18 The Theory of Economic Integration: An Introduction

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Federalists, functionalists, and neofunctionalists in the postwar period were largely concerned with the political results of integration, even if some of them (i.e., most federalists and functionalists) paid little attention to the political dimension of the integration process. They were, after all, chiefly interested in the peaceful resolution of international conflict. Postwar economists were also interested in the integration process in Europe but for different reasons. They were engaged in describing the process of economic integration and its impact on welfare. As war among West European nations became unthinkable in the years immediately following World War II, the economic gains of integration became the chief motive for continuing the process. Thus, the work of the economists took on added importance.

Bela Balassa (1928–1991), a professor of political economy at The Johns Hopkins University, was one of the most productive students of economic integration. Drawing on the work of Jacob Viner and others, Balassa made a major contribution to our understanding of the effects of integration on trade and other economic activities in the 1960s and 1970s. In this introductory chapter to his important work, The Theory of Economic Integration *(1961), Balassa defines economic integration, identifies its stages, discusses political and ideological aspects of the integration process, and specifies what he means by "economic welfare." Finally, Balassa argues that functional*

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integration, while, perhaps, politically expedient, is not as economically defensible as "the simultaneous integration of all sectors."

■ THE CONCEPT AND FORMS OF INTEGRATION

In everyday usage the word "integration" denotes the bringing together of parts into a whole. In the economic literature the term "economic integration" does not have such a clear-cut meaning. Some authors include social integration in the concept, others subsume different forms of international cooperation under this heading, and the argument has also been advanced that the mere existence of trade relations between independent national economies is a sign of integration. We propose to define economic integration as a process and as a state of affairs. Regarded as a process, it encompasses measures designed to abolish discrimination between economic units belonging to different national states; viewed as a state of affairs, it can be represented by the absence of various forms of discrimination between national economies.

In interpreting our definition, distinction should be made between integration and cooperation. The difference is qualitative as well as quantitative. Whereas cooperation includes actions aimed at lessening discrimination, the process of economic integration comprises measures that entail the suppression of some forms of discrimination. For example international agreements on trade policies belong to the area of international cooperation, while the removal of trade barriers is an act of economic integration. Distinguishing between cooperation and integration, we put the main characteristics of the latter—the abolition of discrimination within an area—into clearer focus and give the concept definite meaning without unnecessarily diluting it by the inclusion of diverse actions in the field of international cooperation.

Economic integration, as defined here, can take several forms that represent varying degrees of integration. These are a free-trade area, a customs union, a common market, an economic union, and complete economic integration. In a free-trade area, tariffs (and quantitative restrictions) between the participating countries are abolished, but each country retains its own tariffs against nonmembers. Establishing a customs union involves, besides the suppression of discrimination in the field of commodity movements within the union, the equalization of tariffs in trade with nonmember countries. A higher form of economic integration is attained in a common market, where not only trade restrictions but also restrictions on factor

movements are abolished. An economic union, as distinct from a common market, combines the suppression of restrictions on commodity and factor policies, in order to remove discrimination that was due to disparities in these policies. Finally, total economic integration presupposes the unification of monetary, fiscal, social, and countercyclical policies and requires the setting-up of a supra-national authority whose decisions are binding for the member states.

Adopting the definition given above, the theory of economic integration will be concerned with the economic effects of integration in its various forms and with problems that arise from divergences in national monetary, fiscal, and other policies. The theory of economic integration can be regarded as a part of international economics, but it also enlarges the field of international trade theory by exploring the impact of a fusion of national markets on growth and examining the need for the coordination of economic policies in a union. Finally, the theory of economic integration should incorporate elements of location theory, too. The integration of adjacent countries amounts to the removal of artificial barriers that obstruct continuous economic activity through national frontiers, and the ensuing relocation of production and regional agglomerative and deglomerative tendencies cannot be adequately discussed without making use of the tools of locational analysis.

■ THE RECENT INTEREST IN ECONOMIC INTEGRATION

In the twentieth century no significant customs unions were formed until the end of the Second World War, although several attempts had been made to integrate the economies of various European countries. Without going into a detailed analysis, political obstacles can be singled out as the main causes for the failure of these projects to materialize. A certain degree of integration was achieved during the Second World War via a different route, when—as part of the German *Grossraum* policy—the Hitlerites endeavored to integrate economically the satellite countries and the occupied territories with Germany. In the latter case, economic integration appeared as a form of imperialist expansion.

