

SECOND THOUGHTS ON CENTRAL AMERICA: THE ROSENTHAL REPORT

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As MIGHT have been predicted, the Central American Common Market (CACM) has been in a state of crisis since the short 'Migration War' between El Salvador and Honduras in July 1969. But Central American integration was in jeopardy long before the outbreak of armed conflict,¹ so not all of the present difficulties can be attributed to the war. Moreover, the crisis has not left Central America in complete disarray; free trade continues among four of the five countries and several regional institutions continue to function.

In an effort to resolve the current crisis, the Permanent Secretariat of the Central American Common Market (SIECA), in collaboration with other regional institutions and international agencies such as UNCTAD, has completed a detailed study of the evolution of Central American Integration and its prospects for the future. This study, which we will refer to as the 'Rosenthal Report', is the most complete analysis to date of the CACM.² Its publication provides an

¹ Stuart I. Fagan argues that 'even before the July war, the Central American Common Market was on the verge of collapse...'; *Central American Economic Integration: The Politics of Unequal Benefits* (Institute of International Studies, University of California, Berkeley, 1970), p. 1. The Rosenthal Report shares this view in affirming that 'at the beginning of 1969... the search for a new force to reduce or overcome obstacles in the process could no longer be postponed'. *Nota-Resumen*, p. 4.

² Secretaría Permanente del Tratado General de Integración Económica Centroamericana, *El Desarrollo Integrado de Centroamérica en la Presente Década: Bases y Propuestas para el Perfeccionamiento y la Reestructuración del Mercado Común Centroamericano* (13 vols., Institute for Latin American Integration, Inter-American Development Bank, Buenos Aires, 1973-74). Guatemalan economist Gert Rosenthal headed the group of experts that participated in this study. The Report consists of a summary volume (*Nota-Resumen*) and twelve technical appendices that cover the following topics: (1) evolution of the Central American economy during the 1960-70 period and prospects for the next decade; (2) the 'perfecting' of the Central American Common Market: free trade, customs union and common tariff; (3) programme of integrated industrial development; (4) programme of integrated agricultural development; (5) programme of physical integration; (6) social policy and integrated development; (7) programme of monetary integration; (8) guidelines for a strategy to develop non-traditional exports and a common foreign trade policy; (9) the

opportunity to reconsider the problems and possibilities that integration offers developing countries in general and Central America in particular.

The Rosenthal Report covers a broad range of topics, but much of the text is directed toward three basic questions:

- (a) To what extent has the integration programme contributed to the economic development of Central America and each country in the region?
- (b) Why did the process of integration lose its initial impulse and embark on a series of crises that have led to the present impasse?
- (c) Is it possible to re-structure the programme as a means of accelerating the economic development of the small Central American economies?

In the three sections that follow we analyse the answers to each of these questions. It should be emphasized that attention is focused on what appear to be the most significant aspects of Central American Integration. Each volume of the Report contains ideas and proposals that deserve comment, but are ignored here because of space limitations.

A DECADE OF INTEGRATION AND ECONOMIC DEVELOPMENT

A basic theme of the Rosenthal Report is that 'the terms "integration" and "development" have become inseparable concepts', for 'integration has contributed positively and significantly to the growth of the economies of member countries of the Central American Common Market'.³ This is a strong claim for any integration programme, and one that merits careful analysis.

Manufactured goods account for most of the rapid increase in intra-regional trade during the 1960s,⁴ so it is reasonable to assume that removal of trade barriers and the establishment of a common external tariff is responsible for the fact that manufacturing output grew at an unprecedented rate of 10 per cent per year in the 1960s, and accounted for 17.5 per cent of gross regional product in 1970

financing of integrated development; (10) public finance and integration (programme of tax harmonization); (11) institutional aspects of integrated development; and (12) priority programmes of international technical cooperation for the process of integration. In this article, reference to appendices is by number rather than title.

³ Rosenthal Report, *Nota-Resumen*, pp. xii and 17.

⁴ Manufactured goods accounted for 78 per cent of intra-regional trade in 1963, 87 per cent in 1967 and 90 per cent in 1969. Rosenthal Report, Appendix 2, table 9.

compared to 13.2 per cent in 1960.⁵ Economic integration will, however, have had a positive effect on gross domestic product as well as manufacturing output only to the extent that it has stimulated increased capital formation, the employment of otherwise idle capital and labour, more efficient resource allocation, and lower costs and prices.⁶

Economic Growth

The Rosenthal Report estimates that the CACM has had a positive effect on economic growth in each member country and that 25 per cent of Central America's 1962-68 growth rate is attributable to the formation of the CACM. This estimate is considerably higher than that of two earlier studies of the CACM.⁷ The authors of the Report employ a simple methodology to obtain this estimate, but they do not explain their assumptions or calculations in the summary volume.⁸ Since the econometrics of the technical appendix may frighten the uninitiated, it is useful to trace these calculations in some detail.

The starting point of the Rosenthal Report's analysis is the observed fact that in all the countries the gross domestic product (GDP) grew at a faster rate in the 'post-integration' period than in the previous ten years. This is true whether one defines the 'post-integration' period as beginning in 1961, when the first three countries entered the CACM, or in 1962, when there were four member countries.⁹ (See table 1.)¹⁰

Since the observed growth rates rise in the period following formation of the CACM, it is tempting to conclude, *post hoc ergo propter hoc*, that economic integration has 'caused' an increase in the growth rate of 1.7 to 1.9 percentage points for the region as a whole, and an

⁵ Rosenthal Report, *Nota-Resumen*, table 11-3, p. 12.

⁶ *Ibid.*, pp. 45-6. The authors of the Report also argue (p. 45) that integration contributes to economic growth by reducing dependence on traditional exports. But unless otherwise idle resources are employed, we would argue that this import substitution at best reduces the variation of growth rates from year to year.

⁷ Donald H. McClelland, *The Central American Common Market: Economic Policies, Economic Growth and Choices for the Future* (Praeger Publishers, New York, 1972) and Jeffrey B. Nugent, 'A Study of the Effects of the Central American Common Market and of the Potential Benefits of Further Integration', USAID and SIECA, Guatemala, 1971.

⁸ The conclusions are reported in chapters 2 and 3 of the *Nota-Resumen*. The calculations and to a lesser extent the assumptions are discussed in section II of Appendix 1.

⁹ The Treaty of Managua, which established the CACM, was signed in December 1960 but was not effective until June 1961 for Guatemala, El Salvador and Nicaragua. Honduras entered the CACM in June 1962 and Costa Rica in September 1963. The Managua Treaty was the culmination of a decade of trade liberalization in Central America through bilateral and multilateral treaties.

¹⁰ The growth rates reported in table 1 were estimated by regressing the log of GDP on time.

even greater increase in the lesser developed countries of Honduras and Nicaragua. But it is a mistake to attribute to economic integration the rise in rates of growth of GDP without taking into account

TABLE I

Rates of Growth of Gross Domestic Product, 1950-61, 1961-68 and 1962-68 (per cent per annum)

	1962-68	1950-61	Difference	1961-68	1950-61	Difference
Guatemala	6.1	4.3	1.8	5.7	4.3	1.4
El Salvador	5.8	4.6	1.2	5.9	4.6	1.3
Honduras	6.6	3.5	3.1	6.5	3.5	3.0
Nicaragua	7.2	4.4	2.8	7.1	4.4	2.7
Costa Rica	7.3	6.6	0.6	7.1	6.6	0.5
Central America	6.5	4.6	1.9	6.3	4.6	1.7

Source: Rosenthal Report, *Nota-Resumen*, Table 11-6 and Appendix 1, Table 3.

other factors that affect economic growth. Central American income is particularly sensitive to fluctuations in earnings from traditional exports (notably coffee, bananas, cotton and beef) to third countries. As shown in Table II, for four of the five countries and the region as

TABLE II

Rates of Growth of Exports to Third Countries, 1951-60 and 1961-68 (per cent per annum)

	1951-60	1961-68	Difference
Guatemala	5.6	7.0	1.4
El Salvador	5.2	4.1	1.1
Honduras	1.2	9.7	7.5
Nicaragua	7.3	8.9	2.6
Costa Rica	4.3	6.9	2.6
Central America	4.8	7.1	2.3

NOTE: Fluctuations in export earnings were smoothed by using three-year moving averages.

