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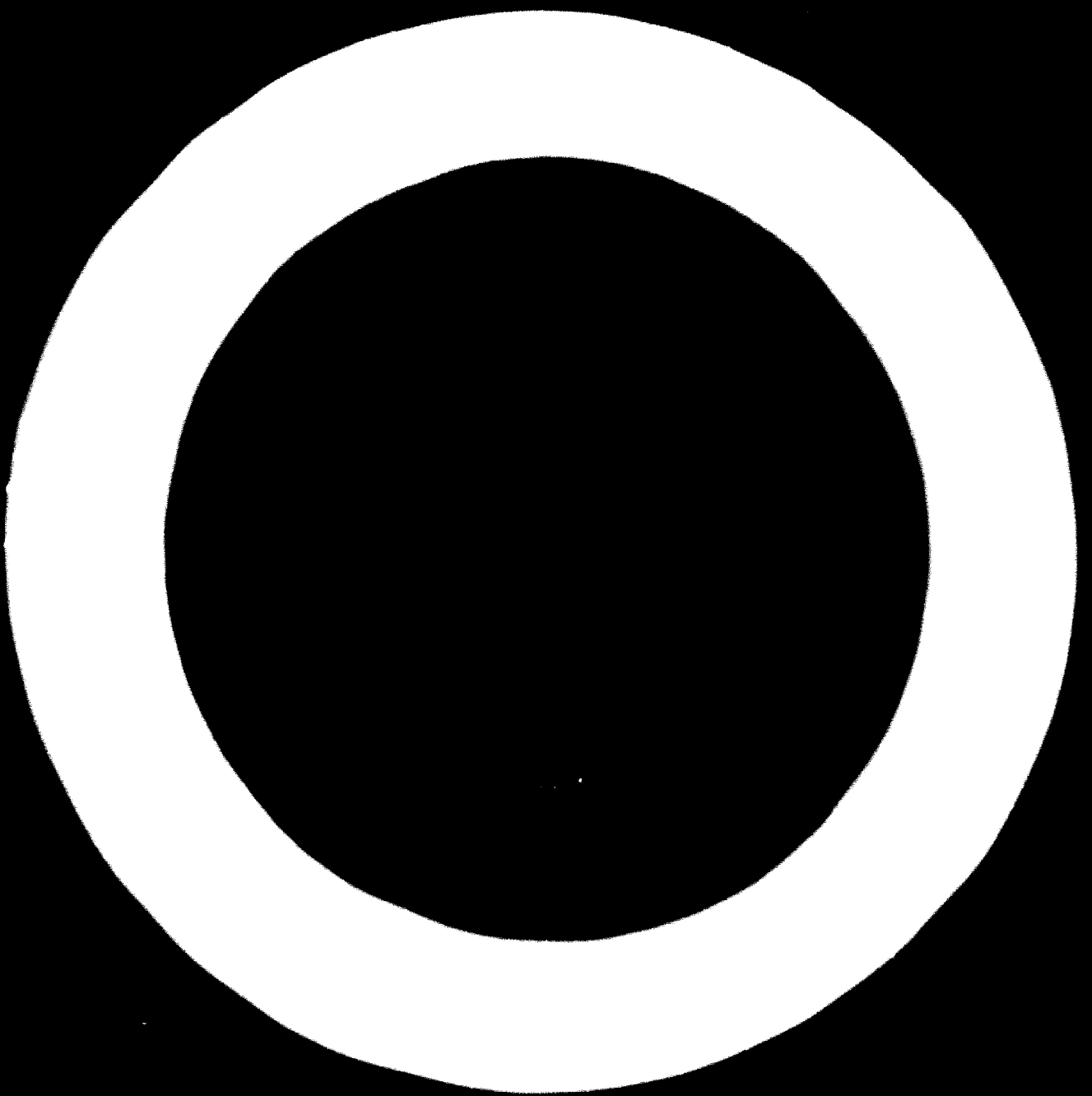
An Appreciation of the Major Problem Areas  
and Scope for UNIDO Action<sup>1/</sup>

