backward and forward linkages' and other external economies than primary production, and thereby induce more future investment.

"(6) Industrialisation and its consequences tend to change the value system of a society in a direction favourable to faster economic growth." <sup>80</sup>

Industrialization, permitting import substitution and export of manufactured products, appears mandatory for most nations.

## II. THE COMMON MARKET AS REMEDY

### *A. Econocentrism*

#### *1. Definitions*

Paragraph 8 of article XXIV of the General Agreement on Tariffs and Trade (GATT) provides:

"(a) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that

"(i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,

"(ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union;

"(b) A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories." <sup>81</sup>

<sup>80</sup> Elkan, *How To Beat Backwash: The Case for Customs-Drawback Unions*, 75 *ECON. J.* 44, 50 (1965).

<sup>81</sup> General Agreement on Tariffs and Trade, Oct. 30, 1947, art. XXIV, para 8, 62 *Stat.* 2013, T.I.A.S. No. 1765, 62 U.N.T.S. 56.

Avoidance of problems involved in distinguishing between internally and externally produced goods and attainment of administrative economies through elimination of intramarket customs facilities render establishment of a common external tariff generally advantageous where politically feasible. The term "common market" normally denotes a customs union within which "not only trade restrictions but also restrictions on factor movements are abolished."<sup>82</sup> "An economic union . . . combines the suppression of restrictions on commodity and factor movements with some degree of harmonization of national economic policies . . ."<sup>83</sup> Although mere economic cooperation among states has been called "integration,"<sup>84</sup> this word is generally employed only to designate groupings of at least the free trade level. These terms, together with such nontechnical labels as "amalgamation" and "combination," are frequently used indiscriminately where precise delimitation of arrangement characteristics is not required. There is with respect to economic analysis no clear line between mere economic integration and federation.

The essence of such arrangements is discrimination: disregarding legal implications of nonadherence to GATT criteria, the degree of liberalization of intraunion trade is normally analytically unimportant so long as a differential with respect to third countries is established. The GATT requirement of substantial elimination of trade restrictions among union partners, designed

<sup>82</sup> BALASSA, *THE THEORY OF ECONOMIC INTEGRATION* 2 (1961).

"A common market incorporates the attributes of a customs union. In addition, it provides for the elimination of restrictions on the movement of labor and capital between the participating customs territories and for some harmonization of national economic policies and institutions (e.g., common labor laws, common agricultural policies, common banking practices, etc.) through action of the member countries."

PINCUS, *THE CENTRAL AMERICAN COMMON MARKET* 75 n.1 (1962).

The Association of the Bar of the City of New York has asserted:

"The main characteristic of a 'common market,' as opposed to a 'free trade zone' or the formation of a 'customs union,' lies simply in the extent of the agreement as to the number of commodities for which trade will be freed. Such a market may refer to one or several categories of products, as in the case of the European Coal and Steel Community; may cover all the 'new industries,' as in the case of the Central American countries; or may even cover all categories of commodities produced by the signatory countries in which case it becomes, in fact, a 'free trade zone' or a 'customs union.'"

COMM. ON FOREIGN LAW, ASS'N OF THE BAR OF THE CITY OF N.Y., *ECONOMIC INTEGRATION IN LATIN AMERICA* 11-12 (1962). This definition appears to have little support in the literature.

<sup>83</sup> BALASSA, *THE THEORY OF ECONOMIC INTEGRATION* 2 (1961). "An economic union has the basic characteristics of a common market, but incorporates some cession of executive power by the member governments to a central authority." PINCUS, *THE CENTRAL AMERICAN COMMON MARKET* 75 n.1 (1962).

<sup>84</sup> TINBERGEN, *INTERNATIONAL ECONOMIC INTEGRATION* (1965); Balassa, *Hacia una teoría de la integración económica*, in *INTEGRACIÓN DE AMÉRICA LATINA* 3 (Wionczek ed. 1964); Haberler, *Integration and Growth of the World Economy in Historical Perspective*, 54 *AM. ECON. REV.* 1 (1964).

to protect the integrity of the most-favored-nation principle, may be criticized on theoretical grounds. Meade argues that gain from trade creation and loss from trade diversion depend in part on the height of tariff barriers prior to amalgamation: where duty rates are not greater than necessary to exclude all import, they measure international production cost differences and hence the benefit to be derived from shifts in activity location. Thus efficiency increase caused by output transfers among partner states will in general be less substantial in the later stages of a progressive tariff reduction program, while disadvantage due to abandonment of extra-union sources of supply should vary only stochastically throughout the adjustment process. It follows that lowering of duties on trade among associated states is more likely to produce world welfare gain than is complete elimination.<sup>85</sup>

"[A] partial all-round reduction by the partner countries of their duties on each other's trade is more likely to do good and less likely to do harm than is the subsequent total elimination of those duties. In this sense the case for a system of partial preferences is stronger than that for a complete customs union. . . . A mutual reduction of import duties by the partner countries will expand their mutual trade, but it may also divert their import and export trades. On the trade expansion there will always be a gain of welfare; but the gain will be lower, the lower are the duties on this trade. At each successive reduction of these duties there will, therefore, be less gain to be reaped from any further expansion of their mutual trade. But since the duties in other countries on the partners' exports and the partners' duties on their imports from outside countries remain constant, the loss of welfare on each unit of trade diversion remains unchanged throughout the process of formation of the union."<sup>85</sup>

## 2. *Theory*

The bulk of economic analysis evaluating the impact of the customs union on international trade has been devoted to exploration of the total world welfare implications of consequent changes in the extent of specialization of production in response to the dictates of comparative advantage. Many early advocates of free trade argued that since uninhibited intercourse efficiently allocates community resources and since customs unions reduce

<sup>85</sup> MEADE, *THE THEORY OF CUSTOMS UNIONS* 110-11 (1955). See also *id.* at 50-51; VANEK, *INTERNATIONAL TRADE: THEORY AND ECONOMIC POLICY* 383-84 (1962). For an outline of theoretical foundations supporting these conclusions see note 91 *infra* and accompanying text. The recent agreement between the United States and Canada with respect to free trade in automobiles contravenes the basic GATT standard. See N.Y. Times, April 6, 1965, p. 49, col. 2. *But see* LEA, *A CANADA-U.S. FREE TRADE ARRANGEMENT—SURVEY OF POSSIBLE CHARACTERISTICS* (1963).