The post–Second World War period has seen an enormous increase in the interest in problems of economic integration. In Europe the customs union and later the economic union of the Benelux countries, the European Coal and Steel Community, the European Economic Community (Common Market), and the European Free Trade Association (the "Outer Seven") are manifestations of this move-

ment. Plans have also been made for the establishment of a free-trade area encompassing the countries of the Common Market and the Outer Seven, but negotiations in the years 1957–60 did not meet with success. However, concessions offered in early 1961 by the United Kingdom with regard to the harmonization of tariffs on non-agricultural commodities give promise for the future enlargement of the Common Market in some modified form.

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The interwar period has witnessed a considerable degree of disintegration of the European and the world economy. On the European scene the mounting trade-and-payments restrictions since 1913 deserve attention. Ingvar Svennilson has shown that, as a result of the increase in trade impediments, the import trade of the advanced industrial countries of Europe shifted from the developed to the less developed economies of this area, which did not specialize in manufactured products. This shift implies a decline in competition between the industrial products of the more advanced economies and a decrease in specialization among these countries. But lessening of specialization was characteristic not only among the more advanced European economies but also of the European economy as a whole. This development can be demonstrated by trade and production figures for the period of 1913–38. While the volume of commodity production in Europe increased by 32 per cent during those years, intra-European trade increased by 10 per cent. The formation of a European union can be regarded, then, as a possible solution for the reintegration of European economies.

Another factor responsible for the disintegration of the European economy has been the stepping-up of state intervention in economic affairs in order to counteract cyclical fluctuations, sustain full employment, correct income distribution, and influence growth. Plans for economic integration are designed partly to counteract the element of discrimination inherent in the increased scope of state intervention.

A related argument regards the establishment of customs unions as desirable for mitigating cyclical fluctuations transmitted through foreign-trade relations. The foreign-trade dependence of the European Common Market countries decreases, for example, by about 35 per cent if trade among the six countries is regarded as internal trade. The memory of the depression in the 1930s gives added weight to this argument. Note, however, that for this proposition to be valid, there is need for some degree of coordination in countercyclical policies among the participating countries.

Last but not least, it is expected that integration will foster the growth of the European economies. This outcome is assumed to be the result of various dynamic factors, such as large-scale economies on a wider market, lessening of uncertainty in intra-area trade, and a faster rate of technological change. In this regard, the increased interest in economic growth has further contributed to the attention given to possibilities of economic integration.

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To summarize, economic integration in Europe serves to avoid discrimination caused by trade-and-payments restrictions and increased state intervention, and it is designed to mitigate cyclical fluctuations and to increase the growth of national income.

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■ INTEGRATION AND POLITICS

In examining the recent interest in economic integration, we have yet to comment on the role of political factors. There is no doubt that—especially in the case of Europe—political objectives are of great consequence. The avoidance of future wars between France and Germany, the creation of a third force in world politics, and the re-establishment of Western Europe as a world power are frequently mentioned as political goals that would be served by economic integration. Many regard these as primary objectives and relegate economic considerations to second place. No attempt will be made here to evaluate the relative importance of political economic considerations. This position is taken, partly because this relationship is not quantifiable, partly because a considerable degree of interdependence exists between these factors. Political motives may prompt the first step in economic integration, but economic integration also reacts on the political sphere; similarly, if the initial motives are economic, the need for political unity can arise at a later stage.

From the economic point of view, the basic question is not whether economic or political considerations gave the first impetus to the integration movement, but what the economic effects of integration are likely to be. In some political circles the economic aspects are deliberately minimized and the plan for economic integration is regarded merely as a pawn in the play of political forces. Such a view unduly neglects the economic expediency of the proposal. Even if political motives did have primary importance, this would not mean that the economist could not examine the relevant economic prob-

lems without investigating elusive political issues. By way of comparison, although the formation of the United States was primarily the result of political considerations, nobody would deny the economic importance of its establishment.

We shall not disregard the political factors, however. Political *ends* will not be considered, but at certain points of the argument we shall examine various economic problems the solution of which is connected with political *means* and political processes. We shall explore, for example, how the objective of exploiting the potential benefits of economic integration affects the decision-making process. Changes in the decision-making process, on the other hand, become a political problem. Nevertheless, we shall go no further than to state the need for coordinated action in certain fields and will leave it for the political scientist to determine the political implications of such developments.

