1. Introduction

My people perish for lack of knowledge.
Hosea 4:6

1.1 ISSUES

The importance and growing influence of international economic integration are well recognised.1 The existence and spread of various preferential trade agreements shape the form, nature and often the direction of the world production and trading system. Integration has affected almost all countries in the world. It has also become an unavoidable and powerful element in most national and international economic policy decisions. In fact, most of the countries throughout the world have either attempted to enter or entered into a trade liberalisation or integration agreement with others.2 Therefore the character of and relation between regional integration and a multilateral trading system continue to be at the heart of the trade and investment policy debate.

Some of the biggest formal achievements in integration, however, have been among the developed countries, in particular the European Union (EU). Integration has both deepened and widened in Europe. Countries in other parts of the world have attempted to emulate some of the integration methods and achievements that took place in the EU, but with varying degrees of success. The eurozone crisis made countries leery about transplantation of all the EU integration tools.

Many policy makers generally had a favourable view of integration. They attempted to use economic integration as a means of securing access to a wider market and reinforcing growth in order to attain a higher level of national welfare. The degree of success in integration, however, has varied between regions. In the EU, following the elimination of tariffs and quotas in 1968, a deepening of integration covered areas such as competition, public procurement and services, thus preceding, even provoking, multilateral negotiations and agreements on these issues.3 Developing countries have changed their inward-looking integration strategies of the 1960s to ones of improved economic ties with the developed North from the 1990s. However, because of changed aspirations, past experiences of integration in the developing world are not always very useful guides for future integration policy. None the less, international economic integration has remained an attractive economic strategy in the developing world. This is because it can serve as a reliable ‘insurance policy’ against sudden changes in the trading behaviour and policy of partner countries. ‘Dividends’ from a policy of integration include an increase in business predictability, which has a potentially positive impact on domestic and foreign investment.

In spite of past experiences with integration, which may have been quite negative in certain developing-country groups and despite deep eurozone troubles, there are
continuing opportunities and challenges. These have been prompted by several developments since the mid-1980s, including:

- deepening and widening of integration in the EU and North America;
- instead of integration among similar countries (North–North or South–South during the 1960s), integration started between developed countries such as the United States (US) and Canada, on the one hand, and a developing one such as Mexico, on the other. The EU has a plethora of preferential deals with the developing countries;
- economic transition in the formerly centrally planned economies in Central and Eastern Europe (the CEE countries) and the 2004, 2007 and 2013 Eastern enlargements of the EU.
- a change in economic policies in the developing countries towards more outward-looking and liberal models;
- change in the structure and location of production (spatial fragmentation of the value-added chain, the move towards knowledge-based goods and services and operations of transnational corporations (TNCs));
- the changing character of protectionism. ‘Voluntary’ export restraint deals, harassment by countervailing measures and especially various and almost limitless government guarantees and subsidies to the troubled industries in the developed world during and in the aftermath of the global financial crisis (2007–09);
- weakening confidence in the multilateral trading system since 1995 and a global spread of preferential trade agreements. Countries wanted to ensure even a limited access for their goods and services against the looming failure of the Doha Round.

A response to these challenges was often found in trade liberalisation agreements and deeper or wider integration. For example, the EU Single Market Programme (1985–92) was an agreement to coordinate policies that historically have been regarded as domestic.

This chapter is structured as follows. Section 1.2 spells out definitions of integration. Section 1.3 presents basic types of integration arrangements, while section 1.4 refers to the issues of interdependence. The ending section 1.5 considers the issue of integration and sovereignty.

1.2 DEFINITIONS

The main objective of economic activities is an increase in welfare. The approach towards this goal deals with the organisation of the human community because players have various and often conflicting interests and potentials. The organisation should allow agents to maximise their utility in the pursuit of their own ends and expectations, subject to their capabilities and the limitations presented by the environment.

International economic integration is one of the means for an increase in welfare: countries can increase the welfare of the integrated group, or of some countries within the group, or of the world as a whole. Machlup (1979, p. 3) stated that the term ‘integration’ in economics was first used in industrial organisation to refer to combinations of firms. Horizontal integration referred to linkages of competitors, while vertical integration referred to the unification of suppliers and buyers. As a term, the integration of economies
of separate states was not found anywhere in the old, chiefly historical, literature on the economic interrelationship between states, or in the literature about customs unions (including the German Zollverein of 1834–71), or in the literature on international trade before the 1940s. Viner (1950) was the first to lay the foundation for the theory of customs unions that represented the core of the traditional theory of international economic integration.