Source: Rosenthal Report, Appendix 1, Table 10.

a whole, these export earnings grew at a faster rate in the 1960s than in the 1950s. The increase in the growth rate is particularly high in the case of Honduran exports, which grew at an average of 7.5 per cent annually in 1961-68 compared to 1.2 per cent in 1951-60.

The authors of the Report do not, however, make any adjustment for the effect of export growth on growth of GDP except in the case of Honduras. For four of the five countries, they thus assume that observed GDP growth rates for 1950-61 would have continued

into the 1962-68 period had the CACM not been formed. The 'hypothetical' 1962-68 Honduran growth rate is calculated at 2.5 percentage points higher than the actual 1950-61 rate in order to make its growth rate comparative with that of the other member countries of the CACM'.¹¹ The actual and hypothetical growth for 1962-68 shown in Table II are thus, with the exception of the adjusted Hon-

TABLE III
*Actual and Hypothetical Growth Rates of Gross Domestic Product,
1962-68 (per cent per annum)*

	<i>Actual growth rate with integration</i>	<i>Hypothetical growth rate without integration</i>	<i>Difference</i>
Guatemala	6.1	4.3	1.8
El Salvador	5.8	4.6	1.2
Honduras	6.6	6.0	0.6
Nicaragua	7.2	4.4	2.8
Costa Rica	7.3	6.6	0.6
Central America	6.5	4.9	1.6

Source: Rosenthal Report, *Nota-Resumen*, Table 11-6.

durán figure, identical to the date reported in the first two columns of table 1.¹² In short, the Rosenthal Report concludes that integration accounts for nearly all of the observed rise in growth rates, or more precisely 1.6 percentage points for the region as a whole with a greater effect in Guatemala and Nicaragua and a lesser, but positive, effect in the other three countries.

The Rosenthal Report also contains predictions for growth rates of GDP in the 1972-80 period which differ according to whether the hypothesis is collapse of the CACM (lower figures) or continued economic integration (higher figures). These predictions, which are reported in Table IV, are identical to the observed growth rates in 1961-68 and 1950-61 reported in Table I. The implicit assumption, for which there is no explanation in the Report, is that 1972-80

¹¹ Rosenthal Report, Appendix 1, section II. Perhaps because of the condensed presentation, it is not clear how it was calculated that Honduras' 7.5 percentage point increase in growth or extra-regional exports requires a 2.5 point adjustment in the GDP growth rate. Nor is it clear whether the adjustment is intended to cover all or only a portion of the export-induced increase in growth of GDP.

¹² Tables 3 and 4 are presented in the summary volume with no explanation other than a reference to the econometric model of Appendix 1. The figures published in the *Nota-Resumen* differ slightly from those shown here, presumably because of rounding errors and printing errors.

TABLE IV

*Predicted growth rates of gross domestic product with and without
Integration, 1972-80 (per cent per annum)*

	<i>With integration</i>	<i>Without integration</i>	<i>Difference</i>
Guatemala	5.7	4.3	1.4
El Salvador	5.9	4.6	1.3
Honduras	6.5	3.5	3.0
Nicaragua	7.1	4.4	2.7
Costa Rica	7.1	6.6	0.5
Central America	6.3	4.6	1.7

Source: Rosenthal Report, *Nota-Resumen*, Table 111-1.

growth rates will equal those of 1950-61 if countries withdraw from the CACM, but that the favourable 1961-68 record will again be achieved in the 1972-80 period if the CACM continues to function. There is no adjustment for differences in rates of growth of traditional exports. Nonetheless, the authors of the Report conclude:

According to the quantitative analysis presented in appendix 1, it is estimated that during the decade of 1970 Central America can attain levels [sic] of economic growth equal to or higher than those attained in the 1962-68 period—despite the unfavourable prospects for traditional exports in international markets—if a strategy of integrated development is pursued. On the other hand, . . . without integration the growth [sic] of gross internal product would exceed only slightly the rate of population growth.¹³

Despite this strong conclusion it is doubtful that a reader of appendix 1 will be convinced, for example, that Honduran GDP will grow three percentage points per year faster if that country re-enters the CACM.

These high estimates for a CACM effect on growth undoubtedly result largely from ignoring the contribution of extra-regional exports to GDP. McClelland in an earlier study assumed, like the authors of the Rosenthal Report, that 1950-61 growth trends would have continued into the future had the CACM not been formed. But he allowed for the effect of extra-regional export expansion and found that the CACM contributed approximately 0.7 percentage points to Central America's average annual growth rate of 6.5 per cent in 1962-68. In other words, an estimated 11 per cent of growth is attributable to the formation of the CACM, while 89 per

¹³ Rosenthal Report, *Nota-Resumen*, p. 48. We do not share this pessimism in respect of markets for traditional exports.

cent is attributable to past trends and an increase in traditional exports.¹⁴

A more high-powered study by Nugent disclosed a CACM effect much smaller than that implied by the McClelland or the Rosenthal Reports. Confining his analysis to the years 1950-66, Nugent found that the CACM resulted in a once-and-for-all increase in per capita income of 0.6 per cent, i.e. U.S. \$1.60 per head, when other variables

TABLE V
*Estimated Percentage Increases in Per Capita Income Attributable to
Economic Integration (regression equations using annual data for
1950-66)*

	<i>With time trend</i>	<i>Without time trend</i>
Guatemala	1.0 to 1.2	1.1 to 3.3
El Salvador	1.4	2.0 to 8.0
Honduras	4.4	3.6 to 4.3
Nicaragua	5.2	3.2 to 7.2
Costa Rica	-3.2 to 0.1	0.0 to 4.0
Central America	0.6	1.1 to 4.0

Source: Jeffrey B. Nugent, 'A Study of the Effects of the Central American Common Market and of the Potential Benefits of Further Integration', mimeo, USAID and SIEGA, Guatemala, 1971, Tables 3 and 4.

reflecting capital per head, normal growth of per capita income, international market conditions and road construction were taken simultaneously into account.¹⁵ The CACM effect on income was greatest in Nicaragua and Honduras, and the effect in Costa Rica was low or negative (see Table V).¹⁶ When the tendency for per

¹⁴ McClelland, *op. cit.*, pp. 37-38. McClelland did not estimate the effect of the CACM on growth in member countries, but such calculations would probably have resulted in estimates substantially lower than 0.7 percentage points, and perhaps even negative, for Honduras, Nicaragua and Costa Rica. This follows from the favourable export performance of those countries in the 1962-68 period. (See Table II).

¹⁵ Nugent, *op. cit.*, section IIC. The equation estimated was $\log y = \text{constant} + a \log K + b \text{ time} + c TT + d R + e \text{ CACM}$, where y is per capita GNP, k the ratio of private capital stock to population, TT the terms of trade for extra-regional exports and imports, R a dummy variable for road construction, and CACM a dummy variable that takes a value of unity in the CACM years (1963-66 for Costa Rica, 1962-66 for other countries) and zero in other years. The coefficient of R had the wrong sign except in the case of the regressions for Guatemala. The dummy variable CACM picks up any increase in per capita income due to fuller employment of capital and labour as well as changes attributable directly to the CACM.