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Following the meeting of the Expert Group on Regional Industrial Co-operation in Vienna from 6 - 10 December, 1971, in which I participated, UNIDO invited me to prepare my own personal appreciation of the major problem areas with respect to regional industrial co-operation and the scope for UNIDO action to facilitate well-founded schemes. <sup>1/</sup>

1. The merits of regional co-operation as a means of promoting economic development in developing countries are today widely accepted. It affords an opportunity to obtain gains from specialization, gives access to economies of scale and can facilitate cost-reducing structural change. These advantages can be obtained not only by larger and more advanced countries, but also by small countries which are at an early stage in their economic development. Recognition of its utility has given rise to a considerable number of groupings in different parts of the world. Most of the existing groupings have in their early stages placed much emphases on trade liberalization. It is now accepted however, that effective co-operation demands more than trade liberalization, important though that is, because the purpose of co-operation is not merely to promote the development of exchange and specialization amongst existing industries and plants, but in particular to promote the purposive development of investment in new plants and new industries on a regional basis. For a variety of reasons, this calls for a co-ordination of industrial development.

2. At the present time, however, it is fair to say that, despite the apparent merits of regional co-operation for industrial development, achievements have been modest and certainly disproportionate to the efforts devoted to promoting it.

3. Trade liberalization has been substantially achieved, or maintained in groupings such as the Central American Common Market, UDEAC, the East African Community. Limited progress towards trade liberalization has also been made in LAFTA. Progress towards influencing by regional agreement the pattern and distribution of industrial investments has by contrast been minimal, except in some cases, for certain infrastructure projects. It is to be noted, however, that in some

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<sup>1/</sup> The Report of the Expert Group Meeting has been reproduced as document ID/WG.111/2. Discussion was based on an issue paper prepared by UNIDO, document ID/WG.111/1. Both documents are available in English, French and Spanish.

new groupings, such as the Andean Grouping, industrial co-ordination is being made a condition of major steps towards trade liberalization.

The heart of the problem

4. At the outset, it seems necessary to consider briefly two related questions. First, what makes it so important to adopt agreed measures to influence the distribution and pattern of industry in regional groupings of developing countries, and secondly why has it proved to be so difficult to effect such agreement if there are indeed recognized benefits to be derived from co-operation. The first question poses itself inasmuch as control over the distribution of industry has nowhere been a pre-condition of economic co-operation in groupings of advanced countries such as EEC and CMEA.

5. The answer to these two questions is to be found in an interrelated group of considerations. In the first place, industrial development in developing countries is promoted primarily by means of protective tariffs or quantitative restrictions. Such measures almost inevitably have the result that purchases from a partner country will involve an excess cost over the cost of importation from the rest of the world. Consequently each country will have an interest in keeping tariffs as low as possible on the product it buys from his partners while at the same time endeavouring to ensure that the tariffs on the products which it-self produces are adequately protective. Secondly, although it is the case that regional co-operation through market sharing makes possible the exploitation of economies of scale and specialization within the region, if each partner has automatic access to the others free of tariffs or other restrictions, industries may be established which provide little or no benefit to the region as a whole. If a country can sell a substantial part of its output of a plant in protected markets of a partner country, those markets in effect subsidise expanded employment and income generation in the producing country. Where national planning takes account of the national value added in its national industrial promotion activities it is not difficult to see how, in these circumstances, conflicts of interest may arise. They will exist however, though they may not be so important even where the industrial

promotion activities of the state are modest. Thirdly, since factors of production have to be paid, even where the value added in a particular project in a regional grouping may be substantial, the surpluses generated for the public sector are frequently modest and limited to the direct and indirect tax revenue generated. This is important to bear in mind because, apart from the possibility of utilising differential pricing policies as between the national market and the markets of the partner countries, these surpluses constitute the only readily accessible source of finance from which it might be possible to effect some redistribution of the costs and benefits which accompany economic co-operation. It must be recorded however, that the practice of using fiscal transfers as partial alternative to distributing benefits by controlling the location of industry has so far been limited. Finally, the long run contribution of industrial development to the process of structural transformation will obviously be closely bound up with its location.