International economic integration does not have a clear-cut meaning for all economists. One of the first definitions of integration was given by Tinbergen (1954, p. 122). He defined, on the one hand, ‘negative integration’ as the removal of discriminatory and restrictive institutions and the introduction of freedom for economic transactions. On the other hand, the adjustment of existing policies and institutions and the establishment of new ones endowed with coercive powers was identified as ‘positive integration’. This introduced some confusion since freedom was described as ‘negative’, while coercion was regarded as a ‘positive’ move! Experience teaches us that it is easier to advance in the direction of ‘negative’ integration (removal of tariffs and quotas) than towards ‘positive’ integration (introduction of common economic policies) because the ‘positive’ approach deals with sensitive issues of national sovereignty. None the less, Anderson and Blackhurst (1993, p. 1) define regional economic integration in a ‘negative’ dimension as ‘the process of reducing economic significance of national political boundaries within a geographic area’. A ‘positive’ introduction of a common currency may escape this definition. Similarly, Baldwin (2010, p. 2) defined integration as ‘the removal of barriers to international commerce’. This is a rather narrow definition as it does not encompass possible ‘positive’ common policies and foreign direct investment (FDI).

Pinder (1969, pp. 143–5) cites the Oxford Dictionary, which describes integration as the combination of parts into a whole. Union is the outcome of the combination of these parts or members. He concluded that integration was a process towards union and defined economic integration as the removal of discrimination between the economic agents of the member countries, as well as the creation and implementation of common policies.

Kahnert et al. (1969, p. 11) understand integration as a process of the progressive removal of discrimination that exists along national borders. That is, however, only a part of what integration brings. Other components of integration, such as a common policy in trade or factor mobility, were left out of the definition.

Mennis and Sauvant (1976, p. 75) consider integration as a process whereby boundaries between nation-states become less discontinuous, thereby leading to the formation of more-comprehensive systems. They believe economic integration consists of the linking up and merging (not the abolition) of the industrial apparatus, administration and economic policies of the participating countries.

Pelkmans (1984, p. 3) defines economic integration as the elimination of economic frontiers between two or more economies. An economic frontier is a demarcation line across which the mobility of goods, services and factors is relatively low. The potential mobility of certain factors was the criterion for economic integration according to this passive definition of integration. There is no indication that such a policy actively promotes mobility and cooperation. The mere removal of ‘economic frontiers’ does not necessarily offer either a carrot or a stick to factors to move. There are many non-economic obstacles to mobility, including language, custom, the propensity to stick to place of birth and the like for labour, while political and other risks inhibit capital movements.

Balassa (1973, p. 1) defines economic integration both as a process and as a state of
affairs. As a process (dynamic concept), integration meant the removal of discrimination between different states, while as a state of affairs (static concept), it meant the absence of different forms of discrimination. The Achilles’ heel of this definition is its restriction in concentrating only on the process or state of affairs among the countries that integrate. One can distinguish among intra-national (inter-provincial), international and world (universal, global) integration. Agreements among states about adjustment or coordination of some economic areas could be called integration, so one could deal with sectoral and general integration. Balassa’s definition did not say whether economic integration was the final goal or a point on the way towards some target. This ambiguity could be avoided by making a distinction between complete and partial integration.

Swann (1996, p. 3) describes economic integration as a state of affairs or a process that involves the combination of previously separate economies into larger arrangements. Lahiri (1998) defines regionalism as a tendency towards preferential trading arrangements among ‘countries belonging possibly to a particular region’ (p. 1126). Would this definition of regionalism be adequate for the free trade area between the US and Israel?

Maksimova (1976, p. 33) argues that economic integration was a process of developing deep and stable relationships concerning the division of labour between national economies. In this sense, it is a process for the formation of international economic entities within the framework of groups of countries with the same type of socio-economic system, which are consciously regulated in the interests of the ruling classes of these countries. It is true that international economic integration is a highly politicised process, but this definition excludes the possibility of integration even by means of preferential agreements between countries that have different political systems. This is important in practice as there has been a whole spectrum of preferential agreements between the EU and developing countries that have the widest range of political systems. None the less, the EU requires that applicant countries for full EU membership have a stable democratic political system comparable to those in the current EU member countries.