■ THE "LIBERALIST" AND THE "DIRIGIST" IDEAL OF ECONOMIC INTEGRATION

The recent interest in economic integration has prompted various proposals concerning the means and objectives of integration. Two extreme views—an all-out liberalist and a dirigist solution—will be contrasted here. The champions of economic liberalism regard regional integration as a return to the free-trade ideals of the pre–First World War period within the area in question and anticipate the relegation of national economic policy to its pre-1914 dimensions. If this approach is followed, integration simply means the abolition of impediments to commodity movements. At the other extreme, integration could also be achieved through state trading and through the coordination of national economic plans without the lifting of trade barriers. This alternative discards the use of market methods and relies solely on administrative, nonmarket means. It can be found in the integration projects of Soviet-type economies; the operation of the Council of Mutual Economic Assistance, comprising the Soviet Union and her European satellites, is based on the coordination of long-range plans and bilateral trade agreements. A similar method, but one which put more reliance on market means, was used by Germany during the last war. In this study we shall examine problems of economic integration in market economies and shall not deal with Nazi Germany and Soviet-type economies. Nevertheless, we shall see that dirigistic tendencies appear in the writings of some Western authors, too.

Among the proponents of the liberalist solution, Allais, Röpke, and Heilperin may be cited. They regard economic integration as identical with trade (and payments) liberalization. Allais asserts that "practically, the only mutually acceptable rule for close economic cooperation between democratic societies is the rule of the free market." Röpke is of the opinion that European economic integration is nothing else than an attempt to remedy the disintegration of the post-1914 period that destroyed the previous integration of national economies. A less extreme position is taken by Heilperin, who rejects the consideration of regional development plans and subsidies to industries for reconversion purposes but accepts state responsibility for investment decisions in certain areas. To the majority of observers, however, the liberalist ideal of integration is a relic from the past, and its application to present-day economic life appears rather anachronistic. As Jean Weiller put it, "It would be a great error to believe that the decision to create a regional union would re-establish the conditions of an economic liberalism, extirpating with one stroke all so-called dirigistic policies."

It can rightly be said that considerations such as the avoidance of depressions, the maintenance of full employment, the problems of regional development, the regulation of cartels and monopolies, and so forth, require state intervention in economic life, and any attempts to integrate national economies would necessarily lead to harmonization in various policy areas. This idea is not new. The need for the coordination of fiscal, monetary, social, and countercyclical policies was stressed in the League of Nations study on customs unions published immediately after the end of the Second World War. In fact, the question is not whether government intervention is needed or not in an integrated area, but whether economic integration results in a more intensive participation of the state in economic affairs or in a more intensive reliance on market methods.

Some authors advocate an intensification of state intervention in economic affairs. The need for economic planning in a union is emphasized, for example, by André Philip and by other French Socialists. In Philip's opinion, "there is no alternative to a directed economy," since "the market can be extended not by liberalizing but by organizing." Although not an advocate of centralized planning, the stepping-up of state intervention is also recommended by Maurice Bye, who contrasts his "integration theory" with Heilperin's "market theory." Considering the pronouncements of French economists and industrialists, it can be said that, by and large, the French view of economic integration contains more dirigistic elements than, for example, that of most German economists and entrepreneurs.

The defenders of dirigistic tendencies fail to consider, however, the lessening of planning and government intervention—and the beneficial effects thereof—in Europe since the end of the Second World War. Although this change does not indicate a return to the pre-1914 situation, it brought about an increased use of the market mechanism and contributed to the spectacular growth of the European economy during the 1950's. It appears, then, that a reintroduction of dirigistic methods would slow down, rather than accelerate, future growth. State intervention may be stepped up in some areas, such as regional development planning, and will also be required to deal with transitional problems, but it is expected that an enlargement of the economic area will intensify competition and lead to less interference with productive activities at the firm level. Therefore, those who regard the European Common Market as a *marché institué* err in the opposite direction from the holders of old-fashioned liberalist views.

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■ ECONOMIC INTEGRATION AND WELFARE

It can be said that the ultimate objective of economic activity is an increase in welfare. Thus, in order to assess the desirability of integration, its contribution to welfare needs to be considered. But the concept of welfare is fraught with much obscurity. First, the noneconomic aspects present some ambiguity; second, even restricting the meaning of the concept to "economic welfare" in the Pigovian tradition, we are confronted with the well-known difficulties of interpersonal comparisons if we try to say anything over and above the Pareto condition: an increase in one man's welfare leads to an increase in social welfare only if there is no reduction in the welfare of any other members of the group. In the case of integration, economic welfare will be affected by (a) a change in the quantity of commodities produced, (b) a change in the degree of discrimination between domestic and foreign goods, (c) a redistribution of income between the nationals of different countries, and (d) income redistribution within individual countries. Accordingly, distinction is made between a real-income component and a distributional component of economic welfare. The former denotes a change in potential welfare (efficiency); the latter refers to the welfare effects of income redistribution (equity).