¹⁶ The ranges shown in Table V are not confidence intervals, but rather the lowest and highest point estimates. The low estimates are derived from regressions in which fewer variables are deleted and/or there is correction for autocorrelation of residuals.

capita income to rise independently over time is excluded from the analysis, the estimates of the CACM effect rise substantially in all countries except Honduras and Nicaragua. These alternative estimates, which are reported in the second column of Table V, rest on an assumption that per capita income would not have increased independent of other variables such as capital per head in the absence of economic integration. Despite the fact that Nugent preferred to exclude the time trend from his regressions, we would argue that economic integration is not responsible for disembodied technical change, improvements in public health and education, and other variables that are correlated with time but excluded from the regression equations.¹⁷

Nugent employed a constrained Cobb-Douglas assumption that prohibits economies of scale, and he ignored the effect of the CACM on total investment, hence on capital and output. His results may therefore be biased downwards, first to the extent that the CACM has permitted the realization of economies of scale and secondly to the extent that the CACM has had a positive effect on capital formation in general, and not just on capital formation in the manufacturing sector. Available evidence suggests, however, that there is an absence of economies of scale in the manufacturing sector of the CACM.¹⁸ Moreover, there is no evidence that economic integration directly affected total private investment in any of the five Central American countries.¹⁹

Despite the low estimate for Central America as a whole, Nugent's results suggest that the CACM has had a fairly substantial and positive effect on income in Honduras. This conclusion is surprising in that it is generally felt that Honduras has benefited least from the programme of economic integration. Honduras has retained her position as the least industrial of the Central American countries, and expanded her manufacturing output at a slower pace than have the other four countries in the past decade. The CACM may, therefore, have contributed to a rise in Honduran per capita income by

¹⁷ The coefficient of the time trend is positive and usually quite significant in all regressions except those for Nicaragua. See Nugent, *op. cit.*, table 3.

¹⁸ Fernando Naranjo, 'Una Medida de Economías de Escala en las Industrias Manufactureras del Mercado Común Centroamericano', Instituto de Investigaciones, Universidad de Costa Rica, mimeo., August 1970.

¹⁹ The CACM dummy variable was not statistically significant in any of Nugent's private investment equations. (See Nugent, *op. cit.* section IV.) The econometric model in Appendix 1 of the Rosenthal Report does show levels of private investment to be higher in the CACM years than is predicted under a hypothesis of no integration. But the hypothesis of no integration consists of projecting the slower GDP growth rates of the pre-integration period into the post-integration period. As a result, investment, consumption and everything else that is a positive function of income is shown to be higher than would be predicted in the hypothetical case.

releasing resources for the expansion of the traditional export sector.²⁰ Several factors can be cited in support of such a thesis. First, Honduras is a land surplus rather than a labour surplus economy, so it is likely that a transfer of labour from protected manufacturing industries to export-oriented agriculture could have a positive effect on national income.²¹ Secondly, economic integration does appear to have resulted in trade creation in Honduras, i.e. in the replacement of Honduran production by lower cost production in partner countries.²² Thirdly, the terms of trade variable is not significant in any of Nugent's regressions for Honduras, which suggests that the export performance of that country in the 1960s was due to an increase in quantity exported (i.e. internal supply) rather than to favourable international prices.²³

In summary, there is evidence that the CACM has had a positive effect on the overall rate of economic growth in Central America, and there is little evidence of a negative effect on income in any member country. The measurement of this income effect depends crucially on the assumptions made, but our impression is that the CACM contribution to economic growth has been much less than is implied by the Rosenthal Report. Since any global type of analysis is subject to the criticism that not all contributing growth factors are accounted for, it is useful to examine the potential sources of CACM-induced growth, i.e. the impact of industrialization on the employment and allocation of resources and on prices and costs in the manufacturing sector.

Employment of Resources

One way in which the CACM may have contributed to economic growth is by stimulating the use of otherwise idle physical and human resources. Surveys of manufacturing industries in the late 1960s show that unused or idle capacity varied from a low of 29

²⁰ In a dynamic context, of course, employment and investment in import-competing industries need not decline, but only increase at a slower rate than would have occurred had Honduras not entered the CACM.

²¹ This would not be true for El Salvador, which has a population density of 164 persons per square kilometre, compared to 23 in Honduras and 36 in Central America as a whole. (Rosenthal Report, Appendix 6, Table 9.) The migration of labour from El Salvador to Honduras was the principal issue in the 1969 conflict between those two countries.

²² For details, see L. N. Willmore, 'Trade Creation, Trade Diversion and Effective Protection in the Central American Common Market', unpublished paper.

²³ Nugent, *op. cit.*, table 3. This result is in accord with I. B. Kravis' thesis that 'internal factors affecting the mobility of resources rather than external demand conditions account for good export performance'. 'Trade as a Handmaiden of Growth: Similarities between the Nineteenth and Twentieth Centuries', *Economic Journal*, December 1970.

per cent in lard to a high of 92 per cent in pharmaceutical products.²⁴ Although reliable statistics on labour unemployment are not generally available, it is estimated that unemployment amounted to eight or fifteen per cent of the labour force in 1970.²⁵ Skilled operators and managers are, however, in short supply in all five countries, and there is even excess demand for unskilled workers in certain areas at certain times of the year.²⁶ Due to an absence of data for early years, it is not known whether resource unemployment was more widespread before the formation of the CACM.

The expansion of intra-regional trade and consequent diversion of trade from foreign to Central American producers could have stimulated fuller utilization of capital in the manufacturing sector of Central America.²⁷ But simultaneously national governments in the region were competing for new investment by granting tax holidays for the establishment of new enterprises and the expansion of existing plants. Without time series data it is difficult to say what the net effect has been. In 1971, however, the average ratio of installed capacity to regional demand was 1.5 in 48 industrial plants.²⁸ The demand constraint thus prevents full utilization of installed capacity in many protected manufacturing enterprises. In short, the net effect of import-substituting industrialization in the 1960s may well have been one of a decrease rather than an increase in rates of capital utilization.

A similar conclusion applies in respect of employment of labour. Manufacturing output grew at an annual rate of 9.7 per cent during the 1960s, but manufacturing employment barely kept pace with the rate of growth of the labour force (3.1 per cent per year).²⁹ New plants have displaced artisan production with modern, capital-intensive methods of production encouraged by duty-free imports of capital equipment.³⁰

In summary, although unemployed capital and unskilled labour do exist in Central America, it is unlikely that the industrialization

²⁴ Rosenthal Report, Appendix 3, 'Addendum Estadístico', table 15.

²⁵ Rosenthal Report, *Nota-Resumen*, p. 28.

²⁶ In Costa Rica, for example, as much as twenty per cent of the coffee crop goes unharvested each year for lack of labour.

²⁷ A number of students of the CACM have assumed that the level of capital utilization rose during the CACM years. See, for example, Karel Holbik and Philip L. Swan, *Trade and Industrialization in the Central American Common Market* (University of Texas, Austin, 1972), p. 10. It is interesting to note that the authors of the Rosenthal Report make no such claim.

²⁸ Rosenthal Report, Appendix 3, Table 9.

²⁹ Rosenthal Report, Appendix 6, Sections II and III.

³⁰ 'During the past decade Central America had no employment policy and... was indifferent as to what firms did in this area'. Rosenthal Report, Appendix 3, Section V-3. See also *Nota Resumen*, pp. 28-9.

of the past decade has affected economic growth by encouraging the employment of idle resources.

