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Economic Integration

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Abstract

Economic integration is the establishment of a unified economic area where consumers and producers of different nations transact freely in a single market. Using the experience of the European Union, this essay offers a bird's–eye view of the trade–offs encountered when supranational structures pursuing collective objectives of integration may infringe on national sovereignty. The range of issues examined include: (A) Determination of policy with multiple veto players. (B) The advantage and disadvantages from centralising policy making. (C) The welfare effects of a customs union from changing the flows of trade and factors of production across different countries. (D) The costs and benefits from adopting a single currency and its consequences for budgetary policy.

1 Definition

Economic integration is the creation of a unified economic area where firms and consumers from different nations buy and sell goods and services in a single market and owners of capital and labour can deploy their resources in any economic activity anywhere in the area. Integration encompasses economic, political and legal dimensions that overlap with each other. Our understanding and assessment of economic integration is inextricably linked to the experience gained from the establishment, geographical expansion and extension of functions of the European Union (EU). Its development has been extensively researched in economics, political science, international relations, organizational sociology, and law. The present essay does not aim to survey any part of this enormous literature.[1] Rather, it offers some pointers on the issues regarding the following issues: setting–up of supranational structures that pursue collective objectives but in so doing may encroach on national sovereignty; determination of policy with multiple veto players; centralisation of policy making; market competition; the trade effects of a customs union; factor mobility; and adoption of a single currency, monetary and budgetary policy.

[1] For textbook expositions, see amongst others Senior Nello (2011), Baldwin and Wplosz (2012) and Saurugger (2013). Detailed analysis of monetary integration can be found in Issing (2008) and De Grauwe (2012). The interested reader is also referred to the papers in the volume edited by Artis and Nixson (2007).

2 European Economic Integration

Construction of the EU started after the end of Second World War and is ongoing. Table 1 presents a brief timeline of landmark events in the development of the EU. To complete the economic union a number of intermediate stages must be accomplished.

(1) Duty–free access to each other nation's market, which requires the abolition of tariffs and non–tariff restrictions on trade between the member–states.

(2) Implementation of a common tariff on trade with non member–states to prevent cheaper imports entering the market through members–states with lower external tariffs, known as a customs union.

(3) Establishment of a free market in goods and services among the member–states to ensure competition; this requires the harmonization of national laws and practices that regulate the market (including the relevant taxes), the abolition of anti–competitive structures, and the prohibition of state aid or other preferential treatment by member–state governments to national firms.

(4) Establishment of a free market in labour and capital, which is achieved by eliminating discriminatory treatment of workers on the basis of nationality, granting firms the right to establish in another member–state, and the removal of restrictions on capital flows.

(5) Establishment of a monetary union where the member–states adopt a single currency, so that prices and trading in the single market will not be affected by national currency fluctuations; in turn a single currency requires establishing a union–wide central bank to conduct monetary policy.

Each successive stage envelops its predecessor. Not all member–states participate in the monetary union, with Denmark, Sweden and the UK deciding to keep their national currencies, while countries that entered the union after the launch of the euro are expected to adopt the currency when their economies are ready to do so. A further step, one yet to be taken by the EU, is the fiscal union where taxes and transfers are decided centrally. It is however noted that contrary to the above checklist the EU has adopted a protective agricultural policy. Each successive step implies a certain loss of national sovereignty, as for example a common tariff prevents a country to decide its own external trade policy, or with a common currency a country can no longer implement an independent monetary policy.

3 Institutions of EU governance

After the horrors of two world wars in a space of twenty years, European economic integration was conceived as the form of international organization to bind together rival European powers, especially France and Germany, in order to prevent another war. That is, economic means were used to accomplish a political objective. What followed was a series of international treaties that over time established an intricate system of Europe–wide governance (control of decision making), changed the scope of national legislative powers and created a body of legal acts and court decisions (known as the "*acquis communautaire*") by which all member–states abide, while on the economic side it has shaped industry structures, wholesale and retail markets, labour markets, trade, investment and monetary flows.