6. These considerations must be seen as operating in conjunction with the observed tendency for market forces in regional groupings of developing countries to produce a concentration of industrial development in the more advanced member countries. This development is commonly accompanied by trade imbalances amongst the members of the grouping which are symptomatic of the inequitable distribution of costs and benefits which often accompanies unco-ordinated regional co-operation arrangements.

7. The implication of these considerations is that the benefits from regional industrial co-operation must be expected to be limited and any arrangements inherently unstable if there is no effective means for ensuring balanced and co-ordinated industrial development in the grouping. Experience suggests that if co-ordination cannot be effected by direct or indirect policy measures the outcome will be intense and unproductive competition for industry on a national basis, giving rise to a proliferation of competing plants, frequently operating with excess capacity. In this way the advantages which a regional market can afford to industrial development by enabling economies of scale and specialization to be obtained may be partly, or in the limiting case, wholly dissipated.

8. It can thus be seen that the problems involved in influencing the allocation of industrial plants in a way which is both efficient and politically acceptable are central to productive regional co-operation among developing countries, and the expert group naturally gave much more attention to them. It was in this context that particular consideration was given to the use of a "package approach" as a means of facilitating agreement on the allocation of selected industrial plant, and also to the possible role of multinational companies as instruments for resolving the interest conflicts inherent in regional groupings as these generally constituted. These two approaches it should be noted, are not necessarily related. Although some analysts have certainly seen the multinational corporation as a suitable instrument for implementing an agreed package deal, others have viewed it essentially as an instrument for implementing specific isolated projects of regional interest, and in this context as a convenient means for effecting an equitable distribution of the benefits which accompany its activities.

9. It must of course be borne in mind that the object of regional industrial co-operation is not to promote or facilitate agreement per se but to facilitate agreements which result in tangible gain to the members which could not otherwise have been obtained. Irrespective of the approach employed, if the only agreements which are negotiable, result in a loss of most of the benefits from co-operation, there will be little to be said for co-operation as a development strategy. For this reason, particular attention should be centred upon the means for promoting agreements which involve the least losses from foregone scale economies, uneconomic dispersion of plants etc. This calls for careful evaluation of the alternatives on a regional basis.

#### Sharing the benefits of industrial co-operation

10. Before commenting upon some of the issues raised by the two approaches on which the expert group focussed its attention, some remarks on the appropriate analytical framework for evaluating integration initiatives and possibilities is therefore called for. It would be out of place in a brief appreciation of regional industrial co-operation problems and issues to discuss the role of different approaches to the initial selection of projects and their merits and possibilities. These matters were



considered by the expert group which felt, as can be seen from the report, that, despite the merits of approaching the problem of project selection within a comprehensive programming framework, there were considerable practical difficulties in the path of such an approach, and that, at an operational level, a more pragmatic approach was called for. This is a viewpoint that an acquaintance with planning techniques in many countries provides ample support for.

11. In relation to the problem of determining the optimal pattern of location and scale of new plants and industries within a region, the same considerations which limit the applicability of comprehensive programming techniques in relation to the optimal choice of projects and sectors in national and regional planning analyses also hold. Although the techniques have been worked out by economists, their practical application is constrained not only by data problems but also by computing problems. Consequently even if input/output tables and other required data were available for the countries of the group, the techniques could only be applied to a consideration of two or three projects for allocation among several countries, or several projects for allocation among two or three countries.

12. An alternative approach would be to follow a partial equilibrium approach and to look only at the inputs and outputs of the projects considered for allocation with a view to minimizing their costs of production and distribution, assuming fixed demands for the product at specified locations within the area. To employ this approach, it would be necessary to know the extent of the markets for the products, its input requirements at all relevant scales of output, and to have information on transport costs of both inputs and outputs within the region and from outside. It would then be desirable to calculate the cost to each member of the grouping of buying the goods subject to scale economies from the minimum cost location points in the region and to compare this with the cost of importing from the rest of the world or producing the goods locally. Such an approach has been attempted in the Brookings Institute study for LAFTA.

13. Where data on these matters is not available, resort to a third approach may be necessary, namely a project appraisal of identified projects utilizing for this purpose pre-feasibility studies and attempting merely to determine the optimal location for each project with some consideration of whether alternative locations are feasible.