It seems clear that if tariff barriers are deemed necessary to satisfy balance of payments constraints a discriminatory duty structure can provide the desired equilibrium at least cost in terms of interational efficiency. See JOHNSON, *THE WORLD ECONOMY AT THE CROSSROADS* 37-48 (1965).

tariffs, economic association was to be encouraged as movement toward optimality. Paradoxically, protectionist thinking was frequently in agreement: there was hope that, through integration, markets for nationally produced commodities could be expanded without a fully compensating rise in imports. "The literature on customs unions in general, whether written by economists or non-economists, by free traders or protectionists, is almost universally favorable to them . . . . It is a strange phenomenon which unites free-traders and protectionists in the field of commercial policy . . ." <sup>86</sup> In a pioneering academic inquiry in 1950, Viner formalized these primitive arguments, demonstrating that although beneficial trade creation through intraunion production shifts is possible, such adjustments can be outweighed by harmful diversion of demand from low-cost supply sources in excluded regions: if some aspects of a system are constrained to nonmaximizing levels, there is no reason to assert that satisfaction of other conditions of optimality will necessarily prove advantageous.<sup>87</sup> He asserted: "Customs unions are not important, and are unlikely to yield more economic benefit than harm, unless they are between sizable countries which practice substantial protection of substantially similar industries."<sup>88</sup>

The normative implications of Vinerian conclusions were soon disturbed by qualifications arising from consideration of consumption effects. Relaxation of the unrealistic assumption that goods would be purchased in a given proportion regardless of relative prices eliminated preclusion of net benefit from trade diversion in a world where only intranationally produced commodities and diverted commodities exist: given competitive conditions, the impact of purchase expense increase due to transfer of demand to less efficient sources of supply can be more than offset by utility advantages derived from universal equation of marginal costs with unit prices.<sup>89</sup> Intro-

<sup>86</sup> VINER, THE CUSTOMS UNION ISSUE 41 (1950). See the comprehensive bibliography in *id.* at 171-211.

<sup>87</sup> Lipsey & Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUDIES 11 (1956).

<sup>88</sup> VINER, THE CUSTOMS UNION ISSUE (1950). See also Makower & Morton, *A Contribution Towards a Theory of Customs Unions*, 62 ECON. J. 33 (1953). From Viner's monograph Meade has deduced a procedure for calculating net world gain or loss from integration programs. If perfectly elastic supply curves and perfectly inelastic demand curves are posited, a measure of welfare change can be obtained simply by comparing dollar values of created and diverted trade weighted by cost differences between alternative supply sources. MEADE, THE THEORY OF CUSTOMS UNIONS 34-36 (1955). See also Bentick, *Estimating Trade Creation and Trade Diversion*, 73 ECON. J. 219 (1963); Grubel, *Estimating Trade Creation and Trade Diversion: A Note*, 74 *id.* 1018 (1964); Bentick, *Estimating Trade Creation and Trade Diversion: Reply and Further Note*, *id.* at 1020.

<sup>89</sup> MEADE, THE THEORY OF CUSTOMS UNIONS (1955); MEADE, PROBLEMS OF ECONOMIC UNION (1953); Gehrels, *Customs Unions From a Single-Country Viewpoint*, 24 REV. ECON. STUDIES 61 (1956); Lipsey, *The Theory of Customs Unions: Trade Diversion and Welfare*, 24 ECONOMICA 40 (1957).

duction into the model of a third good which after union would continue to be supplied by an excluded nation severely limited the implications of this analysis by revealing that divergence of cost-price ratios is inevitable.<sup>90</sup>

Although inapplicability of the criterion derived to the substantial duty alterations likely on union establishment severely restricts the value of his contribution, Meade has shown that, granted a set of highly unrealistic classical assumptions, the welfare effect of marginal variation in tariff rates can be computed by subtraction of diverted from created trade values if both are weighted by their ad valorem burden percentages.<sup>91</sup> The author concludes that chances of amalgamation induced welfare increase are improved if obstructions to world trade are quantitative restrictions rather than tariffs; if a high percentage of total economic activity is concentrated in the combining states; if they are initially competitive but potentially complementary; if prior to unification duties on trade among them are high but the rest of the world is divided into numerous market areas protected by relatively unrestrictive barrier systems; and if sources and markets in prospective partner nations supply and absorb large proportions of the imports and exports traded among them.<sup>92</sup>

Argument foundations are hardly intuitively obvious: Meade posits perfect competition, horizontal supply curves,<sup>93</sup> absence of external economies and diseconomies and of consumer surplus, cardinal noninterdependent additive individual utility functions, and constant universally identical

<sup>90</sup> Lipsey, *Mr. Gebrels on Customs Unions*, 24 REV. ECON. STUDIES 211 (1957).

<sup>91</sup> If  $p_i$  and  $c_i$  are price per unit paid by consumers for good  $i$  and the production cost of that good respectively and  $dX_i$  is the change engendered in its physical quantity, Meade's criterion may be written:

$$\sum_i (p_i - c_i) dX_i.$$

MEADE, *THE THEORY OF CUSTOMS UNIONS* 120-21 (1955).

<sup>92</sup> MEADE, *THE THEORY OF CUSTOMS UNIONS* 107-10 (1955). For further findings see text accompanying note 85 *supra* and note 113 *infra*.