Table 1. The evolution of the EU at a glance	
1952	Belgium, France, Italy, Luxembourg, the Netherlands and West Germany form The European Coal and Steel Community
1957	The Six sign The Rome Treaties are signed forming The European Economic Community (EEC) and the European Atomic Energy Community (Euratom)
1966	The Luxembourg Compromise is accepted, permitting member states to demand legislation to be adopted by unanimity when very important interests are at stake
1967	The three Communities are united as "European Communities"
1973	Britain, Ireland and Denmark join
1978	The European Monetary system and the European Currency Unit are founded
1981	Greece joins
1986	Spain and Portugal join
1986	The Single European Act is adopted creating the Single Market
1990	Eastern Germany joins after German reunification
1992	The Maastricht Treaty is signed creating the European Union
1995	Austria, Sweden and Finland join
1997	The Amsterdam Treaty is signed amending the Maastricht Treaty
1998	The European Central Bank (ECB) is set up
1999	The *Euro* currency is created by irrevocably locking the exchange rates of participating countries and monetary policy making is transferred to the ECB
2000	The Nice Treaty is signed amending earlier treaties
2002	The "*euro*" becomes the sole currency of 12 out of 15 members (Britain, Sweden and Denmark retain their national currencies)
2004	Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Latvia, Lithuania, Estonia, Malta, and (the Greek part of) Cyprus join
2004	The Rome Treaty establishing a Constitution for Europe is signed
2005	Dutch and French voters reject the 2004 Treaty on Constitution; EU leaders suspend its ratification
2007	Bulgaria and Romania join
2007	The Treaty of Lisbon is signed amending the Treaty on European Union and the Treaty establishing the European Community
2009	Treaty of Lisbon enters into force after ratification is completed
2013	Croatia joins

Establishment of the EU by independent states meant the voluntary "pooling of sovereignty" to promote common interests and international public goods, like peace and prosperity, that are best pursued jointly rather than individually by each country. This also necessitated setting up bodies of collective decision making to pursue the common objectives, and simultaneously governance mechanisms to check that the new bodies will act within the agreed limits without infringing on the rights of their creators. The main institutions established to drive and administer the process of integration are the following.

The European Council which consists of the leaders of the EU countries; it sets the EU's general political direction and priorities and deals with complex and sensitive issues that cannot be resolved at a lower level of intergovernmental cooperation. It meets four times a year and is chaired by the President of the European Council. The President of the European Commission and the EU High representative for Foreign Affairs and Security Policy also take part in the meetings. The decisions of the European Council are taken by unanimity or by qualified majority, depending on what the EU Treaty provides for. Though influential in setting the EU political agenda, it has no powers to pass laws.

The Council of the European Union (not to be confused with the previous European Council), also informally known as the EU Council or Council of Ministers, which brings together national ministers from each EU country to: pass EU laws; coordinate the broad economic policies of EU member countries; sign agreements between the EU and other countries; approve the annual EU budget; develop the EU's foreign and defence policies; and coordinate cooperation between courts and police forces of member countries. As a general rule the Council of the EU decides by qualified majority voting. From November 2014 a system known as 'double majority voting' will be introduced. For a proposal to go through, it will need the support of 2 types of majority: a majority of countries (at least 15) and a majority of the total EU population (the countries in favour must represent at least 65% of the EU population). A blocking minority must include at least four Council members; if the latter fails the qualified majority shall be deemed attained. When sensitive issues are decided, for example, security and external affairs and taxation, decisions have to be unanimous rendering veto powers to every single country. The Council of the EU represents the interests of the national governments of the member– states.

The European Commission, which proposes policy measures, manages the day–to–day business of implementing EU policies and spending EU funds and represents the EU internationally. It is an executive supranational body that represents the Community interests. It consists of 28 Commissioners one from each country serving for a renewable term of 5 years. The President and members of the Commission are appointed by the European Council.

The European Parliament, which in an embryonic form represents directly the interests of the peoples of Europe. Its role is to debate and pass laws in combination with the Council; debate and adopt the budget of the EU; and scrutinise other EU institutions. Its members are directly elected for terms of five years. Their number is 751 including its President; there is a minimum threshold of 6 members per country and a maximum of 96 (implying that smaller countries weigh higher in its composition). The members are grouped according to political affiliation and not by nationality. In comparison to national parliaments it has significantly fewer legislative powers, but its powers have increased dramatically over time. It decides by simple majority.