14. Of course, whichever of these approaches is followed, the optimal allocation will frequently be found to be unacceptable having regard to the objective of balance accepted in the group. It will then be necessary to consider other allocations consistent with alternative feasible industrial distributions amongst which the policy makers can choose. The objective will be to minimise the economic cost of any adjustment in the least cost location which may be necessary on equity or distributional grounds or to meet the national developmental objectives of the member countries. But the optimal study is an essential pre-requisite.

15. It is self evident that whatever is the approach to industrial co-ordination followed - whether it is the integration industry system attempted in Central America, the complementarity approach of LAMTA or the package approach which was tried and abandoned in East Africa, the loss inherent in the trade off between the optimal location and considerations of equity should be minimised. This is unlikely to result from a simple project appraisal approach, however, which does not in itself throw up the required information.

#### The package approach

16. Nevertheless, up to the present time, it is basically this third approach, or something very close to it which has been followed in nearly all evaluations of industrial co-ordination among developing countries. These studies usually rest on, or embody, pre-feasibility studies. They give little attention to detailed market analyses, transport costs or the implications of varying scales of production. The studies are rarely detailed enough to estimate costs of production, or to enable the required degree of protection to be indicated for a plant producing a defined range of products or lines. They cannot therefore serve to

enable the costs and benefits to the various partners of the indicated allocation to be adequately evaluated, nor do they provide the material on which the basis of appropriate alternatives might be selected.

17. They therefore fail to provide useful guidance on several counts. In the first place the mere fact that industries may be feasible on a regional basis is no guarantee that an acceptable distribution will be feasible at the levels of protection implicitly afforded. Secondly, if such schemes are used as a basis of a package deal they may result in an outcome which though negotiable, has little economic merit. Finally, if package deals are arranged on the basis of pre-feasibility studies, projects which form part of the initial package may drop out, thus upsetting the nice initial balance, and prejudicing the stability of the projected arrangements.

18. If the package approach is to be employed therefore, it will be desirable for the pre-feasibility studies of industries which may be considered for development on a regional basis to be followed by quite detailed feasibility studies which could be used for the purpose of negotiating a workable package. There will be a natural reluctance on the part of member countries to incur the costs of feasibility studies for industries which they may not in the end get, and it is desirable also that the evaluations should not be unnecessarily replicated. This suggests that there will be an important role for the central secretariats or development banks in these exercises and in this connection some form of joint financing of such studies as is envisaged through the Fund to be established in the Central American Common Market might be of considerable advantage for this purpose.

19. The expert group rightly stressed the importance of evaluating the implications of a range of alternatives in relation to regional industries, namely (i) continuing to rely upon imports; (ii) establishing national plants to serve national markets; and (iii) establishing regional plants to serve part or all of the regional market. Only if this is done can the full implications of co-operation be seen. It is however necessary to recognize that to enable this to be done would

involve collecting information for the purpose of estimating the effects on production costs of operating at different scales and the effects on costs of separating off certain stages in the production process. Information would also be required on costs of transportation and on markets not merely for broad product categories but for precisely specified ranges of products. Some of this information could be collected (though this is rarely done) in the groupings concerned but other information would have to be based on information from other countries or regions, modified to fit local conditions.

The use of multinational regional companies

20. In the context of resolving the conflict of interests involved in regional industrial co-operation, the idea of carrying out single projects or groups of projects of regional interest through the medium of multinational regional companies has received some attention in recent years. The idea was discussed by the group from a number of standpoints but particularly from the standpoint of the role of such companies as instruments for spreading benefits where for instance, technical or economic reasons prevent this from being attempted adequately by means of a package deal involving the dispersement of industrial plants or processes throughout a region.
21. There is a tendency to assume perhaps too readily, that the mere establishment of multinational industries will suffice to resolve the interest conflicts in regional groupings. Plainly, however, this is not so, for the same problems remain to be resolved, whether or not such instruments are used instead of, for instance, relying upon the licensing of private enterprises by a package deal. In the first place, agreement must be reached upon the crucial question of location. Apart from this, agreement would have to be reached upon price and employment policies, profit distribution, capital contribution, taxation, etc. An enumeration of these issues makes it clear that the same issues have to be resolved whatever the institutional form adopted for the enterprise which are the vehicles through which industrial development is effected.