Holzman (1976, p. 59) states that economic integration was a situation in which the prices of all similar goods and similar factors in two regions were equalised. This made the two regions in essence one region or market. This definition implies that economic integration was the realisation of factor price equalisation between two regions. It implicitly assumes that there are no barriers to the movements of goods, services and factors between the two regions and that there are institutions that facilitate those movements.

Marer and Montias (1988, p. 156) point out that economic integration has traditionally been equated with the division of labour in a geographical region, although it was usually not made clear what minimum level of trade would justify speaking of integration. Recently, economic integration has been assumed to consist of the internationalisation of markets for capital, labour, technology and entrepreneurship in addition to markets for goods and services. Marer and Montias argue (p. 161) that the necessary and sufficient condition for complete integration is the equality of prices of any pair of goods in every member country (adjusted for transportation costs). The same remark as that made with regard to Holzman’s definition applies here too.

Drysdale and Garnaut (1993, p. 189) look at integration only as a movement towards one single price for a good, service or factor of production. If one wants to encompass the term ‘integration’, then one needs to refer also to policies that make that movement
happen. In addition, if integration refers to issues such as social policy, including education, then it includes more than a ‘technical’ move towards equalisation of prices.

Panić (1988, pp. 3–5) distinguishes between openness, integration and interdependence. An economy is open if it has few barriers to international trade and factor movements. Because an economy is open does not necessarily mean that it is integrated in the international economic system. International integration has its full meaning only when it describes active participation in the international division of labour. Two or more economies are said to be interdependent when they are linked to such a degree that economic developments in each of them are significantly influenced by the economic situation and policies in the partner country.

Molle (1991, p. 5) equates economic integration with the progressive elimination of economic frontiers between countries. As a rule, the process of elimination of ‘economic frontiers’ is gradual. The transition period for full adjustment to the new situation usually takes, in practice, at least five to ten years. However, following the establishment of the European Economic Area (EEA) in 1994 between the EU and most of the EFTA (European Free Trade Association) countries, the participating EFTA states had to apply the *acquis communautaire* immediately, except in a few specified cases. There was no transition period. When the CEE countries negotiated their entry into the EU, the timing of the entry depended primarily on their ability to accept, implement and enforce the *acquis communautaire* in order to eliminate the need for derogations and transition measures.

El-Agraa (1985, p. 1) refers to international economic integration as the discriminatory removal of all trade impediments between participating nations and the establishment of certain elements of coordination between them. This definition implies the removal of barriers to trade in goods and services, as well as freedom of movement for factors of production. Hence this definition only partly covers free trade areas and customs unions as types of integration. Later, El-Agraa (1988, p. xiii) takes international economic integration to mean an act of agreement between two or more nations to pursue common goals and policies. This is an ‘active’ definition of integration.

Robson (1987, p. 1) notes that economic integration was concerned with efficiency in resource use, with particular reference to the spatial aspect. He defines full integration as freedom of movement of goods and factors of production and an absence of discrimination. Freedom of movement for factors is not allowed for in some types of international economic integration; hence this definition cannot be applied to all arrangements. Later, he defines international economic integration (often termed ‘regionalisation’) as ‘the institutional combination of separate national economies into larger blocs or communities’ (Robson, 1998, p. 1). This definition refers to the institutional (presumably public) combination of national economies. What if two different firms in two different countries integrate on their own? Is this included in the definition or not?

The European Commission (1997c, p. 23) defines market integration as ‘a state where the outcomes of economic decisions are independent of national frontiers’. While this definition may be relevant for the decisions of certain international firms, national frontiers are relevant for the introduction and management of a common currency in an integrated area.

There is also an identification of international economic integration with globalisation. Wolf (2001, p. 15) states that ‘Globalisation is no more than an (admittedly ugly)
name for the process of integration across frontiers of liberalising market economies at a time of rapidly falling costs of transport and communications.  

All these definitions of international economic integration reveal that integration is a complex notion that must be defined with care. Definitions are often vague and do not offer adequate tools for the easing of the process of integration among countries.