The Court of Justice, whose task is to examine the legality of European Union measures and ensure the uniform interpretation and application of EU law. It consists of one judge per EU country and eight ‘advocates–general’ whose job is to present opinions on the cases brought before the Court. Its members are appointed upon the common accord of the governments of the member–states for renewable six–year terms. By far the largest part of the workload of the ECJ is to hear direct actions and give preliminary rulings. Direct actions concern violations of EU law and include enforcement actions, where the Court declares whether or not a member state has infringed or complied with EU law; actions for judicial review, where the Court may annul an act of an EU institution for violating EU law or for failing to make decisions required of them; and actions for damages, where the Court may determine the liability of an EU institution. In preliminary rulings, the Court on the request of a national court interprets a point of EU law; this way it ensures the uniform interpretation of EU legislation.

The European Central Bank; it has been set up to manage the euro and maintain price stability in the EU. More specifically, its tasks are the determination and implementation of monetary policy by setting key interest rates for the 17 countries that currently use the euro as their currency (Austria, Belgium, Cyprus, Germany, Estonia, Greece, Spain, Finland, France, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia and Slovakia); the conduct of foreign exchange operations; the holding and management of the official foreign reserves of the euro area countries; and the promotion of the smooth operation of payment systems. The ECB is also responsible for framing and implementing the EU's economic and monetary policy. It is politically independent of the governments of the member–states.

In comparing the role of the nation–states vis–à–vis that of the supranational bodies established to pursue and administer the objectives of European integration, two competing schools of thought appeared, namely, intergovernmentalism and supranationalism. Intergovernmentalism argues that the process of integration is controlled by the national governments of the member–states which impose the policies that best suit their interests; hence, the institutions of international governance set up by the treaties serve the purposes of their creators, usually the most powerful of the founding states, like France and Germany. On the contrary, supranationalism, or federalism, argues that economic integration, exchange and co-operation across national borders generated a new trans–national community whose interests are best served by setting institutional structures with some autonomous policy making powers previously reserved for the nation–state.

4 Determination of policy with multiple veto players

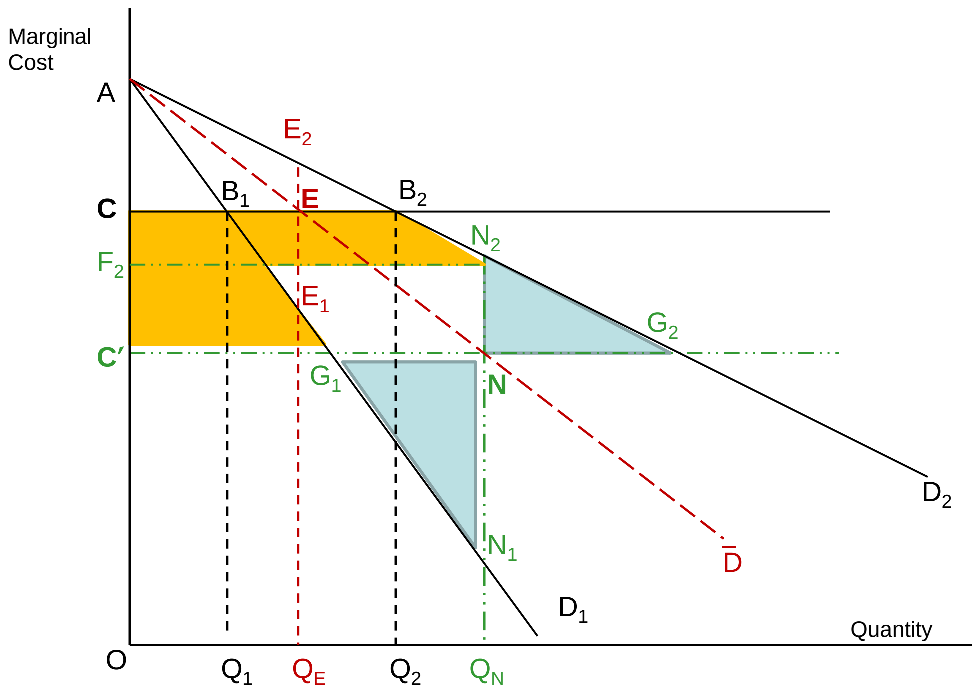
The previous description of the governance organs makes clear that policy making in the EU is a complicated matter involving the strategic interaction of multiple players, where strategic means that the action of an actor takes into account the expected response of another actor whose interests are affected by such actions. The interests of the national and supranational actors may not necessarily coincide on all issues at hand, and whereas only the Commission has agenda–setting powers to initiate legislation, decisions are subject to the veto power of the Council, the Parliament (a process known as co–decision), and, as practice has shown, the Court.