- 2 -

22. This is not to say, of course, that the establishment of multinational enterprises, in the sense of regional companies which are partly or wholly owned by the member states, may not afford more scope for mitigating the problems which arise in relation to the distribution of costs and benefits from regional co-operation than do other forms of enterprise. For instance, it is quite unrealistic to suppose that more than a crude balance of costs and benefits can be achieved by direct controls over industrial location, except in a very costly way. Supplementary adjustments through the operations of the companies themselves could therefore be of value and would be easier to achieve through the instrumentality of a purely private enterprise. Hence there appears to be scope and indeed a need to examine the implications of dealing with cost benefit problems through the operations of such corporations. Issues which call for examination include the constraints upon the use of pricing policies as a means of redistributing benefits, the implications of various forms of differential pricing policies for resource allocation and specialization within the group, etc. Specific consideration of such issues, which has not so far been undertaken, would enable the contribution and the limitations of the use of this mechanism to be seen more clearly.

Indirect approaches to achieving regional balance. •

23. An alternative approach to the problems of balance and co-ordination which the expert group touched upon is the so-called "indirect" approach. This involves the elaboration of incentives which operate more or less automatically in such a way as to encourage balance. Thus specially favourable incentives may be offered to enterprises which locate in the more backward members of a grouping, or positive barriers may be imposed to hinder development in the more advanced countries. Such measures are usually envisaged as operating automatically and administrative intervention is confined to determining eligibility according to prescribed conditions. Bearing in mind the drag on industrial development which will be involved by a need to get previous inter-governmental agreement on the location of particular projects, there is much to be said for making at least some use of this approach, perhaps limiting inter-governmental negotiation to a few major projects. However, it

must be recognized that a willingness to employ this approach implies a willingness to accept balance in terms of the quantity of development rather than its character, for though it would be possible to devise automatic arrangements which would have regard not only to the scale of development but also its character, the administrative complexities of doing so would be considerable and there is only one known case in which it has been attempted.

24. Accepting this however, an initial question which has to be considered concerns the objects which are to be sought by differentiation of policy instruments. Presumably it will be designed to overcome a country's putative disadvantage as an industrial location which **manifests itself** in higher costs of production. But it is then necessary to reach agreement on the extent of the cost disadvantage which is to be overcome, and on whether only temporary or also continuing disadvantages are to be dealt with in this way. Clearly, if all cost differentials are to be offset within the region by differentiated incentives, the advantages of regional co-operation may be substantially eliminated. These matters thus require further consideration in the light of the objectives of regional policy and the alternatives evaluated in the same way that similar issues are considered in relation to protection against the rest of the world. Once again then it is to be emphasized that the use of the indirect approach does not get around the difficulties of interest conflict, it merely presents them in a different form.

25. The use of the indirect approach also raises the question of the effectiveness of different policy measures as incentives to balanced development and their detailed implications. An evaluation is needed of this aspect. A useful starting point would be to consider different fiscal incentives in relation to their effect on internal rates of return. Other differential incentives could be evaluated with respect to the same yardstick.