<sup>93</sup> Additional work has further qualified the mounting body of normative conclusions through exploration of the impact of posited patterns of increasing marginal costs. If the lowest cost producer of a commodity is excluded from a union of two other regions, the duty on the commodity is at no time prohibitive, and the common external tariff of the union on the commodity is less than the higher of the two levies prior to amalgamation, impact will be positive if:

$$\frac{\frac{\partial S_H}{\partial P_H}}{\frac{\partial S_L}{\partial P_L}} > \frac{\tau - t_L}{t_H - \tau},$$

where  $S$  and  $P$  equal quantity supplied and price,  $t$  and  $\tau$  represent tariff rates before and after union, and the subscripts  $H$  and  $L$  denote symbol applicability to union members having higher and lower duties respectively before amalgamation. Spraos, *The Conditions for a Trade Creating Customs Union*, 74 ECON. J. 101 (1964). See also Mishan, *Trade Creating Customs Unions—A Comment*, 75 ECON. J. 238 (1965); Spraos, *Trade Creating Customs Unions—A Rejoinder*, 75 ECON. J. 241 (1965).

income marginal utilities.<sup>94</sup> Ingenious geometric analysis has enabled Vanek to derive parallel conclusions from less limiting premises: in particular, mere ordinal rankings are found sufficient. Although the author deduces that in general an advantageous union would require participation of at least two-thirds of the world economy if the external tariff is some average of those in force in the member states before integration, he asserts that benefit can always be obtained if excluded nations are compensated for amalgamation losses through reduction of duties applicable to their exports.<sup>95</sup>

### 3. Limitations

The main current of customs union theory is thus best characterized as an expansion of the neoclassical international trade framework to embrace discriminatory activities: inclusion of a third country has complicated the model without altering the approach. "[T]he existing theory of customs unions is almost completely confined to the specialization of production according to comparative advantage. Problems of economic growth . . . are ignored."<sup>96</sup> To the development economist, conscious abstraction from dynamic elements renders findings at best useless and more probably misleading:

"[T]he Viner formula for the evaluation of customs unions is subject to some grave objections. Like the neoclassical case for free trade, of which it is a corollary, it assumes fixed preference systems, constant production functions (technology) and fixed stocks of the factors of production; in short, it is concerned with making the best of a static world. Where the principal concern of policymakers is that of achieving the maximum rate of growth (and this is probably as characteristic an aim of those in the developed world as of those in the poorer nations), the trade creation and trade diversion aspects of a customs union may be of relatively little importance. What is wanted, rather, is an indication of the effect a customs union will have upon changes of

<sup>94</sup> Reformulating Meade's index to take account of international disparities in income marginal utility, Vanek derives the measure:

$$\sum_n A_n \left( \sum_i p_n^i dX_N^i - \sum_i c_n^i dX_n^i \right),$$

where  $A_n$  represents the marginal utility of income for the  $n^{\text{th}}$  country and the subscripts  $n$  and  $N$  denote production and consumption magnitudes respectively. VANEK, *INTERNATIONAL TRADE: THEORY AND ECONOMIC POLICY* 375 (1962).

<sup>95</sup> VANEK, *GENERAL EQUILIBRIUM OF INTERNATIONAL DISCRIMINATION: THE CASE OF CUSTOMS UNIONS* (1965). The complexities encountered in continued extension of analysis are best illustrated by Vanek's inclusion of a 107-item compendium of "results." *Id.* at 211-31.

<sup>96</sup> Staley, *Costa Rica and the Central American Common Market*, 15 *ECONOMIA INTERNAZIONALE* 117, 122 (1962). See Cooper & Massell, *A New Look at Customs Union Theory* (Rand Corp. Papers P-2972, P-2972-1, Oct., Nov. 1964).

preference systems and upon the rate of growth of technological capability and the stock of productive factors."<sup>97</sup>

Much of the more pragmatic inquiry stimulated by postwar economic problems of the international community is similarly inapplicable to backward areas. Supporters of integration have stressed resulting heightened competition, promising both stronger pressures inducing intrafirm cost reduction and more rapid growth because of additional innovation incentives. Welfare gain potential has been attributed to anticipated increase in the variety of goods available to the consumer.<sup>98</sup>

The implications of Continental amalgamation for underdeveloped countries have likewise received disproportionate attention. The President of Uruguay, in a statement expressive of Latin American attitudes toward preferences offered African nations, has proclaimed: "The formation of a European Common Market . . . constitutes a state of near-war against Latin American exports."<sup>99</sup> There is talk of counterbalancing United States action.<sup>100</sup> While expansion of discrimination in favor of former colonies throughout important segments of the Western market undeniably threatens the unity of the third world and is obviously economically detrimental to countries excluded from association, the difficulties raised are simply not sufficiently complex to support extensive analysis.<sup>101</sup>

<sup>97</sup> Helleinner, *Nigeria and the African Common Market*, 4 NIGERIAN J. ECON. & SOCIAL STUDIES 283, 286-87 (1962).

<sup>98</sup> The best general survey of the problems and prospects of common markets is BALASSA, *THE THEORY OF ECONOMIC INTEGRATION* (1961). For an excellent classification of advantages and disadvantages of union see STREETEN, *ECONOMIC INTEGRATION* 26-77 (1961). See also SANNWALD & STOHLER, *ECONOMIC INTEGRATION* (1959); JANSSEN, *FREE TRADE, PROTECTION AND CUSTOMS UNION* (1961).

<sup>99</sup> Observer (London), July 30, 1961, p. 4, col. 1, quoted in DELL, *TRADE BLOCS AND COMMON MARKETS* 211 (1963). See also Dell, *Apresiasi sobre el funcionamiento del Tratado de Montevideo*, in *INTEGRACIÓN DE AMÉRICA LATINA* 94, 112 (Wionczek ed. 1964).

<sup>100</sup> See *Preferencias Comerciales Norteamericanas para América Latina*, 15 COMERCIO EXTERIOR (MEX.) 5 (1965); Szulc, *U.S. Said To Study Latin-Tariff Plan*, N.Y. Times, March 17, 1965, p. 10, col. 3.