Allocation of Resources

If employment of otherwise idle resources cannot account for the existence of a positive CACM effect on income, the explanation must be sought in the increased specialization that may have resulted from intra-regional trade liberalization. Standard customs union theory does emphasize the gains to be obtained from trade creation, i.e. the shift of resources from import-competing industries to export industries in which the country has at least an intra-union comparative advantage. But in the short run trade creation implies cost in the form of dislocation of labour and the loss or re-allocation of some capital investment due to the expected decline of import-competing industries. In the early years of the CACM trade creation was for this reason feared rather than welcomed in Central America.³¹

Fears of massive resource re-allocation in the wake of trade creation proved to be largely unfounded for two reasons. First, trade diversion dominated over trade creation in the region as a whole and in Guatemala, El Salvador and Nicaragua.³² This does not, of course, imply that trade creation effects were absent, but only that trade diversion dominated on balance. Secondly, most of the adjustment to trade creation in the CACM took place in the form of increased intra-industry specialization, i.e. specialization at the level of products rather than industries. Intra-industry specialization in production and trade is beneficial because a country can realize gains in efficiency through longer production runs of a smaller variety of products, with no need to abandon or halt the expansion of existing production facilities.³³ The expansion of trade in manufactures has, however, resulted in considerably less intra-industry specialization in Honduras than in other member countries, and

³¹ One of the early promoters of Central American integration notes that 'since we knew very well that the vested interests in each country, especially those interests attached to a number of high-cost industries, were not going to show much support for free trade, we emphasized new industries which did not yet exist in the region'. Jorge Sol, 'Proceso de la integración Económica Centroamericana', *Revista de la Integración Centroamericana* 4 (April 1972), p. 77. See also Jorge Borbón, *Costa Rica y la Integración Económica Centroamericana* (Asociación Nacional de Fomento Económico, San José, 1961) and C. E. Staley, 'Costa Rica and the Central American Common Market', *Economía Internacional* 15 (February 1962), pp. 117-30.

³² For details, see Willmore, op. cit.

³³ See L. N. Willmore, 'Free Trade in Manufactures among Developing Countries: The Central American Experience', *Economic Development and Cultural Change* 20 (July 1972), pp. 659-70.

only in that country is there evidence of substantial adjustment problems attributed to competition from intra-regional imports.³⁴

The Cost of Industrial Development

The gains from specialization in Central America were threatened by the fact that the CACM external tariff is generally higher than the national tariffs that existed prior to economic integration, particularly in the case of consumer goods and construction materials.³⁵ Moreover, an increasing proportion of raw materials and intermediate goods were imported free of duty in the 1960s, with the result that the available levels of effective protection greatly exceeded the already high (200 per cent) levels of nominal protection for consumer goods.³⁶

Had the prices of locally produced manufactures increased following economic integration, there would, of course, have been a negative effect on real income in the region. Surprisingly, however, the import substitution that occurred behind a high external tariff may have actually resulted in price *decreases* rather than increases on average. Price statistics in Central America are generally unreliable, so this inference is based upon the fact that the *unit values* (dollars per kilogram) of goods moving in intra-regional trade remained steady in 17 per cent and declined in 44 per cent of the ninety product categories that account for the bulk of intra-regional trade. In only 26 per cent of the categories did unit values increase by more than 10 per cent.³⁷

Although these product categories are based on responsibly dis-

³⁴ For evidence of the difficulties of resource re-allocation in Honduras' manufacturing sector, see Roberto Robleda, 'La Industria del Calzado y algunos Problemas y Perspectivas de Desarrollo', *Economía Política* (Honduras), January 1972, pp. 19-27; Jacabo Waiselfiss, 'El Comercio Exterior, El Mercado Común y la Industrialización en Relación al Conflicto', in Marco Virgilio Carías et al, *La Guerra Inútil: Análisis Socio-Económico del Conflicto entre Honduras y El Salvador* (EDUCA, San José, 1971), pp. 197-208; and 'Debe Procurarse la Protección de las Industrias que están Consolidándose', *La Industria* (Honduras), October 1971, pp. 28-29.

³⁵ The establishment of a common external tariff resulted in a rise in the weighted average tariff from 35 to 45 per cent, and a rise in the unweighted average tariff from 34 to 50 per cent. See Rosenthal Report, Appendix 2, Table 1 and Gert Rosenthal, 'The Role of Private Foreign Investment in the Development of the Central American Common Market', unpublished manuscript, 1973, table 7.

³⁶ 'The rising proportion of customs franchises for raw materials and intermediate goods given throughout the decade caused an increase in tariff protection for consumer goods; in other words the effective protection tended to rise during this period'. Rosenthal Report, Appendix 2, Section I-1.1.

³⁷ These calculations are based on a comparison of 1966 unit values with those of 1962 and are reported in McClelland, *op. cit.*, pp. 60-63. Similar calculations and conclusions for the 1964-68 period can be found in International Bank for Reconstruction and Development (IBRD), *Report of the Industrial Finance Mission to Central America* (Washington, D.C., 1971), Table 14 and p. 24.

aggregate trade statistics, they are broad enough to encompass a variety of differentiated items. In particular, decreases in quality or a rise in the importance of cheaper price lines could account for some of the observed constancy or decreases in 'prices'. Nonetheless, these defects of the statistical measure do not destroy the general conclusion that prices declined in a high proportion of cases for goods moving in intra-regional trade.³⁸ This downward price movement could result from increased specialization in an expanded market, the introduction of competition across national boundaries, and cost savings from tax exemptions that are passed on to consumers. In short, it appears that many of the Central American tariff rates are prohibitive and could be reduced without any effect on extra-regional imports or domestic output.³⁹

To conclude this section, we note that if the main objective of economic integration is to increase the rate of growth of GDP, as the Rosenthal Report implies, then the CACM in the 1960s was at best a moderate success. But if the goal of economic integration is to stimulate industrialization at a low cost in terms of forgone income, then the fact that there is little evidence of a negative CACM effect on income means that the CACM was highly successful in its first eight years of operation. The high attained rate of growth of manufacturing output, which equalled that of GDP in Honduras and exceeded the GDP growth rate in the other four countries in 1962-68, would no doubt have been more costly had it occurred autarkically with less specialization in production.

II. STAGNATION OF THE PROCESS OF ECONOMIC INTEGRATION

Even though the CACM may have had a positive effect on the economic development of Central America and of each member country, the manner in which the integration programme was carried out led to its own demise. After the formation of a common

³⁸ The use of unit values as proxies for comparing Central American to world prices is less acceptable. The importance of specific duties by weight in Central American tariffs means that the *ad valorem* equivalent tariff is higher for lower price lines, biasing extra-regional imports toward higher quality and higher priced goods. It is presumably for this reason that McClelland (op. cit., pp. 59-60) finds that in 71 per cent of the cases, 1966 unit values for goods produced in Central America were *lower* than those for imports from outside the region. The Rosenthal Report (Appendix 3, Section V-2) cites a similar study by SIECA that found unit values for intra-regional imports to be lower than unit values for extra-regional imports in 57 per cent of a total of 168 product categories in 1963 and 66 per cent of 221 product categories in 1968.

³⁹ The difference between *available* and *utilized* rates of protection may, however, be important if it represents protection against a future fall in foreign import prices or allows Central American producers to neglect quality control.

market, the process of integration lost its initial drive and began to stagnate. A number of factors account for this stagnation, but the most important are economic disparities, the lack of strong regional institutions, the absence of coordinated national and regional policies, exhaustion of the 'easy' phase of import substitution, increased economic dependence and loss of political support.

Disparities among Member Countries

The early proponents of economic integration in Central America chose to emphasize the existence of similarities rather than disparities among countries of the region, but they nonetheless accepted the principle of reciprocity of benefits as fundamental to the integration programme. Each participating country was to be assured of benefits through industrial programming, i.e. the geographic allocation of manufacturing activities on an equitable basis. Free trade and a common external tariff was to apply not to all products, but only to those for which there was prior agreement on the location of production.⁴⁰ In this manner polarization effects were to be avoided and each country would participate in the industrial development of the region.