Harmonization of policy measures

26. Discussion of the use of differentiated fiscal measures leads to the question of the harmonization of other policy measures in relation to the promotion of a co-ordinated industrial structure. This matter was thought to be important by the expert group although the subject received little specific consideration. In view of this one or two general comments may not be out of place.
27. It is of course evident that the purpose of trade liberalization and industrial co-operation may be entirely frustrated by the imposition of quantitative restrictions, exchange obstacles and so on. The group rightly drew attention to these aspects of policy and to the need to take steps to ensure that the beneficial effects of agreed industrial co-ordination measures would not be frustrated by contrary-acting measures in these other fields. From the standpoint of productive co-ordination it is indeed just as important to deal with these obstacles by clear-cut conventions, and to develop arrangements for their enforcement as to eliminate the more evident obstacles to co-ordinated industrial development.
28. This said however, there are several important considerations to be borne in mind in this connection, which are sometimes lost sight of. The first is that in arrangements for regional industrial co-ordination, decisions on the extent to which it is desirable to harmonize non-tariff policies whether in the field of structural policies (taxation, etc.) or in the field of macro-policies (monetary policy, exchange rate policy, etc.) must presumably be taken in the light of the magnitude of the costs which failure to harmonize will impose on the individual countries and the region. Many aspects of policy will be relatively unimportant from this point of view and can be safely disregarded. Secondly, even where this is not the case, any impairment of developmental effects which may arise from a failure to harmonize these other policies must be balanced by the member countries against the opportunities which unharmonized policies afford them to pursue more effectively other national objectives in the fields for example of income distribution, income stabilization, etc. this balance will frequently argue for a refusal to harmonize.

29. It is nevertheless plain that some co-ordination of policy instruments will be required. This is particularly important in the case of taxation where co-ordination of jurisdictional principles will almost certainly be required if an appropriate pattern of specialization is not to be frustrated. It is questionable however, how far it is necessary to go in co-ordination in other directions. For instance, effective co-ordination does not appear to demand a harmonization of indirect tax rates, nor of social security provisions.

30. The theory of harmonization has been worked out by economists at some length and there is much practical experience of dealing with these issues in some of the more developed groupings such as EEC. It would be helpful if this work could be considered in relation to the special problems of groupings of developing countries with a view to delimiting clearly the areas where co-ordination of systems and methods is important and for which a minimum of agreement among the member countries is called for. But even if this were not done, it would clearly be necessary to give particular attention to this problem in evaluating the opportunities and problems of an actual or potential economic grouping of developing countries.

#### Alternative to the import-substitution strategy

31. It will be plain from what has been said already that the case for regional industrial co-operation and the conflicts of interest which arise, stem basically from the pursuit of an import-substitution strategy, and in particular, from the methods chosen to protect industry. It is worth considering therefore, whether some of the difficulties of regional industrial co-operation might not be overcome if different methods of promoting industry were to be followed. This question was raised at the expert group meeting but there was insufficient time to enable it to be pursued.

32. The point at issue is this. Although there is a sound case for giving special encouragement to industry in the interests of promoting economic development in developing countries, it is arguable that, for a variety of reasons, this should not be done through tariffs since



these devices discourage the development of agriculture and of export industries which are forced to use high cost local substitutes for imports. If instead industry were directly subsidized to take account of local factor scarcities and external benefits conferred by industry, greater efficiency and higher employment would be encouraged.

35. From the standpoint of this paper, the bearing of such a policy is that it would presumably substantially reduce the need for industrial co-ordination and the case for the formation of economic groupings and the conflicts inherent in the pursuit of import substitution policies on a regional basis. Protective tariffs could presumably be very low, and if the policy succeeded in its objective of making industries cost-competitive, very little if any additional cost would in general be involved in buying a neighbour's product rather than one from the rest of the world. Thus a major area of conflict in industrial development would be eliminated. The need for some degree of industrial co-ordination in a region would remain, but it would presumably be much reduced. It would be limited to those cases in which economies of scale are important and where transport costs within the region are much lower than those between the region and the rest of the world. In such cases it may not be profitable to realize economies of scale by exporting the product outside the region although it may be profitable to do so within the region. Hence if the plant is to be established within the region it may be necessary for assurances to be provided that other countries within the region will not also build similar plants or at any rate, will not discriminate against it. Apart from these industries, investment decisions could be made solely by national governments, or by private enterprises, without the need for inter-governmental consultation. This is an important advantage for the need to enter into such consultations and to effect such agreement before investment decisions are taken by the state or commitments entered into with private investors is undoubtedly an important brake on development. Moreover, if industrial co-ordination by the path of inter-governmental agreement is pursued, the scale of the negotiating problem will certainly increase as the level and variety of industrial development increases in less developed countries.

Issues and problem areas requiring further work.