<sup>101</sup> For an example of perhaps over-comprehensive coverage see the multi-volume study SECRETARIAT, *ECONOMIC COMM'N FOR EUROPE, IMPLICATIONS FOR TRADE AND DEVELOPMENT OF DEVELOPING COUNTRIES OF ECONOMIC GROUPINGS OF DEVELOPED COUNTRIES AND/OR PREFERENTIAL TRADING ARRANGEMENTS*, U.N. DOC. NOS. E/CONF.46/31, 31/Add.1 (1964). See also DEP'T OF ECONOMIC AFFAIRS, PAN AMERICAN UNION, *THE EFFECTS OF THE EUROPEAN ECONOMIC COMMUNITY ON THE LATIN AMERICAN ECONOMIES* (1962); Economic Comm'n for Latin America, *The Achievement of Co-Ordination in Latin American Trade Policy: Relations With the European Economic Community*, Econ. Bull. Latin Am., Oct. 1962, p. 127; *La Necesidad una Política Comercial Común Latino-Americana*, 13 COMERCIO EXTERIOR (MEX.) 77 (1963); *América Latina y la Comunidad Económica Europea*, 12 COMERCIO EXTERIOR (MEX.) 651 (1962).

See Convention of Association Between the European Economic Community and Associated African States, July 20, 1963, translated in 2 INT'L LEGAL MATERIALS 971 (1963). See Everling, *Die Neuregelung des Assoziationsverhältnisses zwischen der*



Scholarly effort, directed primarily toward events in Western Europe, has thus been largely exhausted in exploration of effects of combination of economically advanced states:

"Interest in customs unions and free trade areas has received its greatest stimulation from recent European experience. The bulk of the discussion, both theoretical and empirical, of the economic advantages and disadvantages of such customs arrangements has consequently been geared to the European context. The existing accepted theory of customs unions, as originally [*sic*] formulated by Viner, is therefore of limited relevance to policy-makers in the 'underdeveloped' world. . . . The European situation is one of industrialized market economies, characterized by highly skilled and mobile labor forces, and close trading interrelationships. Prices at least approximate marginal costs and marginal social values. In this context, the questions asked by the economist may legitimately lean frequently towards the neoclassical ones of economic efficiency and optimal resource allocation."<sup>102</sup>

Unconsidered employment of criteria created for evaluation of the European Communities in studies of feasibility of integration among economically diminutive underdeveloped countries has yielded unwarranted negative conclusions. Allen, for example, asserts: "[A]n extremely low level of economic development will tend to keep economic benefits at a minimum. . . . [T]he higher the stage of economic development, the greater is the potential economic gain."<sup>103</sup>

### B. Amalgamation Rationale

#### 1. Support

Nevertheless, economists in increasing numbers are recognizing the possibility of integration among backward states as a potential partial solution, perhaps permitting self-extrication from the difficulties of underdevelopment. General Principle Ten established by the United Nations Conference on Trade and Development recommends: "Regional economic groupings, integration or other forms of economic co-operation should be promoted among developing countries as a means of expanding their intra-regional and extra-regional trade and encouraging their economic growth.

*Europäischen Wirtschaftsgemeinschaft und den afrikanischen Staaten und Madagaskar sowie den überseeischen Ländern und Hoheitsgebieten*, 24 ZEITSCHRIFT FÜR AUSLÄNDISCHES ÖFFENTLICHES RECHT UND VÖLKERRECHT 472 (1964); van den Bergh, *The New Convention of Association With African States*, 1 COMMON MKT. L. REV. 156 (1963). See also Cohen, *The Association of Third Countries With the European Economic Community Pursuant to Article 238*, 26 U. PITT. L. REV. 521 (1965).

<sup>102</sup> Helleiner, *supra* note 97, at 285-86. See also Onitiri, *Towards a West African Economic Community*, 5 NIGERIAN J. ECON. & SOCIAL STUDIES 27 (1963).

<sup>103</sup> Allen, *Integration in Less Developed Areas*, 14 KYKLOS 315, 319, 329 (1961).

. . ." <sup>104</sup> Reynoso, commenting on this declaration, asserts: "[S]e llegó finalmente a un consenso de opinión mundial en el sentido de que los programas de integración económica . . . constituyen un instrumento importante para el desarrollo económico." <sup>105</sup> Linder believes: "[U]na unión aduanera entre países subdesarrollados . . . tiene a su favor más argumentos puramente económicos que su contraparte entre los países industriales." <sup>106</sup> In a burst of excessive enthusiasm Herrera asserts: "It is certain that without integration there will be no economic development in Latin America." <sup>107</sup>

The United States can be regarded as a convincing example of the value of common market arrangements. <sup>108</sup> Certainly perpetuation of preunification interstate disharmony would have precluded the rapid economic expansion actually achieved. <sup>109</sup> Intranational European commerce likewise suffered until relatively recently from domestic impediment. The Trade Treaty of 1786 removed the ban of France on the import of British textiles. A French observer complained:

"Although English merchandise is subject to duties of 10 per cent or 12 per cent, England can supply nearly all the provinces of the kingdom more cheaply than can our own industry. Our goods are subject to customs duties which prevent them from meeting English competition. It costs from 10 per cent to 12 per cent to send silk gauze, cotton cloth and velveteen from Lyon to Brittany, and it costs as much to send Flemish products into the interior of the kingdom. Woolen goods manufactured in Lille pay 7½ per cent at the bureau in Peronne alone. The cloth of Languedoc arrives in Paris and in Brittany only after having paid 15 per cent or 16 per cent in duties and expenses." <sup>110</sup>

<sup>104</sup> U.N. Conference on Trade and Development, Final Act, U.N. Doc. No. E/CONF.46/L.28, Annex A, at 13 (1964).

<sup>105</sup> Reynoso, *Prólogo*, in *INTEGRACIÓN DE AMÉRICA LATINA* at xi (Wionczek ed. 1964).

<sup>106</sup> Linder, *Uniones aduaneras y desarrollo económico*, in *INTEGRACIÓN DE AMÉRICA LATINA* 15, 25 (Wionczek ed. 1964).

<sup>107</sup> Herrera, *The Financing of Latin American Integration*, *Int'l Development Rev.*, Sept. 1963, p. 7. For a discussion of changes in the attitudes of United States officials toward the Latin American Free Trade Association see Wionczek, *La historia del Tratado de Montevideo*, in *INTEGRACIÓN DE AMÉRICA LATINA* 53, 79-93 (Wionczek ed. 1964).