The qualified majority voting rule used by the EU (in approximately 80% of all its decisions), in combination with its supranational character raises a host of important issues: The first regards efficiency in decision making, which relates to how easy it is for the EU as a collective group to take a decision. This is the question of how likely is to find a majority given the specific voting rule and the distance between the policy preferences of the national and supranational actors. In general the answer depends on the required majority, the number of countries and the weight (number of votes) of each country. Second, the distribution of power among member–states which is approximated by the weight awarded to each member–state in the Council of Ministers. In the EU the countries with small populations, like Luxembourg, have been given greater weights than the more populous countries, like Germany. This goes a long way to explain the observed pattern of EU spending in favour of less populous countries. The third issue regards legitimacy of EU. A decision is legitimate when it is accepted that the decision maker has the right to take that decision. At one extreme, if the EU is considered as a union of states, as in a confederation, then legitimacy requires one vote per state. At the other extreme, if it is a union of peoples, then legitimacy requires equal power per citizen entitling more populous countries with increasing voting weight in the Council. Historically the union–of–the peoples approach has been the EU norm since more populous states have a larger voting weight.

5 Centralization v decentralization of policy making

Economic integration requires that some policies are decided by the supranational institutions, "the central authority", and a common policy applies to all member–states. Examples include external tariff, market competition, environmental protection, monetary policy – if a single currency is adopted, financial regulation and even some aspects of budgetary policy. This "harmonisation" of policy opens up the debate of the merits of centralisation versus decentralisation. When the member–states have different preferences for those policies but are forced to consume a greater (or smaller as the case may be) level of the service than it would have been optimal given their preferences when acting independently, a welfare loss results. This is depicted in Figure 1 which shows the demand for a public service by 2 countries *1* and *2*, D_1 and D_2 respectively, when the supply (marginal cost) of provision is *C*. Under decentralisation the two countries act independently and consume Q_1 and Q_2 corresponding to the intersection of demand and supply. When they form a union, the central authority equates average demand $\overline{D}$ to supply and provides the same quantity Q_E to both *1* and *2*. Since $Q_1 < Q_E < Q_2$, that is, country *1* over–consumes and country *2* under–consumes the public service, centralisation generates the welfare losses measured respectively by the decrease in consumer surplus EB_1E_1 and EB_2E_2. Such losses depend on the diversity of preferences and the elasticity of demand (the distance between the demand curves and their slopes respectively). Had the central authority the relevant information about the different preferences in the two countries, it would have been able to provide them with the individually optimal levels of the service; in the latter case however, there would be no reason to form a union and centralise policy making.

Figure 1: Diversity of preferences, economies of scale and welfare of centralisation



Welfare gain of Country 1 at N: $CB_1G_1C'–G_1NN_1$
Welfare gain of Country 2 at N: $CB_2N_2F_2–N_2NG_2$

A second argument in favour of decentralisation relates to the political benefits it offers. Specifically, citizens of independent states can choose their own government, so that they have the incentive and opportunity to make informed decisions about policies that affect them and they exercise more effective control over the discretionary powers of politicians. This way the political principal–agent problem is mitigated and accountability of politicians to voters is improved. In response to this issue the EU has adopted the principles of *subsidiarity* and proportionality.