34. This appreciation concludes with suggestions for action arising from the issues and problem areas identified. Useful suggestions for further work in relation to regional industrial co-operation must clearly take account of what is already going on and the characteristics of existing technical assistance exercises. In this connection it must be noted that substantial work programmes are under way under the auspices of UNIDO, UNCTAD, ECA, ECAF, CDFP, etc. Nevertheless, it is my impression that gaps remain to be filled in relation to what may broadly be termed supporting activities, and also that there is room for improving the usefulness of the technical assistance services provided.
35. As to UNIDO itself, the emphasis of its work so far has been operational. To improve its value and to give it direction in the field of industrial co-operation it would be of value for a variety of supporting activities to be initiated designed to develop practical solutions or ways of contributing to such solutions, for the problems discussed earlier in this appreciation.
36. In the first place, if projected schemes of industrial co-ordination are to be properly evaluated and effective schemes formulated, it will be necessary for information to be compiled relating to the way in which costs vary with plant size and with the composition of output. This information would presumably be based on technological studies but it could usefully be supplemented by studies of manufacturing costs and prices and of the price competitiveness of plants in developing countries. There is an additional need to analyse for a selected range of industries, the obstacles and costs involved in separating particular stages of production in the interests of regional industrial balance. It is understood that some regional groups of developing countries are in the process of collecting information of this kind. They might be invited to consider making it available to UNIDO. In the meantime a programme of research might usefully be developed at UNIDO into the implications of these matters and regional groups encouraged to consider the collection of cost and price information on a standardized basis with a view in due course to UNIDO's making available the experience to the members of other groupings.

37. UNIDO so far has been called upon only to undertake pre-feasibility studies in relation to industrial possibilities in regional groupings. It is apparent from these studies and equally from those made by other UN organizations and indeed also by private consultants, that there is a need, even at a comparatively early stage of evaluation, for much more attention to be given to detailed market research if the implications of particular patterns of regional industrial development are to be clarified adequately for the participants. Such market studies need to be carried out not merely for broad product groups, as has usually been the case, but for fine product groups. These studies may then be related to the cost evaluations referred to in para 36 above and considered in relation to their implications for the developing pattern of regional trade.

38. Related to the second requirement, there appears to be a need to develop skills in UNIDO which would permit of the evaluation and direction of market studies undertaken on behalf of requesting parties in connection with technical assistance assignments. It is difficult to overemphasise the importance of adequate market studies in connection with regional co-operation evaluations. Too often, short cut methods and impressionistic approaches are employed. These are insufficient to justify any given operation and inadequate to enable costs and required levels of protection to be determined and thus the implications of the proposals for the various participants to be clearly understood.