<sup>108</sup> For critical discussion of the proposition see Dell, *Economic Integration and the American Example*, 69 *ECON. J.* 39 (1959); Fabricant, *Study of the Size and Efficiency of the American Economy*, in *ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS* 35 (E. A. G. Robinson ed. 1960). See also DELL, *TRADE BLOCS AND COMMON MARKETS*, at xvi (1963).

<sup>109</sup> "New York attempted to keep out firewood from Connecticut and produce from New Jersey by imposing heavy duties on those goods; . . . New Jersey replied by placing a prohibitive tax on the Sandy Hook lighthouse, which happened to be on New Jersey soil, and the town of New London in Connecticut suspended all trade with New Yorkers." Freund, *Foundations and Development of American Federalism*, in *FEDERALISM AND THE NEW NATIONS OF AFRICA* 153, 155 (Currie ed. 1944).

<sup>110</sup> BOSHER, *THE SINGLE DUTY PROJECT: A STUDY OF THE MOVEMENT FOR A FRENCH CUSTOMS UNION IN THE EIGHTEENTH CENTURY* 23 (1964).

"Tolls on trade were collected throughout Europe in medieval times . . . Tolls

## 2. *Static Gain*

Regardless of its validity, much of traditional analysis cannot serve as a guide to decision-makers contemplating amalgamation: while it measures total world utility alteration, they pursue national advantage. Within the framework of comparative statics Vanek has demonstrated that integration will normally benefit participating nations.

Posit combination of countries *a* and *b*. Assume only two commodities, *x* and *y*, are produced. Let country *a* trade exclusively with *b*, exchanging *y* for *x*, while country *b*, in addition to its trade with *a*, exports *x* to and imports *y* from the rest of the world. In figure 1 vertical and horizontal sides of rectangle  $O_aBO_bA$  represent joint output by states *a* and *b* of goods *x* and *y* respectively. If individual supplies of *a* and *b* are calculated from  $O_a$  and  $O_b$ , a point such as *P* will define quantities produced by each. Indifference curves such as  $u_a$ ,  $u_b$ , and  $u'_b$  may with caution be used to define community preferences. Amounts exchanged may be measured along axes  $Px$  and  $Py$ .

World terms of trade are given by  $PC_b$ . Before integration country *a* imposes an ad valorem duty of  $\frac{PP_a}{C_{ap}P}$  on imports of good *x*; similarly, coun-

try *b* taxes shipments of good *y* at a rate  $\frac{PP_b}{C_{bp}P}$ . Revenue is distributed among citizens of the recipient countries. Exchange will equate the marginal rate of substitution with the internal price ratio in each country: equilibrium will be reached at points  $C_a$  and  $C_b$ , where price lines  $P_aC_a$  and  $P_bC_b$  are tangent to indifference curves  $u_a$  and  $u_b$  respectively.

If the offer curve of the group of excluded nations is infinitely elastic and the levy of country *b* on commodity *y* is retained in the common external tariff, world terms of trade will remain unchanged on unification and the internal price ratio of states *a* and *b* will equal  $P_bC_b$ . Country *a* can achieve a level of satisfaction equivalent to  $C_a$  at  $C'_a$  where indifference curve  $u_a$  has the slope of  $P_bC_b$ . So long as  $C'_a$  falls below and to the right of *k*, state *b* can profit through integration without damage to its partner by advancing to indifference curve  $u'_b$ . While possibility of loss cannot be excluded, gain will result over a wide range of parameter values. Alteration of world terms of trade would provide additional benefit.<sup>111</sup>

were established in the first place because they were among the simplest and most effective of taxes. It was possible to collect them without preparing tax rolls, with only the most rudimentary kind of assessment, and with the greatest possible certainty, because travelling merchants were obliged to use roads, rivers and seaports, and if they could not or would not pay as directed, their goods could be confiscated. . . . Because of their advantages as a method of taxation, tolls had come to be collected by many different authorities: governments of towns and provinces, feudal barons on their estates, rulers at the frontiers of their domains and principalities."

*Id.* at 1.

<sup>111</sup> VANEK, GENERAL EQUILIBRIUM OF INTERNATIONAL DISCRIMINATION: THE CASE OF CUSTOMS UNIONS 22-26, 53-87, 97-109 (1965).

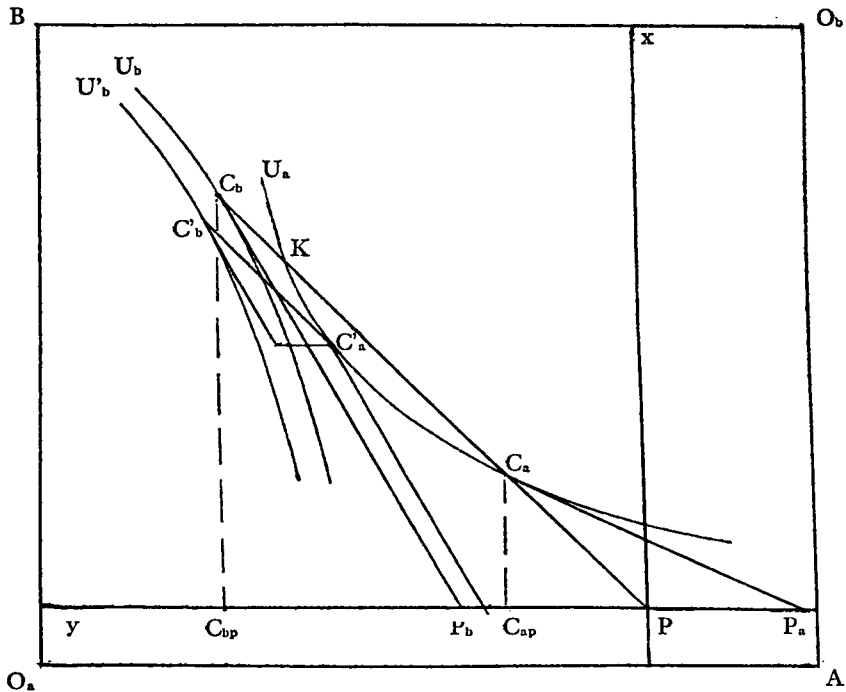


Figure 1

### 3. Increasing Returns

The concept of economies of scale has not been ignored in the major studies. Viner states: "When a small country by itself, because of the limited size of its domestic market . . . may be unable to reach a scale of production large enough to make low unit-costs of production possible, two or more such countries combined may provide a market large enough. . . ." <sup>112</sup> Meade recognizes: "[T]he formation of a customs union is more likely to raise economic welfare the greater is the scope for economies of large-scale production . . . ." <sup>113</sup>