Integration means different things in different countries and at different times. In the developed market economies, integration is taken to be a way of introducing the most profitable technologies (often linked with economies of scale), allocating them in the most efficient way and fostering free and fair competition; during the period of central planning in the CEE countries it meant the planning of the development of certain industrial activities; while in the developing countries, integration was one of the tools for economic development. At the time of the German Zollverein the grouping of countries meant the development of economic interdependence, nation-building and self-reliance.

Today, international economic integration refers to an increase in the level of welfare. Machlup (1979, p. 24) states that one of the most obvious signs of international economic integration is the non-existence of customs posts between integrated countries. Total economic integration among countries with market economies is not achieved until these countries know the level of their mutual trade. There are no statistics to show the volume of trade between Pennsylvania and Ohio, for instance.

There is an unresolved question about what is to be integrated. Is it to be citizens, markets, production, consumption, commodities, services, regions, factors, money, resources, something else, all of this together, or just some of these components? What are the measures for the advance, stagnation or decline of international economic integration? What is the essence of international economic integration and what are the criteria for the appraisal of this process? Machlup (ibid., p. 43) argues that trade is the quintessence of economic integration and the division of labour its underlying principle. If one ignores transportation and other trade-related costs, then the basic principle for the appraisal of international economic integration is equality of prices for comparable goods and services in all integrated countries.

Machlup’s test is much easier for standardised goods and services than for differentiated ones. A meaningful comparison of the price gap of a good in different markets should take into account not only the transport costs but also, and more importantly, the consumption patterns in different countries. This is an extremely difficult exercise, even in monetary unions. Income, tastes, preferences, traditions and climate may be homogeneous in relatively small areas, sometimes even within a single country. The more homogeneous are the countries, the easier the test.

What is usually omitted from definitions of international economic integration is any consideration of FDI and integrated international production. Compared with mere trade, FDI introduces a more profound and longer-term dimension into integration among countries. However, if foreign-owned production is to take place, an integration scheme has to provide freedom of establishment.

Finally, we can conclude that international economic integration is a process and a means by which a group of countries strives to increase its level of welfare. It involves the recognition that a weak or strong partnership between countries can achieve this goal in a more efficient way than by unilateral and independent pursuance of policy in each country. Integration requires at least some division of labour and freedom of movement.
for goods and services within the group. Relatively ‘higher’ types of integration arrangements also require a free mobility of factors of production within the integrated area, as well as certain restrictions on these movements between the integrated area and countries outside it.

The essential point is that the countries that integrate adopt a kind of inward-looking approach and take more care about what happens in the group than about what happens outside it. In addition, at least some consultation, if not coordination of competition, monetary, fiscal and regional development policies, is a necessary condition for the success and durability of integration, as is the case in federal states. This is to be supported by an effective dispute settlement mechanism. The process of integration may be practically unlimited, just as is the continuous integration of various regions within a single country. From a ‘technical’ point of view, international economic integration can be a finite process, that is, the elimination of tariffs and quantitative restrictions, as well as the introduction of rules of competition and common external protection in a customs union. However, new dimensions of competition, non-tariff barriers (NTBs), standards, new technologies, as well as changes in the market, require continuous adjustments of individual countries and the group as a whole. This all makes integration more an evolving and continuing process than a limited one. International economic integration is a process by which the firms and economies of separate states merge in larger entities. Such a definition of integration, incorporating the ideas in this paragraph, will be maintained throughout this book.

Free trade and the unimpeded movement of factors is the first-best policy in a world that does not have any distortions. This is only a hypothetical situation. The rationale for international economic integration may be found where there are distortions. When one distortion (such as a universal tariff of a country) is replaced by another (for example, a common external tariff of a customs union), the net welfare effect may be unchanged, positive or negative. The theory of international economic integration is the analysis of a second-best situation and it is not surprising that general principles cannot be found. What matters, however, is not only the prediction of theory, but rather what happens in real life.

This book shows that, despite the second-best character of international economic integration in theory, in practice integration/regionalism may, under certain conditions, be a workable and acceptable economic strategy. A policy recommendation for small and medium-sized countries is that, in a world of continuous technological and market changes, and fragmented production chains, when there are risks and uncertainties, integration may expand and secure markets for the greatest variety of a country’s goods and services in the future and, hence, mitigate the costs of the necessary and inevitable adjustment.