With the signing of the Managua Treaty in December 1960, Central America abandoned this principle of reciprocity and gave priority to the formation of a free trade area in which all products produced in the region would circulate freely. This policy change left polarization tendencies unchecked and allowed market forces rather than industrial programming to determine the location of economic activity.⁴¹ Initial disparities among member countries were aggravated, for there 'is no doubt that the economic activities stimulated by the creation of the Common Market—especially in the manufacturing sector—tended to concentrate in those countries which had a relatively large national market, where the human and physical infrastructure and existing productive capacity was relatively more developed'.⁴² The Central American experience thus

⁴⁰ To quote an ECLA document, the similarities in the level of economic development of the five republics provides the basis for and even the necessity of an effort to coordinate their economic development. . . . Activities that are established with the Central American market in mind ought to be the object of free trade. . . . [but] the concept of commercial policy transcends the mere elimination of tariffs and requires formulas that guarantee access to markets. United Nations Economic Commission for Latin America, *Informe Preliminar sobre Integración y Reciprocidad Económica en Centroamérica*, 1952. The principle of reciprocity formed the basis of the Multilateral Treaty of Free Trade. (Treaty of Tegucigalpa) signed in 1958.

⁴¹ For an historical analysis of this fundamental change in Central American integration policy, see Alberto Fuentes Mohr, *La Integración Económica de Centroamérica de 1951 a 1962: Apuntes Históricos* (INTAL, Buenos Aires, forthcoming).

⁴² Rosenthal Report, *Nota-Resumen*, p. 32.

lends support to Hansen's thesis that 'backwash' effects in a customs union of developing countries are stronger than 'spread' effects, unlike the case of integration among industrial nations.⁴³

The authors of the Rosenthal Report are reluctant to attribute increased disparities to the integration programme, for each country appears to have attained a higher rate of growth of GNP within the CACM than would have been possible in the absence of integration.⁴⁴ But a developing country enters a customs union not only—perhaps not even primarily—in the hope of accelerating growth of national income, but also in the expectation of diversifying the structure of its economy through the expansion of manufacturing production. Suppose, for example, that Honduras' participation in the CCAM did increase national income, but only through the operation of trade creation effects that release resources for the expansion of traditional exports. It follows that a similar result could have been achieved through a *unilateral* reduction of Honduran tariffs, with no need to concede preferential treatment to imports from neighbouring countries.⁴⁵ In other words, the presence of trade creation and higher levels of income is not a sufficient or even a necessary condition for continued participation in an integration scheme.⁴⁶

In the CACM no procedures were set up to examine the problem of disparities among countries, to estimate the costs and benefits of the integration process, or to insure an equitable distribution of those costs and benefits.⁴⁷ Member countries have not been able to agree

⁴³ R. D. Hansen, 'Regional Integration: Reflections on a Decade of Theoretical Efforts', *World Politics* 21 (January 1969), pp. 242-71. See also R. Güsten, 'Integration Attempts and Disintegration Tendencies in Developing Countries', *Economics (Biannual Collection of Recent German Contributions to the Field of Economic Science)*, No. 7, 1973.

⁴⁴ 'It is difficult to find a relationship of cause and effect between integration and the imbalances [in intra-regional trade and production]. On the contrary, according to the analysis presented in Appendix 1, each of the countries attained a higher rate of growth than would have been possible without integration'. Rosenthal Report, *Nota-Resumen*, p. 35.

⁴⁵ See C. A. Cooper and B. F. Massell, *A New Look at Customs Union Theory*, *Economic Journal* 75 (December 1965), pp. 742-7.

⁴⁶ At the end of 1970, Honduras not only re-established tariffs on imports from the rest of Central America, but raised the tariff on many items to a rate that exceeds the CACM external tariff. Honduras thus appears to seek increments in the output of import-competing manufacturing industries, even if this is at the expense of traditional exports and national income. Congreso Nacional de Honduras, 'Medidas para impulsar la producción nacional y normar el comercio exterior', Decree No. 97, 31 December 1970.

⁴⁷ The CACM adopted three instruments to aid the relatively less developed members: régime of Integration industries, agreement on fiscal incentives and the Central American Bank of Economic Integration; but only the third has had any positive effect in practice.

collectively that the integration programme coincides with their own national interests and provides more benefits than costs for each participant.⁴⁸ Some countries thus felt that they bore excessive costs or received insufficient benefits, and have tended to resort to unilateral action when their demands are not met. These actions and the associated retaliation produced a series of crises that threatened the very existence of the CACM.

Regional institutions

A second factor that has seriously hindered the integration programme is the lack of adequate regional institutions. Central Americans have recognized the need to develop regional organizations that transcend narrow national interests. Castillo, for example, argued nearly a decade ago that 'strong Central American Institutions are essential for the continued success of the programme for economic integration'.⁴⁹ But the institutional development of the CACM has been so weak that the Rosenthal Report concludes that

during the decade of the 1960s, existing institutions were less and less appropriate for the rapid and effective resolution of the problems confronting the process of integrated development, and this contributed to the obstruction of progress in regional integration.⁵⁰

This lack of institutional maturity can best be appreciated with the aid of three concrete examples. First, each member country reserves the right to approve modifications and to administer regional agreements. Even small changes in the common external tariff, for example, require ratification by the legislative assembly of each country; and the application of the Agreement on Fiscal Incentives (tax holidays) was left in the hands of national authorities in each country. The treaties and agreements of the CACM, unlike those of the European Economic Community,⁵¹ do not provide for gradual institutional change over time.

Secondly, no institution was created to solve the conflicts that inevitably arise in a programme of integration. Intergovernmental bodies such as the Executive Council function as arbitrators, but this solution is not satisfactory because the rules for voting and for the

⁴⁸ The perception of costs and benefits may vary from one country to another; for this reason it is difficult to define precisely the concept of an equitable distribution of costs and benefits. For a detailed discussion, see E. Lizano, *Problemas Actuales de la Integración: La Distribución de Beneficios y Costos en la Integración entre Países en Desarrollo* (United Nations TD/B/394, Geneva, 1973).

⁴⁹ Carlos M. Castillo, *Growth and Integration in Central America* (Praeger Publishers, New York, 1966), p. 117.

⁵⁰ Rosenthal Report, *Nota-Resumen*, p. 38.

⁵¹ A. Etzioni, "European Unification: A Strategy of Change", *World Politics* (October 1963), p. 40.

formation of quorum in effect give each country the power of veto. Within the existing institutional framework, problems are thus left unresolved until they grow to crisis proportions.⁵²

Thirdly, no institution of a supranational character was created in the CACM. An essentially regional or 'meta-national' process was thus administered at a national level,⁵³ with the result that short-term national interests dominated the longer-term interests of the region as a whole. Moreover, it was not possible to elaborate a Central American position on national problems that affected the integration process, such as the demographic problem of El Salvador, the problem of 'balanced development' in Honduras or the monetary problems of Costa Rica.

Coordination of National and Regional Policies

Another closely related factor that has contributed to the stagnation of the integration process is the almost complete lack of coordination between national and regional policies. The CACM has not adopted any effective procedure to harmonize diverse national policies or to limit the freedom of action of member countries.⁵⁴ Moreover, it is only recently that governments have begun to realize that domestic policies do have a significant impact on the integration programme.