Its importance has nevertheless been minimized. Viner concludes: "It does not seem probable that the prospects of reduction in unit-costs of production as the result of enlargement of the tariff area are ordinarily substantial, even when the individual member countries are quite small. . . ." <sup>114</sup> Scitovsky admits that European plants are generally below optimum size but argues that factors other than market magnitude, for instance excessive product differentiation and preference for family enterprise, are determinative. He asserts that ignoring the impact of quantitative restrictions the gains from increases in specialization induced by union among the EEC states, Scandinavia, and Britain would be "less than one twentieth of one

<sup>112</sup> VINER, THE CUSTOMS UNION ISSUE 45 (1950).

<sup>113</sup> MEADE, *THE THEORY OF CUSTOMS UNIONS* 110 (1955).

<sup>114</sup> VINER, *THE CUSTOMS UNION* ISSUE 46 (1950).

per cent of the gross social product of the countries involved.”<sup>115</sup> A mere one per cent of national income has been held to be the absolute maximum benefit Britain can derive from membership in the European Free Trade Association.<sup>116</sup>

Much of the projected gain from consolidation of the sheltered markets of backward nations can nevertheless be attributed to anticipated advantageous exploitation of economies of scale. Brown has strongly criticized the traditional approach:

“I do not think that most of the theoretical discussion of this subject helps us much. The treatments of Viner, Meade, Makower and Morton, Gehrels, and Lipsey . . . are concerned almost entirely with the effects on economic welfare . . . on the assumption that there are no productive economies of large scale. . . . [I]t takes comparative advantages and trade-patterns as they are now instead of considering what they are likely to be, say, a generation hence.”<sup>117</sup>

Robinson states:

“It is not going too far, perhaps, to say that it seemed to be our general impression that most of the major industrial economies of scale could be achieved by a relatively high income nation of 50 million; that nations of 10-15 million were probably too small to get all the technical economies available . . .”<sup>118</sup>

Carnell asserts: “The economic argument turns largely on the alleged advantages of the economies of scale.”<sup>119</sup>

<sup>115</sup> SCITOVSKY, *ECONOMIC THEORY AND WESTERN EUROPEAN INTEGRATION* 67, 27-32, 110-35 (1958). An important segment of this volume first appeared as Scitovsky, *Economies of Scale, Competition, and European Integration*, 46 AM. ECON. REV. 71 (1956).

<sup>116</sup> Johnson, *The Gains From Free Trade With Europe: An Estimate*, 26 MANCHESTER SCHOOL ECON. & SOCIAL STUDIES 247 (1958). See Bhambri, *Customs Unions and Underdeveloped Countries*, 15 ECONOMIA INTERNAZIONALE 235 (1962).

<sup>117</sup> Brown, *The Benefits of Regional Economic Integration Among African Countries*, 2 DEVELOPMENT RESEARCH DIG. 77, 78-79 (1963).

<sup>118</sup> E. Robinson, *Introduction*, in *ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS* at xviii (E. Robinson ed. 1960). Allen argues:

“Some of the smallest nations can afford to have optimum-size, small-scale manufacturing facilities. A shoe factory, for example, requires a capital facility valued at \$500,000 to \$2 million to operate efficiently. Diversified meat packing requires an investment of \$10 to \$20 million, fresh meat packing requires capital of only \$1 million. An optimum-size flour mill has capital requirements of \$700,000 to \$3.5 million, gypsum products \$4 million to \$6 million. Many other activities, including cement, soap, fountain pens, canned fruits and vegetables, tires and tubes need \$25 million or less in capital facilities to achieve optimum scale.”

Allen, *supra* note 103, at 322-23. From this data he concludes: “Thus, many manufacturing facilities, primarily light manufacturing and consumer goods are within the market size of quite small less developed countries and there is no certainty that an increase in the size of the market would result in significant economies.” *Id.* at 323. This does not necessarily follow: he has not discussed the capacity of these enterprises but their cost. Allen then adds: “The question is not always just one of an adequate market but of attracting investment or allocating resources for investment purposes in the first place.” *Ibid.* The posited dichotomy is misleading to the extent that market characteristics guide investment decisions. In any event both prospective demand and capital funds are required.

<sup>119</sup> Carnell, *Political Implications of Federalism in New States*, in *FEDERALISM AND*

While it has been obvious, at least since Adam Smith's description of a pin manufacturing plant, that large output permits increased factor efficiency, operationally meaningful general cost-output relationships remain difficult to quantify.<sup>120</sup> Studies of particular industries provide some relevant data. In oil production, for example, unit cost of degassing operations declines at least until an output of 300,000 barrels per day is achieved. Because unit transmission friction varies inversely with pipeline diameter average petroleum land transportation costs fall until volume reaches approximately 400,000 barrels per day. A refinery with a daily capacity of 500,000 barrels will have substantial cost advantages over smaller plants.<sup>121</sup> It has been asserted that the unit cost of production of a given type of aircraft declines by over 10 per cent if the model run is increased from 100 to 200 planes. The purchase price of a single large subsonic jet transport is roughly five million dollars.<sup>122</sup> Balassa states:

"Over 1 million ingot tons is the annual output of an integrated steel plant of efficient size, costs are approximately 18 per cent higher at capacity levels of 0.5 million tons and 33 per cent higher in a plant producing 0.25 million tons per year. Yet, among less developed countries, steel production exceeds 1.0 million tons a year only in India, Brazil, and Mexico . . . ." <sup>123</sup>

One plant of minimum optimum size is capable of supplying between 10 and 30 per cent of American typewriter demand.<sup>124</sup>

ECONOMIC GROWTH IN UNDERDEVELOPED COUNTRIES 16, 21 (Hicks ed. 1961). See Cooper & Massell, Towards a General Theory of Customs Unions for Developing Countries (Rand Corp. Paper P-2919, May 1964); Cooper & Massell, Toward a General Theory of Customs Unions for Developing Countries (Rand Corp. Paper P-2919-1, Sept. 1964).