Subsidiarity means that a policy is assigned to the supranational (=central) authorities when it cannot be achieved by the national authorities. According to proportionality the content and form of EU action shall not exceed what is necessary to achieve the objectives of the Treaties.

By contrast, the arguments in favour of centralisation underline the benefits from economies of scale, correction of externalities and elimination of inefficient non co–operative behaviour. Centralisation often involves significant economies of scale where increasing all inputs by the same proportion increases output more than proportionally and costs rise more slowly than output, resulting in important gains for the consumer. Graphically, the presence of economies of scale that are exploited under centralisation yields a supply curve at C', lower than C. The new equilibrium obtained by the intersection of C' and $\overline{D}$ is denoted by point N yields a larger equilibrium quantity for the two countries $Q_N > Q_E$. The gains from cost savings for country 1 and 2 are shown respectively by the areas CB_1G_1C' and $CB_2N_2F_2$ and the corresponding losses from over – and under – consumption are represented by the triangles NN_1G_1 and NG_2N_2. Thus, the net welfare gains from centralization for 1 and 2 are given by the differences $CB_1G_1C'–NN_1G_1$ and $CB_2N_2F_2–N_2G_2N$.

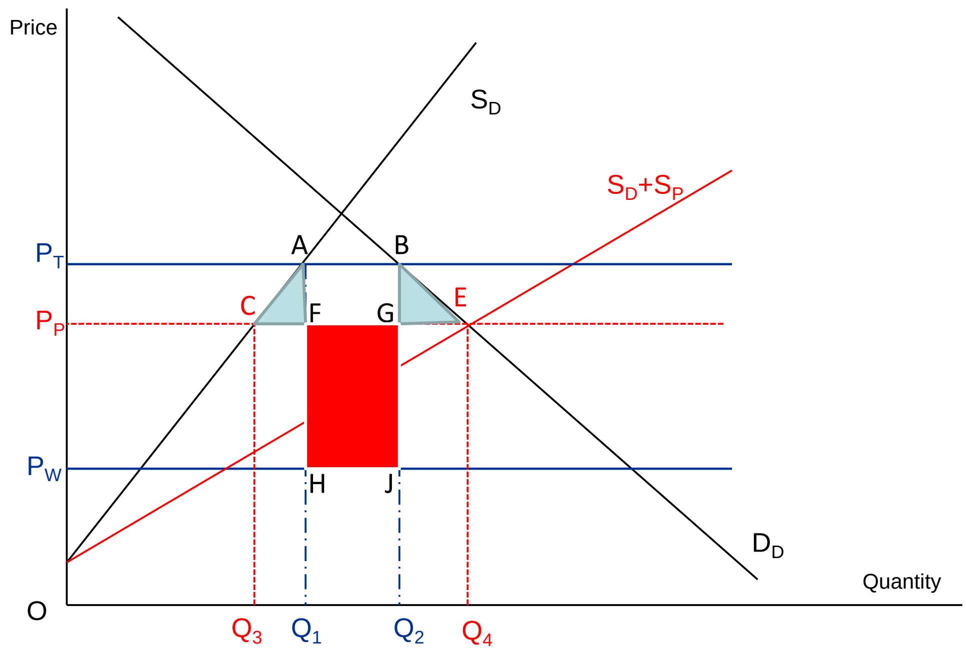
Centralised decision making is also better equipped to address problems of positive or negative externalities (or spillovers), that is, situations where actions taken in one country (like burning fossil fuels, or fishing) may increase or decrease the welfare of another country. However, the presence of externalities does not necessitate centralization, since such problems can be addressed by cooperation between the parties concerned. A third argument in favour of centralization is its ability to avoid non–cooperative behavior by different countries. Countries competing against each other to attract business and mobile factors of production in their territories, which in turn increase the tax basis, may engage in games of competitive tax rate reductions (or other cost–cutting incentives, like relaxation of health and safety standards at the workplace) ultimately resulting in lower taxes and lower welfare in what is referred to as a ‘race to the bottom’, that is, the lowest tax rate or protection for the workforce.