1.3 TYPES

If trade is impeded by tariffs, quotas, NTBs and obstacles to factor mobility, then consumption in an integrated area is potentially higher than the sum of the consumption of individual countries that are potential partners for integration. International economic integration removes, at least partly, these and other distortions to trade, competition,
investment and, possibly, factor mobility. In this sense, international economic integration between at least two countries can be of the following seven theoretical types:

- A **preferential tariff agreement** among countries assumes that the tariffs on trade among the signatory countries are lower in relation to tariffs charged on trade with third countries.
- A **partial customs union** is formed when the participating countries retain their initial tariffs on their mutual trade and introduce a common external tariff on trade with third countries.
- A **free trade area** is an agreement among countries about the elimination of all tariff and quantitative restrictions on mutual trade. Every country in this area retains its own tariff and other regulation of trade with third countries. The bases of this agreement are the rules of origin. These rules prevent trade deflection, which is the import of a good from third countries into the area by country A (which has a relatively lower external tariff than the partner country B) in order to re-export the good to country B. None the less, production deflection is possible if the production of goods that contain imported inputs is shifted to countries that have lower tariffs if the difference in tariffs offsets the difference in production and trade costs. There is a possibility that various free trade areas overlap. This provides ample opportunities for lobbying, as each new participant country may negotiate its rules of origin.
- In a **customs union**, participating countries not only remove tariff and quantitative restrictions on their intra-group trade (a free trade area), but also introduce a common external tariff on trade with third countries. The participating countries pool sovereignty in trade policy. This often presents difficult, especially in reaching accord on the common external tariff. That is why there are few customs unions and many free trade areas in the real world. The participating countries in a customs union should take part in international negotiations about trade and tariffs as a single entity.
- In a **common market**, apart from a customs union, there is free mobility of factors of production. Common regulations (restrictions) on the movement of factors with third countries are introduced.
- An **economic union** among countries assumes not only a common market, but also the harmonisation of fiscal, monetary, industrial, regional, transport and other economic policies.
- A **total economic union** among countries assumes union with a single economic policy and a supranational government (of this confederation) with great economic authority. There are no administrative barriers to the movements of goods, services and factors; hence prices are equalised net of transport costs.

The basic theoretical types of international economic integration are given in Table 1.1. What matters is that the process of integration does not need to be gradual from the ‘lower’ types of integration towards ‘higher’ ones. For instance, a group of countries may decide to create a common market and ‘jump’ over the ‘lower’ types of integration such as a free trade area and a customs union. Everything depends on the ambitions, intentions, goals and existing and future potentials of the group of countries and on their
specific integration agreement. Table 1.1, however, does not cover the new, market-driven and practical economic integration models practised in South-East Asia. Vibrant integration takes place in this region on a ‘technical’ trade-facilitation level. It has been spontaneously driven from the 1980s by the new production- and organisation-related technology that permitted spatial fragmentation of production and creation of supply chains, as well as by market forces, rather than by formal integration deals and grand political goals. Governments and firms are interested in the removal of barriers that slow trade and impede the smooth operation of value-adding and distribution chains. Trade deals are not necessarily about tariffs, but rather about reduction of costs at and behind the border. Integration in this region does not have a strictly defined goal; rather it is based on shared interests. Elsewhere, the EU and the US reduce trade barriers on the condition that partners open up markets for services, engage in FDI, respect human rights and labour standards, contribute to the war on drugs and protect the environment.

The decision about entering into a customs union or any other type of integration has always been primarily political, but economic considerations usually play a very important role. The decision to abandon part of national sovereignty regarding taxation of trade (all in a customs union, a part of that in a free trade area) is generally made by politicians. The EU was, after all, not established in 1957 in order to liberalise trade, but rather to exclude the possibility of war between France and Germany. Economic integration was just a means for the achievement of that political goal.