With regard to potential welfare, separate treatment is allotted to changes in the quantity of goods produced and changes in their distribution. First, there is an increase (decrease) in potential welfare

if—owing to the reallocation of resources consequent upon integration—the quantity of goods and services produced with given inputs increases (decreases) or, alternatively, if the production of the same quantity of goods and services requires a smaller (larger) quantity of inputs. If we regard inputs as negative outputs, we may say that a rise in net output leads to an increase in potential welfare. A higher net output entails an increase in potential welfare in the sense that a larger quantity of goods and services can now be distributed among individuals so as to make some people better off without making others worse off. Second, potential welfare is also affected through the impact of economic integration on consumers' choice. Restrictions on commodity movements imply discrimination between domestic and foreign commodities; a tariff causes consumers to buy more of lower-valued domestic and less of higher-valued foreign goods. The removal of intra-union tariffs will do away with discrimination between the commodities of the member countries but will discriminate against foreign goods in favor of the commodities of partner countries. In short, economic efficiency means efficiency in production and efficiency in exchange, and an improvement in one or both constitutes an increase in potential welfare.

Given a change in potential welfare (the real-income component), we also have to consider the distributional component in order to determine changes in economic welfare. It can easily be seen that an evaluation of changes in income distribution would require interpersonal comparisons of welfare. The new welfare economics, however, does not admit the possibility of making interpersonal comparisons. As a possible solution, it has then been suggested that changes in welfare could be determined in terms of potential welfare; that is, the *possibility* of making everybody better off (or, at least, no one worse off) would be taken as equivalent to an increase in economic welfare. This proposition can be criticized primarily on the grounds that the hypothetical situation *after* compensation is irrelevant if compensation actually does not take place. Nevertheless, changes in the real-income component give a good approximation of changes in welfare *within a country,* since compensation is politically feasible, and in case of integration this would actually be carried out to some degree in the form of assistance to relocating workers or reconverting firms. In addition, a nation can be regarded as an entity, where a redistribution of income accompanying an increase in real income can be accepted—provided that the redistribution does not run counter to generally accepted ideals of equity.

The distribution component cannot be neglected if economic integration redistributes income between countries, especially be-

tween the member states of a union, on the one hand, and the nonparticipating economies, on the other. It is not possible to claim an increase in world welfare in every case when the increase in real income in the participating countries will be greater than the loss to third countries. This proposition would hold true only if international comparisons of welfare could be made or if we disregarded differences in the marginal utility of income between countries. The first possibility was ruled out above, and the equality of the marginal utility of income is no less implausible. According to some, the marginal utility of income in an underdeveloped economy might be two or three times as high as in the rest of the world. If such a view were accepted, a union of developed economies which would register gains in the real-income component might still reduce world welfare by redistributing income from "poor" to "rich" countries.

In the preceding discussion we have followed the customary exposition of welfare economics in using the concept of potential welfare in a static sense. Thus an increase in potential welfare was taken as equivalent to an improvement in the allocation of resources at a point of time. Static efficiency, however, is only one of the possible success criteria that can be used to appraise the effects of economic integration. Instead of limiting our investigation to a discussion of efficiency in resource allocation under static assumptions, greater attention should be paid to the impact of integration on dynamic efficiency. I have elsewhere defined dynamic efficiency as the hypothetical growth rate of national income achievable with given resource use and saving ratio. In technical terms, whereas static efficiency would require that the economy operate on its production-possibility frontier, dynamic efficiency can be represented by the movement of this frontier in the northeast direction. The concept of dynamic efficiency can be used in intercountry comparisons to indicate which economy is capable of faster growth under identical conditions with regard to resources and saving, or, alternatively, it can be applied for comparing the growth potentialities of an economy at different points of time. In the present context, we wish to compare the hypothetical growth rate attainable *before* and *after* integration, under the assumption of given initial resources and saving ratio.

Given the static efficiency of an economy, the main factors affecting its dynamic efficiency are technological progress, the allocation of investment, dynamic interindustry relationships in production and investment, and uncertainty and inconsistency in economic decisions. In addition to these factors, the actual growth of national income would also be affected by an increase in the proportion of national income saved and/or by interference with the individual's

choice between work and leisure. Changes in the latter variables will be disregarded here, partly because we assume that they are but rarely affected by economic integration, partly because their effects cannot be evaluated in welfare terms, given the disutility of increased saving and/or work. Under these assumptions an increase in the rate of growth can be considered as equivalent to an improvement in dynamic efficiency and represents a rise in potential welfare.