The treatment of direct foreign investment and the granting of fiscal incentives are two related examples that perhaps best illustrate this disregard for the effects of national policies on the integration programme. In both cases, the countries followed very liberal policies in order to attract as many new industrial projects as possible. Over the years, the negative effects of these policies began to be felt in the form of reduced tax revenues, excess capacity, and industrial production that is both capital- and import-intensive. Much of this could have been avoided had there existed Central American policies administered by regional institutions rather than national governments.

⁵² INTAL has completed a thorough study of conflict resolution in the CACM: 'Estudio Comparado de los procedimientos que de hecho se utilizan para la solución de conflictos originados en la aplicación de las reglas de libre comercio en el Mercado Común Centroamericano y en la ALALC', mimeo, 1971.

⁵³ C. M. Castillo, cited by José Sancho in 'El Marco Institucional del Mercado Común Centroamericano y las Perspectivas de un Esquema Comunitario', *Derecho de la Integración*, 13 (July 1973), pp. 63-72.

⁵⁴ One serious effort to limit the authority of national governments has not met with great success. In March 1964 the Executive Council of the CACM passed Resolution 26, which applies article IX of the Managua Treaty and prohibits the extension of duty franchises for intermediate goods and raw materials produced in the region. But 'suspension of import duty exemptions has been obtained for only 55 per cent of the 105 solicitations registered in SIECA', Rosenthal Report, Appendix 3, Section VI-4.

Other domestic policy measures have had a more immediate impact on the CACM. Costa Rica's monetary and agricultural price support policies are typical examples. That country's expansionary monetary policy led to balance of payments and exchange rate problems, restrictions on imports and a serious crisis in the CACM. A similar crisis appeared when Costa Rica, after signing an agreement on free trade in basic grains, attempted to retain price supports that were higher than those of the other four countries. The inevitable result was that producers in other countries exported a substantial portion of their crops to Costa Rica, and the price stabilization agency was flooded with foreign grain. The solution adopted by Costa Rica was not to reduce price supports, but rather to impose quotas on the importation of basic grains.

The Central American countries were either unaware of, or did not want to accept the fact that participation in an integration scheme means that social and economic policy cannot be conducted without any regard for the effects on other member countries.⁵⁵ Decision-making power has remained in the hands of national governments, with the result that in the decade of the 1960s national interests prevailed over regional interests in nearly all cases.⁵⁶

Import Substitution

The major reason for formation of the CACM was to stimulate industrialization through a process of accelerated import substitution:

Unlike what occurred in many Latin American countries, import substitution in Central America was not inspired by balance of payments problems. . . . Central America, in forming the Common Market and adopting a clearly protectionist [external] tariff, announced from the beginning a policy of 'inward-looking' industrialization.⁵⁷

But 'it appears that toward the end of the decade [of the 1960s], the 'easy' stage of import substitution was nearly exhausted',⁵⁸ and this contributed to the stagnation of an integration process that depended upon import substitution as its source of dynamism.

Why did the 'first stage' of import substitution end so quickly in Central America? Nowhere in the Rosenthal Report is this important question asked. Nevertheless, the explanation that the authors of the Report seem to have in mind is that further import substitu-

⁵⁵ 'The governments ought to recognize that the formation of a regional economic system is, in large measure, incompatible with the maintenance of a traditional concept of sovereignty, at least in economic affairs', Rosenthal Report, *Nota-Resumen*, p. 8.

⁵⁶ *Ibid.*, p. 31.

⁵⁷ Rosenthal Report, Appendix 3, Section III-1.

⁵⁸ Rosenthal Report, *Nota-Resumen*, p. 53.

tion has become difficult because of the high costs that must be borne, in part by consumers, but particularly by producers, when intermediate goods are produced in the region.⁵⁹

We would argue, however, that 'backward linkages' are difficult to form in the manufacturing sector not so much because production costs are high, but rather because short-term national interests deprive producers of intermediate goods of the protection that they require.⁶⁰ In theory, the Central American external tariff protects intermediate goods with an unweighted average duty of 35 per cent,⁶¹ and article IX of the Managua Treaty prohibits governments from extending duty franchise on goods available from producers in the region. In practice, each government is anxious to protect its industries from competitors in other Central American countries, thus freely grants franchises for the importation of inputs, including inputs available from Central American producers.

Enforcement of article IX has been left in the hands of national authorities, so in most cases there has been no enforcement of this provision of the Treaty. Import substitution is biased towards consumer goods as a result; there is particularly high effective protection for industries that are heavily dependent on imported inputs, while there is little protection for industries producing intermediate goods. Textiles, to cite only one example, can easily be supplied by existing Central American producers. Yet in 1971, extra-regional imports supplied 34 per cent of the apparent consumption of textile products while Central America's 51 textile plants were operating at only 65 per cent capacity.⁶²

⁵⁹ The Report states, for example, 'with respect to backward linkages' it should be noted that in many cases this process contains a social cost in requiring tariff protection and 'the inefficient operation of a basic industry has serious consequences not only for its own costs, but also for the costs of all the firms that use the raw materials and intermediate goods produced in that industry'. *Nota-Resumen*, p. 59 and Appendix 3, section IV-3 (p. 179). See also S. Schiavo-Campo, *Estructura y Sustitución de las Importaciones en el M.C.C.A.* (SIECA, Guatemala, 1972), who concludes that the 'first stage' of import substitution in Central America has just about run its course and suggests that 'most of the emphasis for a successful transition to a "second stage" should be placed on export expansion'.

⁶⁰ For other plausible reasons for resistance to backward linkage, see A. O. Hirschman, 'The Political Economy of Import-Substituting Industrialization in Latin America', *Quarterly Journal of Economics* 82 (February 1968), pp. 1-32.

⁶¹ This is relatively low compared to the average tariff of 122 per cent for non-durable consumer goods. These *ad valorem* equivalents were calculated by the I.M.F. and are reported in Rosenthal, *op. cit.*, table 7.

⁶² SIECA, *Análisis de la Situación Actual de la Industria Textil Centroamericana, y sus Posibilidades de Sustituir Importaciones y de Efectuar Exportaciones a Terceros Países* (SIECA/CNMC-XI/D.T.2/Rev. 1, Guatemala, 27 June 1972), tables 5 and 6, pp. 25-26. Article 14 [of the Second Protocol of Managua], which prohibits the concession of duty franchises for the importation of pure or mixed cotton yarn and for cloth of any fibre, was not always fulfilled, and even the Central American

A large number of plants producing a wide variety of intermediate goods are operating at very low levels of capacity utilization, have shut down, or have switched to the production of consumer goods as a result of violations of article IX. But there have been a few cases of success as well. The glass container factory in Guatemala, for example, has not encountered serious problems even though it is the only plant of its kind in Central America and is highly dependent on markets in the other four countries. Part of its success may be attributed to the fact that its fob prices are only 10 per cent higher than the c.i.f. prices of imports;⁶³ but more important is the fact that the major consumers of glass containers in the region are important shareholders in the company.⁶⁴ One way to promote backward linkages may thus be to encourage the formation of multinational Central American companies so that consumers of intermediate goods are also owners of the means of production.⁶⁵

Economic Dependence

The process of integration was intended to reduce Central America's dependence on the rest of the world, but it has actually increased economic dependence in three different ways. First, foreign investors took advantage of many of the opportunities created by the formation of a protected regional market.⁶⁶ Secondly, regional institutions have been financed in large part by donations from foreign governments, especially the United States, because member countries have not contributed enough funds to meet even current expenses.⁶⁷

Economic Council agreed to exceptions from this rule. *Ibid.*, p. 19. We do not deny that there has been some import substitution of textiles. We have cited this precisely to show that the process of import substitution has got 'bogged down' even in the 'easy' import substitutes.

⁶³ Rosenthal Report, Appendix 3, 'Addendum Estadístico', table 14.