An interesting case occurred following the establishment of a free trade area between Canada and the US in 1988. There were moves to include Mexico in the NAFTA (North American Free Trade Agreement). If the US were to enter into a bilateral free trade deal with Mexico, and then conclude similar bilateral arrangements with other (Latin American) countries, that would create the ‘hub-and-spoke model’ of integration (which was undesirable for Canada and other countries involved). The US, as the regional hub, would have a separate agreement with each spoke country. As such, it would have great advantages of negotiating individually with each partner country, as well as being the only country with a tariff-free access to the markets of all participants. This would further enhance the US locational advantages for FDI. Therefore Canada decided to be involved in the free trade deal with Mexico in order to avoid the negative consequences of the hub-and-spoke model of integration.

<table>
<thead>
<tr>
<th>Policy action</th>
<th>Free trade area</th>
<th>Customs union</th>
<th>Common market</th>
<th>Economic union</th>
<th>Total economic union</th>
</tr>
</thead>
<tbody>
<tr>
<td>Removal of tariffs and quotas</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Common external tariff</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Factor mobility</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Harmonisation of economic policies</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Total unification of economic policies</td>
<td>No</td>
<td>No</td>
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</tr>
</tbody>
</table>
1.4 INTERDEPENDENCE

The interdependence of economic life among countries created a situation in which national economic problems increasingly became a matter of international concern. The predominant way of solving these international problems is at the national level, where the most decisive influence is wielded by a small number of large and highly developed countries, as well as a few oil-exporting ones. While free market competition can create a situation in which large firms can absorb their small competitors, such an analogy is not possible when dealing with sovereign countries. Large and developed countries cannot always behave like firms (Panić, 1988, p. 284).

Statements from prominent public figures, in particular from the larger nations, often make headlines and can have an impact on the currency market, trade policy and investments. Therefore such remarks need to be treated with caution. A statement by former US President Bill Clinton that each nation is 'like a big corporation competing in the global marketplace' is like saying that the US and Japan are competitors in the same way as Coca-Cola competes with Pepsi (Krugman, 1996b, p. 4). Firms are rivals for a limited pool of potential profits. What distinguishes states from firms is that one firm may absorb another, which is not possible in normal circumstances in the case of states. In addition, states may introduce protectionist measures (international disintegration). Such an option is not open to firms. Countries are not firms. They cannot be driven out of every business. However, countries can be driven out of some lines of business, which may have permanent effects on trade. States produce goods that compete with one another, but more importantly states are one another’s export markets and suppliers of useful things. David Ricardo taught us in 1817 that international trade is not about competition, but rather about mutually beneficial exchange. The purpose of trade is imports, not exports. Imports give a country the chance to get what it wants. Exports are a toll that a country must ‘suffer’ in order to pay for its imports. Those ideas by Ricardo were as much misunderstood two centuries ago as they are today.

Coordination of economic policies and international economic integration may alleviate and even solve a number of international economic problems. Economic nationalism, as opposed to coordination and integration/regionalism, has always been quite an appealing economic strategy in certain circles. This is because the tools for protection from the unfavourable effects of integration and trade liberalisation, which have a basically short-term nature, are not fully developed. In any case, this book argues that countries integrate:

- to secure access to markets of partner countries;
- to secure and cement domestic market-orientated reforms;
- to adapt trade barriers according to preferences of the involved countries;
- because of trust among the participating countries;
- because a very large group of countries may have many conflicting objectives and interests;
- because integration potentially weakens and shrinks the power of vested interests and monopolies;
- because integration agreements can be employed as a bargaining tool with third countries;
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- because terms-of-trade effects and gains to exporters provide benefits from preferential trading agreements that are not available from unilateral trade liberalisation policies;
- because in the long run the benefits of integration may be felt by all;
- because the long-term dynamic benefits are greater than the possible short-run static costs; and
- because international economic integration is a desirable strategy, at least for small and medium-sized countries.

In theory, economic efficiency can be fostered by a policy of free trade that stimulates competition. It rationalises production of goods and services and provides conditions for a higher average standard of living and greater welfare in the future. The adjustment to free trade, at least within the integrated group, should not be traumatic at all. There is substantial evidence of this in the relatively frictionless overall adjustment to the successive reductions in tariffs under the General Agreement on Tariffs and Trade/World Trade Organisation (GATT/WTO) and the system of transparent rules for trade, as well as the smooth transition to the creation and enlargement of the EU. Similar stories may be told for the cases of EFTA and NAFTA.