<sup>120</sup> See generally, ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS (E. A. G. Robinson ed. 1960); BANDT, DIMENSION DU MARCHÉ ET OPTIMUM DE PRODUCTION (1962). "Statistical evidence bearing on the existence of economies of scale in industry is, for the most part, sketchy and incomplete, although the logic of the economic and technical origins of such economies has been extensively developed." Moore, *Economies of Scale: Some Statistical Evidence*, 73 Q.J. ECON. 232 (1959). Generalizing the "6 rule" derived by engineers seeking an approximate guide to machine cost as a function of output, the author inconclusively explores relationships of the form

$$E = kC^a,$$

where E and C represent capital expenditure and created capacity respectively, k is an unrestricted constant, and a is a constant having a value between 0 and 1. For strong support of the rule see Schuman & Alport, *Economies of Scale: Some Statistical Evidence: Comment*, 74 Q.J. ECON. 493 (1960). See also Reply, 74 Q.J. ECON. 497 (1960); Bruni, *Internal Economies of Scale With a Given Technique*, 12 J. IND. ECON. 175 (1964). See generally V. SMITH, INVESTMENT AND PRODUCTION (1961).

<sup>121</sup> See LEEMAN, THE PRICE OF MIDDLE EAST OIL: AN ESSAY IN POLITICAL ECONOMY (1962).

<sup>122</sup> See Sturmeay, *Cost Curves and Pricing in Aircraft Production*, 74 ECON. J. 954 (1964).

<sup>123</sup> BALASSA, ECONOMIC DEVELOPMENT AND INTEGRATION 92 (1965).

"[I]t has been shown that a doubling of the output of ammonia involves a 40 per cent increase in labor costs and 81 per cent rise in capital costs, while the relevant figures for ammonium nitrate and ammonium sulphate—the two most important types of fertilizers—are 27 and 68 per cent, and 20 and 65 per cent, respectively."

Id. at 91. See BALASSA, *op. cit. supra* note 98, at 139.

<sup>124</sup> Bain, *Economies of Scale, Concentration, and the Condition of Entry in Twenty Manufacturing Industries*, 44 AM. ECON. REV. 15, 23 (1954).

Although frequently useful as crude approximations, more comprehensive studies of scale economies are seldom reliable. From the distribution of median plant sizes in Great Britain, for example, analysts have derived a list of goods which cannot be efficiently manufactured in quantities demanded by the Uganda population but can be produced at reasonable cost for the entire East African market: included are canvas, lace, wood crates, paper, scientific instruments, tools, hats, bicycles, paints, and linen.<sup>125</sup> There is, however, little reason to conclude that the median British factory is of minimum optimal size: it may be larger if constant returns prevail over a significant portion of the production function; on the other hand, intra-industry specialization could lead to underestimation.<sup>126</sup>

Although exact measurement of potential benefit must await future empirical analysis, an extreme example of limitation of entrepreneurial opportunity through market size restriction can provide qualitative illustration of argument thrust. On February 18, 1965, Gambia became the thirty-seventh independent state of Africa. This new nation, comprising 300,000 persons inhabiting a territory 200 miles long and between 15 and 30 miles wide, has been called by a former British Governor-General "a geographic and economic absurdity." Although peanuts are its only cash crop,<sup>127</sup> additional income is obtained through smuggling cigarettes into surrounding Senegal: Gambia imports over a million packs per day. Colonial diversification efforts proved unsuccessful: "A mining scheme failed (no minerals); an ambitious shark fishery collapsed (no demand). The British government put 2,000,000 dollars into a model poultry farm . . . but . . . after a production of 40,000 eggs—at \$50 an egg—the farm was transformed into a teacher's college."<sup>128</sup> "British aid now amounts to \$2,240,000 for development projects, plus \$748,000 to meet a recurrent budget deficit."<sup>129</sup> An approximation of Gambian national income may be derived through multi-

<sup>125</sup> See Brown, *Economic Separatism Versus a Common Market in Developing Countries*, 13 YORKSHIRE BULL. ECON. & SOCIAL RESEARCH 33 (1961).

<sup>126</sup> See Massell, *East African Economic Union: An Evaluation and Some Implications for Policy* (Rand Corp. Memo. RM-3880-RC, Dec. 1963).

"[W]hile this method may be applicable in the case of homogeneous commodities, such as cement, it leads to misleading results in regard to cotton textiles, footwear and other consumer and producer goods where product differentiation is prevalent. In the latter instances, the efficient operation of a median British plant presupposes its integration into an industry manufacturing heterogeneous products with individual plants specializing in different varieties of the same commodity. Thus, while the consumption of footwear in an underdeveloped country might equal the production of a median British plant, efficient operation could still not be ensured in such a country since its only plant would have to produce all kinds of footwear in use rather than one or two varieties."

BALASSA, *ECONOMIC DEVELOPMENT AND INTEGRATION* 88-89 (1965). "[I]t can be held that Professor Brown underestimates—mainly by implication, but to some extent also explicitly—the order of size which an economy has to reach before the limitations of small scale cease to be a serious obstacle to its further development." Elkan, *How To Beat Backwash: The Case for Customs-Drawback Unions*, 75 *ECON. J.* 44 (1965).