⁶⁴ Hirschman (op. cit., p. 21) notes that if a consumer of an intermediate product also owns the plant producing it, 'most of the... objections to the expansion of manufacturing via backward linkage fall to the ground'. His point becomes less relevant, of course, as the number of consumer-owners increases.

⁶⁵ A similar argument is presented in a somewhat different context by Roberto López in *Empresas de Accion o Capital Multinacional en Centroamerica* (SIECA, Guatemala, 1972).

⁶⁶ Rosenthal (op. cit., p. 385) estimates that 'something like 30 per cent of total industrial production in Central America in 1968 was turned out by plants partially or totally financed by foreign capital, while these same plants held slightly over one third of total industrial fixed assets'. He also shows (p. 393) that 'direct foreign investments have played a very significant role in the level of intra-regional exports during the past decades. In the case of Guatemala, sales of wholly or partially owned foreign enterprises accounted for 44.6 per cent of manufactured products exported to the rest of the region...'

⁶⁷ Foreign agencies, for example, provided 88 per cent of the 1967 budget of the Organization of Central American States, and 40 to 50 per cent of SIECA'S budget in recent years. Rosenthal Report, Appendix 9, Section IV-A.

Thirdly, because import substitution is biased toward consumer goods, Central America has become increasingly dependent on imported raw materials and intermediate goods. When balance of payments problems arise, it is more difficult to curtail imports of intermediate than final goods because import restrictions on inputs affect output and employment as well as consumption.⁶⁸

Groups that previously supported the integration process have become disillusioned with the increased dependency that has resulted. Local entrepreneurs face competition from foreign-owned plants, the aspirations of intellectuals and technocrats have been frustrated, and national bureaucrats find it more difficult to control some of the major economic variables of their country. This discontent has contributed to the stagnation of the process of economic integration.

Political Support

Perhaps the most serious obstacle to Central American integration is the lack of groups within the power structure of each country that support the integration process. The authors of the Rosenthal Report lament the fact that 'during the past decade, no important pressure groups arose to defend the conformation of economic unity in Central America',⁶⁹ but they fail to add that the integration programme lost much of the support it had once held.⁷⁰

It is true that some groups never supported economic integration; but neither did they effectively oppose it. Consumers and workers, for example, are poorly organized and play no active political role in Central America. Farmers and the traditional export interests provide another example. These groups had no particular interest in a programme of integration and industrialization that threatened to raise the price of inputs and the wages of labour; nevertheless, their opposition was minimal.⁷¹

In contrast, the integration programme in the early years did receive considerable support from industrialists, technocrats, national

⁶⁸ Another factor that has made balance of payments policy more difficult is the increasing importance of payments to foreign investors in the form of dividends, royalties and technical assistance fees. See *ibid.*, section III-B and Rosenthal, *op. cit.*, pp. 256-76.

⁶⁹ Rosenthal Report, *Nota-Resumen*, p. 38.

⁷⁰ One symptom of this loss of support is the fact that newspaper coverage of the CACM and Central American affairs declined in member countries after 1963. M. A. Seligson, 'Transactions and Community Formation: Fifteen Years of Growth and Stagnation in Central America', *Journal of Common Market Studies* XI.3 (March 1973), pp. 173-90.

⁷¹ 'The main participants in the decision-making process were the national bureaucrats, the private producers and the regional technocrats'. I. Cohen, *Regional Integration in Central America* (Lexington Books, 1972), p. 82.

bureaucrats and intellectuals. But over time these groups lost faith in the programme.

The industrialists had perhaps the most to gain from the integration-process, and showed the most interest in its continuation. In each crisis that arose, the chambers of industry were prepared to offer advice and pressure for settlement. But various factors have caused this group to reduce their support: the exhaustion of 'easy' import substitution, competition from direct foreign investments, the feeling of Honduran industrialists that integration provides them with insufficient benefits, the possibility of losing what has already been obtained (protected intra-regional trade of US \$350 million a year) if they try to obtain more, and finally the availability in recent years of other options such as subsidized extra-regional exports. The industrialists, in short, are no longer leaders of the integration process.

The technocrats played a very important role in the early stages of economic integration,⁷² but they eventually learned that it is not easy to transform influence into power when governments retain tight control of the decision-making apparatus. When the technocrats recognized that their position was precarious, they avoided taking a stand on controversial issues. Thus 'the tecnicos gave up their role as agents of change and became the agents of the status quo'.⁷³

The national bureaucrats accepted integration willingly, for they saw in it the possibility of resolving social and economic problems of the member countries. But they soon learned that integration presents a series of problems such as declining revenues from import duties and the reactions of other member countries to 'domestic' policy decisions. The bureaucrats were not prepared to face these problems, and this diminished the initial acceptance of integration by this group.

The intellectuals at first saw in integration the possibility of affirming Central American autonomy through economic union. This position changed radically over time as they saw the emergence of a new type of dependency in the CACM. A large proportion of the intellectuals now openly oppose the integration programme, which they regard as merely another opportunity for international capitalism to dominate under-developed countries.

In summary, Central Americans have become disillusioned with a framework of integration that appears to create additional prob-

⁷² See Joseph S. Nye, Jr., 'Central American Regional Integration', *International Conciliation* 562 (March 1967).

⁷³ Cohen, *op. cit.*, p. 85.

lems rather than solve existing social and economic problems. The recurring crises of the CACM have not represented creative opportunities as hoped for by Haas and Schmitter,⁷⁴ but rather a process of continual attrition. The 'spread-around' attributed by Schmitter to the CACM has led to stagnation rather than 'spill-over' into the political arena.⁷⁵

Two things could pull the CACM out of its current impasse: an external catalyst⁷⁶ or a politicization of the process. With regard to the first, it remains to be known why the United States, which acted in the role of external catalyst for so many years, has not made any effort to resolve recent crises with regard to a possible politicization. The Rosenthal Report is precisely an attempt to elaborate and propose such an alternative.

III. PROPOSALS FOR A RESTRUCTURED COMMON MARKET: TOWARD THE INTEGRATED DEVELOPMENT OF CENTRAL AMERICA ?

To the authors of the Rosenthal Report 'in Central America "development" and integration are inseparable concepts . . . For the future, integration represents the most adequate response . . . to the principal social and economic problems of Central America'.⁷⁷ But for the integration programme to be viable, 'it is not sufficient to return to the situation that existed prior to the conflict [between El Salvador and Honduras in 1969] and substantial modifications must be made in the scheme which then operated among the five countries'.⁷⁸ In the jargon of Central American technocrats, there is need to 'perfect and restructure' the Central American Common Market.

The Proposed Strategy

What are the salient features of the strategy proposed in the Rosenthal Report? Table VI provides a synopsis of the principal aspects of this strategy, the main policy instruments to be used, and the results that are expected.⁷⁹

⁷⁴ E. B. Haas and P. C. Schmitter, 'Economics and Differential Patterns of Political Integration: Projections about Unity in Latin America, *International Organization* 18 (August 1964), p. 716.

⁷⁵ P. C. Schmitter, 'Central American Integration; Spill-over, Spill-around or Encapsulation?', *Journal of Common Market Studies* IX.1 (September 1970), pp. 1-48.

⁷⁶ See Joseph S. Nye, Jr., 'Patterns and Catalysts in Regional Integration', *International Organization* 19 (Autumn 1965), pp. 870-84.

⁷⁷ Rosenthal Report, *Nota-Resumen*, pp. 6-7.

⁷⁸ *Ibid.*, pp. 5-6.