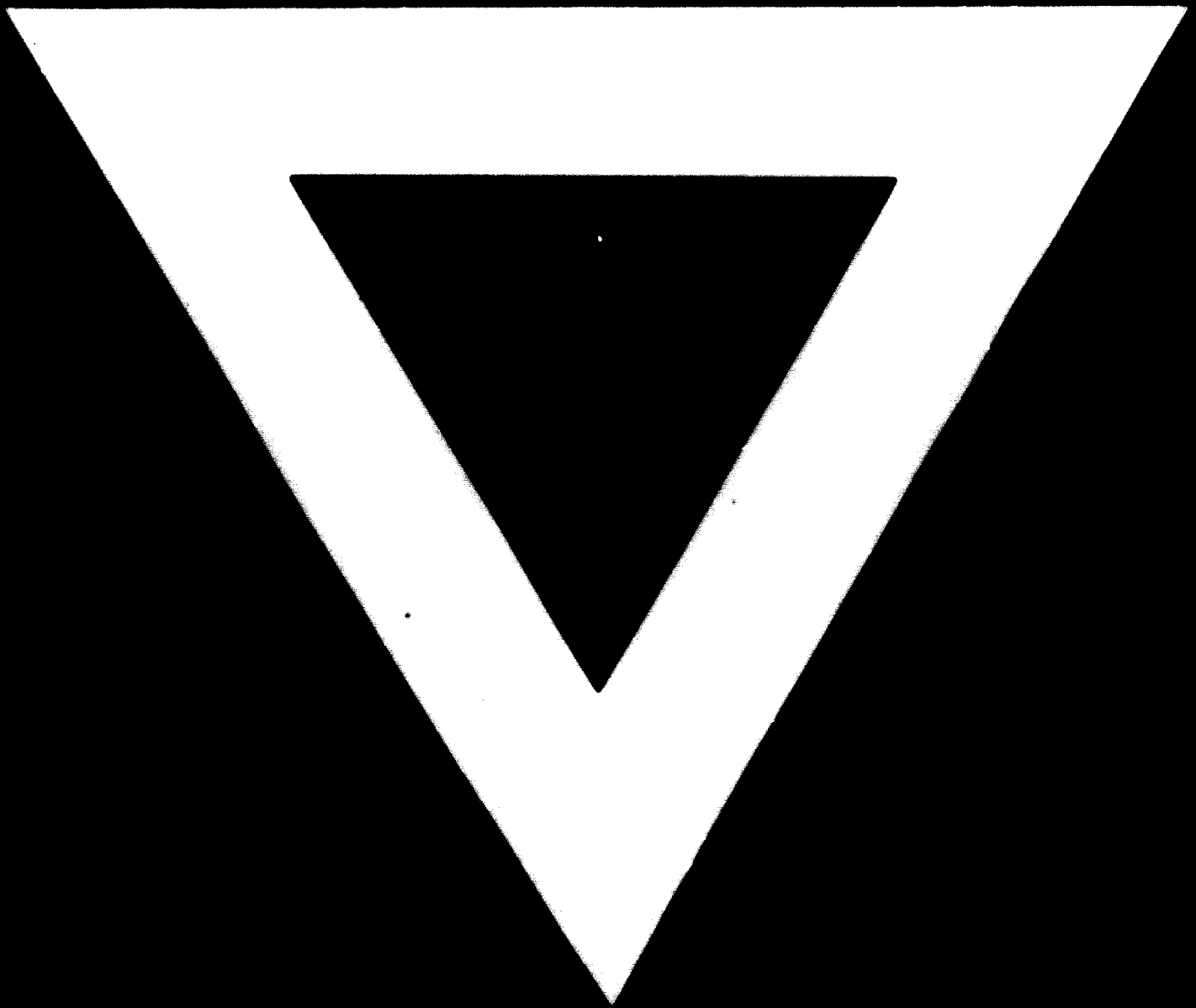
39. No one familiar with the field can fail to be struck by the scarcity of penetrating evaluative studies of particular policy instruments and experience with their use in groupings of developing countries. These would be valuable for the purpose of evaluating their impact, the range of alternatives and perhaps, for the purpose of providing detailed guidelines to other groups contemplating their use. Such studies should of course, place great emphasis on the practical problems of implementing such measures.

40. Other consultants to UNIDO have suggested the desirability of a study being undertaken of the ways in which subsidies might replace

tariff protection as the major incentive for promoting industrial development in developing countries. The idea behind this proposal is to promote exports, the efficient use of factors, and other desirable policy objectives. Such a study however has not been conceived from the standpoint of its implications for regional industrial co-operation. Prima facie however, as shown above, such a proposal would have important implications for regional co-operation. It is therefore suggested that if this study is undertaken, it should be supplemented by one in which the implications of the change for regional industrial harmonization are fully explored.

41. In conclusion, two final general points should perhaps be made. First of all, although the emphasis of this appreciation has been upon regional industrial co-operation with particular reference to UNIDO's work, not all of the suggestions which have been made for studies are necessarily wholly appropriate for UNIDO. Where they are, it is in any case vital that UNIDO should work closely with other agencies which have developed programmes in this field, particularly UNCTAD, since there are many areas where interests, experience and expertise overlap. Secondly, some of the suggestions made essentially involve supporting rather than operational activities but there are narrow financial limits to the amount of supporting work which can be undertaken by UNIDO. Some of the suggestions could nevertheless be implemented in the course of undertaking operational assignments. However, if this work is not carried out either to backstop technical assistance projects, or in the course of them, as is appropriate, it must be anticipated that there will continue to be carried out a variety of pre-feasibility analyses which insufficiently illuminate the issues and which fail to provide a satisfactory basis for decision taking by interested governments.





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