<sup>127</sup> Gambia "was developed as a peanut colony." *Gambia Becomes Independent*, *Asia & Afr. Rev.*, March 1965, p. 7.

<sup>128</sup> *Time*, Feb. 26, 1965, pp. 32, 35.

<sup>129</sup> *N.Y. Times*, Jan. 31, 1966, p. 42, col. 1.

plication of population by 113 dollars, the African average per capita earnings in 1960.<sup>130</sup> The result, roughly 34 million dollars, could hardly be said to provide a market base capable of supporting a spectrum of optimal firms. At the very least one may feel certain that cars and trucks will be imported for the foreseeable future: the minimum annual output value required for efficient production in the American automobile industry is conservatively estimated to be in excess of one billion dollars.<sup>131</sup>

#### 4. *Dynamic Benefit*

We have found industrialization generally necessary for growth: both import substitution and export of even partially finished goods normally require manufacturing facilities. Although temporary tariff protection to infant industries<sup>132</sup> may be justified by benefit derived from generation of external economies,<sup>133</sup> especially from development of worker skills,<sup>134</sup> continued excess of domestic production costs over world supply prices entails heavy sacrifice of real income by the community. Forced adoption of inefficient techniques may squander scarce investment funds by raising capital-output ratios without concomitantly increasing profit.

Admittedly, iron ore can be mined only at deposit sites and orange

<sup>130</sup> U.N. DEPT OF ECONOMIC AND SOCIAL AFFAIRS, *WORLD ECONOMIC SURVEY* 1963 pt. I, U.N. Doc. No. E/3908(ST/ECA/84), at 21 (1964).

<sup>131</sup> BAIN, *BARRIERS TO NEW COMPETITION* 76 (1956). See also Weiss, *An Evaluation of Mergers in Six Industries*, 47 *REV. ECON. & STATISTICS* 172, 176 (1965). For significant lower British estimates see Brems, *Cost and Indivisibility*, 12 *J. IND. ECON.* 142, 149 (1964). The problem of inadequate internal markets currently confronts almost all developing states: among them gross national product exceeds \$7 billion only in India, Brazil, Mexico, and Pakistan. BALASSA, *ECONOMIC DEVELOPMENT AND INTEGRATION* 80 (1965).

<sup>132</sup> See Myint, *Infant Industry Arguments for Assistance to Industries in the Setting of Dynamic Trade Theory*, in *INTERNATIONAL TRADE THEORY IN A DEVELOPING WORLD* 173 (Harrod & Hague eds. 1963).

<sup>133</sup> See Bardhan, *External Economies, Economic Development, and the Theory of Protection*, 16 *OXFORD ECON. PAPERS* 40 (1964); Bardhan, *Factor Market Disequilibrium and the Theory of Protection*, 16 *OXFORD ECON. PAPERS* 375 (1964). For a good review of recent studies see Mishan, *Reflections on Recent Developments in the Concept of External Effects*, 31 *CANADIAN J. ECON. & POL. SCI.* 1 (1965).

<sup>134</sup> See note 20 *supra*.

"It was early observed by aeronautical engineers . . . that the number of labor-hours expended in the production of an airframe . . . is a decreasing function of the total number of airframes of the same type previously produced. Indeed, the relationship is remarkably precise; to produce the  $N^{\text{th}}$  airframe of a given type, counting from the inception of production, the amount of labor required is proportional to  $N^{-1/3}$  . . . .

...  
"Lundberg . . . has given the name 'Horndal effect' to a very similar phenomenon. The Horndal iron works in Sweden had no new investment (and therefore presumably no significant change in its methods of production) for a period of 15 years, yet productivity (output per manhour) rose on the average close to 2% per annum."

Arrow, *The Economic Implications of Learning by Doing*, 29 *REV. ECON. STUDIES* 155, 156 (1962). See Sturme, *supra* note 122.



groves would not prove profitable to the inhabitants of Greenland; nevertheless many goods can be created or processed with advantage near their consumption points. Factor endowments are not divinely decreed constants. In backward regions a primary problem is the lack of a protected market sufficiently large to absorb the output of a plant of minimum optimum size. Euphoric dreams of shortrun export potential will seldom evoke the capital needed to build from the beginning beyond even extrapolated domestic demand: normally comparative advantage will at least initially lie elsewhere, and subsidization permitting invasion of sheltered foreign markets would appear unjustifiable.

Economic union among Gambia and neighboring African states would immeasurably ameliorate its presently poor prospects of future economic viability. Expansion of the protected market would spur domestic entrepreneurial activity by significantly extending opportunities for rational industrialization. Local establishment of tire producing facilities on a scale sufficient to supply the demand of the entire integrated area, for example, would permit both economic autonomous satisfaction of internal needs and conservation of foreign exchange through barter of excess output for other vital manufactures similarly supplied by partner states.

Postulation of differing production functions among potential union members allows support of regional arrangements involving underdeveloped states even under assumptions of constant costs. If Gambia and Senegal can respectively supply tires and textiles with comparative advantage, traditional arguments of trade theory demonstrate that international specialization and concomitant exchange will raise real income in both states. Differences in cost structure among prospective partners are, however, likely to be the result of politically undesirable development disparities, which specialization would only aggravate.<sup>135</sup>

### III. CONCLUSION

Low saving ratios and limited export potential restrict growth of backward states and impede politically necessary narrowing of international income differentials. Examination of European amalgamation potential in the context of traditional trade theory induced advocacy of the common market primarily as a device of advantage to groupings of advanced nations. In recent years, lack of alternative development opportunities has nevertheless focused attention on integration as a partial solution to third world expansion problems. Regional combination can stimulate industrialization through provision of protected markets sufficiently broad to permit scale economies. Intraunion specialization allows acquisition by participants of required imports without foreign exchange expenditure.

<sup>135</sup> See Cooper & Massell, *Towards a General Theory of Customs Unions for Developing Countries* (Rand Corp. Paper P-2919, May 1964); Cooper & Massell, *Toward a General Theory of Customs Unions for Developing Countries* (Rand Corp. Paper P-2919-1, Sept. 1964).