Large and developed countries depend to a lesser degree on external relations than do small countries. In theory, these countries may have a diversified economic structure that provides the opportunity for an autarkic economic policy, while such a policy for small countries in a situation of economies of scale and other externalities does not have a long-term economic rationale. Without secure and free access to a wider market, a relatively limited domestic market and demand in small countries often prevent the employment of the most efficient technology, even if trade barriers are prohibitive. If certain production takes place, the consequences include short production runs, high prices and a lower standard of living. The efficient operation of many modern technologies requires secure access to the widest market, which does not exist in small, and sometimes medium-sized, countries. Elimination of tariffs, NTBs, restrictions on factor mobility, as well as international coordination of economic policies and integration can be solutions to this problem of country size. The goal is to increase, improve and secure access to the markets of the participating countries.

A liberal trade and flexible adjustment policy for a small country may be a superior alternative to the policy of long-term protection. The competitive position of small countries can be jeopardised if protection increases the price of inputs. Moreover, protection can provoke retaliatory measures from trading partners. It can also inhibit the adjustment incentives of the protected industry, with an overall negative long-term impact on the whole economy. While having a limited influence on the events in the world economy, small countries can have leverage over their own competitive future by means of a liberal economic policy and/or international economic integration.

1.5 SOVEREIGNTY

International economic integration is popularly criticised on the grounds that it reduces a country's national sovereignty (undisputed political power). When two or more sovereign
countries sign a treaty, they agree to do and/or not do specified things. Therefore it is not a valid criticism of any international treaty to say that it entails a loss of national sovereignty. All treaties do so in one way or another. The real issue is: do the countries’ concessions constitute a mutually beneficial deal? Is the surrender of sovereignty justified by the results? Consider, for example, the Canadian debate leading up to the Canada–US Free Trade Agreement in Lipsey and York (1988).

Canada is a relatively small (in economic terms) and open economy. The competitive future of this country has been seriously jeopardised by the uncertain future of the relatively liberal international trading system. So, Canada negotiated and subsequently signed a free trade agreement with the US in 1988. Negotiations and the pre-election period at that time were subject to one of the greatest debates in Canadian history. The opponents of the agreement tried, with initial success, to persuade a majority of Canadians that the deal would significantly reduce Canadian sovereignty and distinctiveness. The fuss created by opponents of the deal was perhaps one of the greatest in the history of international economic integration. Giving their vote to the Conservatives, the Canadians, however, supported the agreement.10

There was a fear that Canada would need to harmonise a range of economic policies with the US. If experience is a reliable guide, then this fear is not relevant. The Netherlands has a developed and costly social policy, while Belgium spends relatively less in this area. Yet these two countries have been in a free trade area for more than half a century without harmonising their social policies. As for other economic policies, pressures for harmonisation do exist. If tax rates differ among countries and if factor movement is allowed, then, other things being equal, factors will move to countries where the tax burden is lower. But note: these harmonising pressures exist even in a situation without integration! For example, within a common market, apart from the agreed-upon matters, countries will have to give each other ‘national treatment’. This means that they can adopt any policy they wish, even those that are completely different from policies in the partner countries, with just one important proviso: the country should not use these policies to discriminate among partner countries on the basis of their nationality. International economic integration is not the enemy of diversity in many economic policies. In other cases, such as EU monetary policy within the eurozone, integration reduces the diversity of the main policy instruments. This issue raises all sorts of problems when economies at various levels of development, facing different problems, become integrated. Such policies should be coordinated, or even harmonised.

If a small country (such as Cuba or North Korea) accepts and pursues a long-term policy of protection and isolation, as opposed to liberalisation, openness or international economic integration, it chooses a long-term deterioration in its international economic position. This is coupled with a reduction in living standards in relation to countries that do not employ protectionism as their economic strategy. Can a country preserve its sovereignty and the welfare of its citizens in the face of a long-term declining trend in the standard of living?

The expectation of a net economic gain compared with the situation without international economic integration is the most fundamental incentive for such integration. Anticipated gains from secure access to a larger market include an increase in the efficiency in the use of factors due to increased competition, specialisation, economies of scale, increases in investment (domestic and foreign), improvements in terms of trade,
reduced risk and a tendency towards equalisation of factor prices. Integration will be beneficial when cooperation and coordination of policies takes place instead of the disintegrated exercise of sovereign economic power through conflicting policies. National sovereignty is pooled, rather than given up. Small- and medium-sized open countries need to realise that it is much less a choice between national sovereignty and international economic integration, and much more a choice between one form of interdependence and another. If one's goal is to increase the competitiveness of goods and services produced in a small country and secure the widest markets for its output in the future, then international economic integration is a serious alternative to the national freedom to implement and continue with damaging economic policies.