In evaluating the effects of economic integration, we shall use dynamic efficiency as the primary success indicator, taking into account both changes in the efficiency of resource allocation in the static sense and the dynamic effects of integration. In addition, attention will be paid to the impact of integration on income distribution, on the regional pattern of production and income, and on the stability of the participating economies.

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■ THE SECTORAL APPROACH TO INTEGRATION

In this chapter, distinction has been made between various forms of economic integration. All these forms require concerted action in the entire field of economic activity, be it the abolition of customs barriers or the coordination of fiscal policies. Another approach to economic integration would be to move from sector to sector, integrating various industries successively. The application of this method had already been commended in the interwar period, and it found many champions in the period following the Second World War. Proposals were made to integrate various sectors such as the iron and steel industry, transportation, and agriculture. The Stikker Plan advocated the integration of national economies by removing barriers, industry by industry. Supporters of this view contended that national governments were more inclined to make limited commitments with reasonably clear implications than to integrate all sectors at the same time. The flexibility of this method was also extolled, and it was hoped that integration in one sector would encourage integration on a larger scale.

From the theoretical point of view, various objections can be raised against the sectoral approach. Whereas the simultaneous integration of all sectors allows for compensating changes, integration in one sector will lead to readjustment in this sector alone, the reallocation of resources in other sectors being impeded by the continued existence of tariffs and other trade barriers—hence the losses suffered by countries whose productive activity in the newly inte-

grated sector contracts will not be compensated for until the next phase. More generally, under the sectoral approach every step in integration results in a new and temporary equilibrium of prices, costs, and resource allocation, and this "equilibrium" is disturbed at every further step. Production decisions will then be made on the basis of prices that are relevant only in a certain phase of integration, and shifts in resource allocation will take place which may later prove to be inappropriate. On the other hand, the adjustment of relative prices and the reallocation of resources proceed more smoothly if all sectors are integrated at the same time, since some industries are expanding, others contracting, and unnecessary resource shifts do not take place.

Integration sector by sector puts an additional burden on the external balance also. At various steps, pressures will be imposed on the balance of payments of countries where the newly integrated sector is a high-cost producer. In the absence of exchange-rate flexibility, this process unnecessarily burdens exchange reserves in some, and inflates reserves in other, participating countries. If, on the other hand, exchange rates are left to fluctuate freely, temporary variations in rates of exchange will bring about transitional and unnecessary changes in the international division of labor.

In addition, lack of coordination in monetary, fiscal, and other policies is likely to cause difficulties under the sectoral approach, since differences in economic policies can lead to perverse movements of commodities and factors. For example, if inflationary policies are followed in one country while deflationary policies are pursued in another, an overadjustment will take place in the integrated sector (or sectors), while trade barriers restrict adjustments in other industries. Finally, any joint decisions made with respect to the integrated sector will affect all other branches of the participating economies.

A noneconomic objection of considerable importance should also be mentioned here. The sectoral approach is bound to bring about a conflict between producer and user interests in individual countries. In countries with relatively high production costs, for example, users will welcome integration because of its price-reducing effect; high-cost producers, however, will object to it. Experience suggests that producer interests have greater influence on governmental decisionmaking; hence these pressures are likely to have a restrictive effect on integration if the sectoral approach is followed. The interests of exporting and importing countries being opposed, there can be no "give and take"—the necessary pre-condition for intercountry agreements in most practical instances.

These theoretical objections suggest the inadvisability of integration sector by sector. This conclusion does not mean, however, that integration in one sector may not be beneficial if political obstacles hinder integration in all areas. The European Coal and Steel Community is a case in point. At the time of its inception, the realization of a European Common Market was not yet possible, but the governments of the participating countries were prepared to accept a limited measure of integration. The establishment of the Coal and Steel Community has been conducive to the expansion of production and trade in the partaking industries, and the Community demonstrated the possibility of integration in Europe, thereby contributing to the establishment of the Common Market.

It has also been argued that the difficulties of adjustment in production and trade in the Coal and Steel Community have been less than expected because the considerable increase in the national incomes of every participating country has made adjustment easier. This does not, however, rule out the possibility of maladjustments in other industries which will not be corrected until trade barriers are removed in all sectors. In addition, the Coal and Steel Community has encountered serious difficulties with respect to transportation policies, fiscal and social problems, etc., which have been due—to a great degree—to the fact that integration extends over only one sector.