⁷⁹ Table VI does not pretend to be complete, for the Report contains more than a hundred specific proposals. Some of the items that we have classified as 'policy

1. *Formation of an economic community*: Many of the Report's proposals for institutional reform are intended to provide regional institutions with sufficient autonomy to protect community interests from short-term national interests. The proposed Central American Economic Community would have not only inter-governmental agencies, but also community institutions, including an independent Tribunal composed of persons approved by the Supreme Court of each member country. Many of the crises that have plagued the CACM would be avoided with community institutions that facilitate (i) the coordination of national policies with those of the region; (ii) the prevention, or at least the anticipation, of problems that are in the process of integration; (iii) the analysis of national problems in the light of the integration programme; and (iv) rapid resolution of conflicts that do arise.

2. *Equitable distribution of costs and benefits among member countries*: The Report recognizes that 'balance among countries constitutes a primary requirement of the strategy' along with a 'reasonably equitable distribution of costs and benefits', for these aspects are 'indispensable if the participation of all members is to be retained in the process'.⁸⁰ Concrete proposals to aid the relatively less developed countries include the assignment of economic activities to specified countries, preferential financing through the central American bank for Economic Integration, priority in external technical and financial aid, and more generous tax concessions for investors that locate their plants in the less developed countries of the region.⁸¹ Even a partial solution to this problem of economic disparities will help to remove one of the main obstacles to Central American integration.

3. *Participation of social groups*: The Report stresses that integration requires the active participation of many interest groups, and suggests that 'the lack of broad participation in the integration process is nothing more than a reflection of what occurs at the national level in each country'.⁸² Participation would thus be encouraged both at the national level, when development plans are drawn up, and at the regional level, when major decisions are made. At both levels interested parties would be guaranteed the right to express their points of view and to influence policy. This broadened participation

instruments' are, of course, worthy and ambitious goals in their own right. See SIECA, *Resumen Esquemático* (SIECA/CAN-I/D.K., Guatemala, October 1973).

⁸⁰ Rosenthal Report, *Nota-Resumen*, pp. 62, 56 and 101.

⁸¹ *Ibid.*, pp. 101-2.

⁸² *Ibid.*, pp. 39-40.

would have several positive effects: (i) the decision-making process would become more open and pluralistic, (ii) interest groups would form to support integration, and (iii) controversial aspects would be debated before they gave rise to crises.

4. *Increase in demand for Central American products.* The Rosenthal Report recommends income redistribution in each country as the main instrument to increase demand, for the 'horizontal' expansion of the market was completed in the 1960s, and 'now the principal way to attain a dynamic increase in demand . . . is by expanding the market vertically through a significant increase in the income of those segments of the population that currently live at the margin of the market economy'.⁸³ The proposals to stimulate the consumption of Central American inputs through industrial programming and the prohibition of duty exemptions (except for a draw-back on extra-regional exports) would also have an effect on demand, but this receives less emphasis in the Report. Demand for Central American products in third countries would be encouraged through active export promotion and the negotiation of preferential tariffs in other markets.⁸⁴ Increased demand would create new investment and employment opportunities, and thus greater possibilities for economic growth.

5. *Coordination of external economic policies.* In order to obtain more benefits from relations with third countries, the Report recommends that the five countries coordinate their policies with regard to (i) direct foreign investment in the region; (ii) bargaining for better terms for traditional and non-traditional exports to industrial countries; (iii) external finance; (iv) transfer of science and technology; and (v) restrictions on imports, when necessary. This coordination of policies would allow Central America to increase its autonomy and decrease its dependence on decisions made outside the region.

Political Feasibility

The proposed strategy would overcome most of the obstacles to Central American integration, but what is the possibility that member countries will accept and implement such a strategy? Given the social and political realities of Central America in the 1970s, our opinion is that there is little chance of this occurring.

⁸³ *Ibid.*, p. 53.

⁸⁴ Surprisingly, the Report does not recommend any subsidies for non-traditional exports other than a draw-back of duties paid on imported inputs. El Salvador and Costa Rica, however, recently began to provide subsidies for non-traditional, extra-regional exports, and other countries are likely to follow their lead.

Many of the crucial proposals in the Report require member countries to transfer administrative and decision-making power to community institutions. A common policy on fiscal incentives and direct foreign investment, for example, requires community ad-

TABLE VI
Synopsis of the strategy

<i>Strategy</i>	<i>Policy Instruments</i>	<i>Goals</i>
1. Formation of an economic community	Community institutions with considerable autonomy	Balance national interests with those of the region
2. Equitable distribution of costs and benefits among member countries	Coordination of social and economic policies Geographic allocation of industrial activities Establish priorities for external aid	Avoid crises caused by disparities among countries
3. Participation of social groups	Selective fiscal incentives Participation of private groups in community and national decision-making bodies	Pluralist decision-making Strengthen interest groups that support integration
4. Increase demand for Central American products	Income re-distribution in each country Promotion of extra-regional exports Encourage backward linkages	Accelerate growth of output and employment in each country
5. Coordination of external economic policies	Coordinate policy with regard to direct foreign investment, trade, foreign debts, and transfer of science and technology	More autonomy and less dependence

ministration and sanctions; otherwise each government will, in the future as in the past, attempt to increase its manufacturing output at the expense of other member countries. The proposals to encourage backward linkages, promote non-traditional exports and reduce economic disparities all depend, in large measure, on the regional implementation of a common industrial policy, on the transfer of power to community institutions.

The lack of political pluralism in Central America is a serious obstacle to any transfer of power to community institutions. Political power in each country tends to be vested in a relatively small group

of persons who rule in their own self-interest rather than in the interest of a broad electorate.⁸⁵ These dominant groups are extremely reluctant to relinquish their tight control of social and economic policy. The process of integration requires member countries to cede some of their natural sovereignty, and it is precisely for this reason that integration is not likely to advance very far in Central America.

The oligarchic power structure of Central America is also an obstacle to the implementation of the proposed domestic reforms, namely income re-distribution and pluralistic decision-making. It should be remembered that many of the groups that wield economic and political power accepted the CACM as an *alternative* to domestic reform. The freeing of intra-regional trade, for example, allowed countries to widen the market 'horizontally' and avoid widening it 'vertically' through a re-distribution of national income. For this reason, we can expect the dominant groups to oppose any strategy of integration that requires economic and social reform.

In sum, the process of integration depends primarily on social and political change in each member country.⁸⁶ It is not possible to expect such a substantial reform of the integration programme as the one proposed in the Rosenthal Report when this depends in turn on improbable changes in the internal political structure of each country.

Conclusion

The Rosenthal Report is a document that is both useful and important. It is useful because it contains a large amount of previously unpublished data and because it analyses a decade of integration in a way that is always provocative even if not always convincing.⁸⁷ It is important because for the first time since the late 1950s, technocrats have had the courage to act as agents of change in presenting a coherent set of controversial proposals for reform.

There is little doubt that if adopted, the proposals of the Rosenthal Report would accelerate both economic integration and economic development in Central America. To force the pace of integration is, however, to attempt to accomplish the impossible,

⁸⁵ Nye suggests that dominant groups in Central America conceive of 'government power less as a means of transforming than as a means of ensuring a share of economic resources for themselves and their clique'. 'Central American Regional Integration', *op. cit.*, p. 14.

⁸⁶ External forces are also of obvious importance in the case of countries as small as those of Central America.

⁸⁷ In our opinion, much of the economic analysis of the Report would have been improved had there been less reliance on the results of a questionable econometric model.

given the existing structure of power in the countries of the CACM. But if the pace of integration cannot be forced, it is still worthwhile to patch over some of the more glaring inequalities and inefficiencies, to create a viable though less than perfect programme of integration. Sidney Dell wrote over a decade ago 'if there is any region in the world that could benefit from economic integration, that region is Central America'.⁸⁸ His observation is equally valid today.

⁸⁸ *Trade Blocs and Common Markets* (Alfred A. Knopf, New York, 1963), p. 206.