Let us now move on to the basic theory and practice of international economic integration.

NOTES

1. Haberler noted as early as 1964 that ‘We live in the age of integration’ (Haberler, 1964, p. 1).
2. Preferential trade agreements and integration are progressively taking place among countries that are not spatially near each other. Therefore the term international (regional) economic integration is wider than regional trade integration and liberalisation. None the less, these terms may sometimes be used interchangeably in this book.
3. It is widely accepted that the Dillon (1959–62), Kennedy (1963–67) and Tokyo (1973–79) rounds of trade negotiations were attempts by the US and other developed market economies to reduce the discriminating effect that came from the creation and enlargement of the EU.
5. The existence and operation of the EU is based on law. The whole body of the established EU laws, policies and practices are called the acquis communautaire or the EU patrimony. It is widely estimated that the acquis consisted of about 100,000 pages of active legal acts in 2014. The ever-evolving and expanding acquis is enlarged by several thousand new legal acts each year. However, most of these EU legal acts have limited time duration.
7. Competitiveness is the faculty of a firm (or a country) to produce more assets that are in demand than its domestic and foreign competitors. This is based on productivity, innovation, education, infrastructure, finance, health and institutions. Competitiveness is measured by the difference in relative prices between home and foreign goods. Even though international trade is more extensive than ever before, national living standards are chiefly determined by domestic economic factors, rather than by competition for world markets. After all, the ‘globalised’ US economy trades only about 13 per cent of its GDP, roughly the same as a century ago. In addition, at least 70 per cent of employment and value added in the US is in ‘non-tradable’ industries that do not compete on world markets.

The rate of growth in the standard of living in large developed countries depends on national productivity growth. Period. A comparison of the productivity growth in other countries does not matter for domestic living standards. If domestic productivity growth is 1 per cent per year, the national income of that country grows roughly 1 per cent per year, even though productivity growth elsewhere is 0 or 4 per cent (Krugman, 1996c).

There is always rivalry for status and power between states. Hence it is interesting to compare them. But asserting that Japanese growth diminishes US status is very different from saying that it reduces the US standard of living. ‘So let's start telling the truth: competitiveness is a meaningless word when applied to national economies’ (Krugman, 1996b, p. 22).
8. There are, however, unfortunate examples, as when the US absorbed Hawaii, or Turkey took over northern Cyprus. One may also hesitate to define in this light the reintegration or Anschluss of East Germany by West Germany in 1989 or the Russian reintegration of the Crimean peninsula in 2014.
9. There are strong equilibrating forces that can ensure that a country sells goods in world markets. David Hume pointed out two centuries ago that, in the case of the gold standard, a country that imports more
than it exports has a drain on gold and a fall in the money supply. Prices and wages fall; hence the goods and labour in that country become cheap so that they grow attractive to foreign buyers. The deficit in trade is corrected. In the modern world without the gold standard, deficits are not usually corrected by the depreciation of prices and wages, but rather through the depreciation of national currencies.

10. It is interesting to note that there was neither great nor heated public debate about the Eastern enlargement in the EU(15) countries when eight CEE countries plus Cyprus and Malta joined the EU in 2004. The same holds for the 2007 entry of Bulgaria and Romania. The Croat entry of the EU in 2013 went largely unnoticed. Even though these enlargements (especially 2004 and 2007) would provoke seismic changes in the EU (general institutional organisation, allocation of common funds, migrations and farm policy), the general public in the EU(15) were apathetic about the enlargement. The Eastern enlargements (like many EU-related issues) were regarded as a done deal by the European elite behind the backs of its citizens, just as was the case with the Maastricht Treaty and the introduction of the eurozone. The European elite needs to win the hearts and minds of the people for the integration project. If it continues to disregard the public, results that come from ballot boxes may easily slow down and fragment the whole integration process in Europe, as was the case with the failed referenda on the European Constitution in France and the Netherlands in 2005.