6 Trade and growth effects of economic integration

The economic rationale of integration among sovereign nations is that it promotes trade and growth and hence it increases welfare. In the short–run abolition of trade barriers allows economies to specialise according to their comparative advantage which increases the volume of trade; however against such benefits one must set the costs from trade protection measures against non – members. These static effects of economic integration for an importing country are sketched in Figure 2.

The lines D_D, S_D and P_W denote respectively the domestic demand for the imported good, the domestic supply and the world supply at the exogenously given P_W price. When the country applies a tariff to imports from all countries the domestic price rises to P_T domestic supply and demand are shown by OQ_1 and OQ_2, imports by Q_1Q_2 and import expenditure by Q_1HJQ_2. When a trade union is formed with a partner country that excludes other countries, domestic supply is represented by the line S_D+S_P and equilibrium is obtained at E where D_D intersects S_D+S_P. Domestic demand rises to OQ_4, domestic supply falls to OQ_3 implying the larger Q_3Q_4 volume of imports. Consumer welfare has increased by the sum ACF+BEG; this represents the gain from lowering the import price and is known as the trade creation effect. However, the Q_1Q_2 imports now enter the country at the P_P rather than P_W price paid to the partner country implying that the expenditure on Q_1Q_2 is HJGF. This is known as the trade diversion effect. Thence, the net welfare effect of forming the union is ACF + BEG – HJGF, which can be positive or negative. In other words, it is not a priori clear whether the preferential trade arrangement will benefit or harm the country–members.

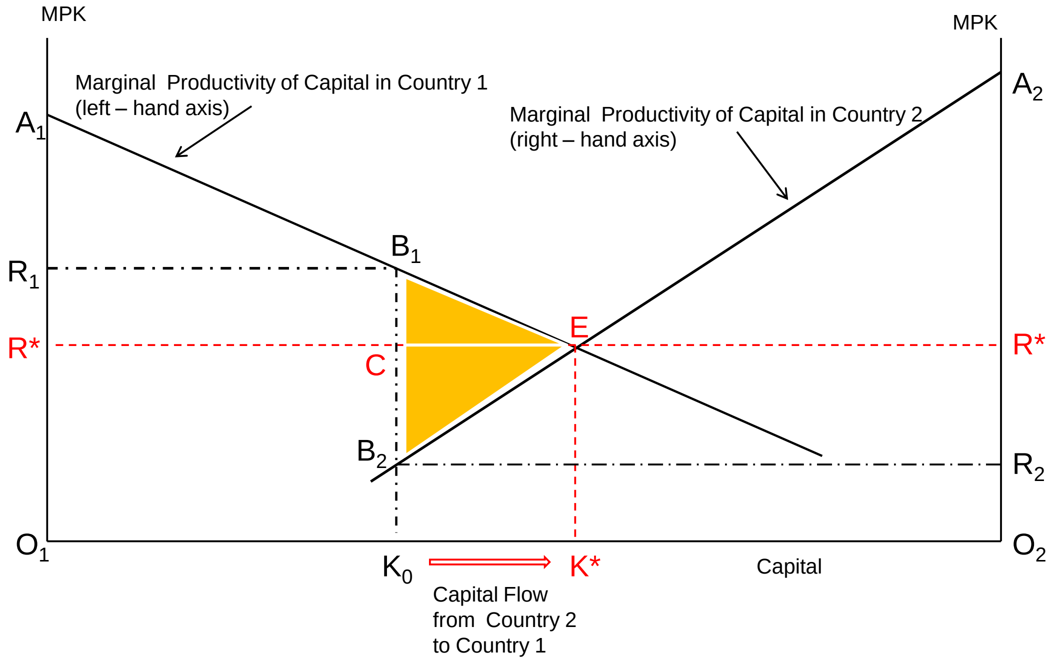
Figure 2: Trade and Welfare Effects of a Customs Union



Net welfare effect of preferential trade: ACF + BEG – HJGF

The effect of factor mobility is shown in Figure 3 using the example of capital mobility. Assume again a two – country setting, where the capital endowment of country 1 and 2 respectively are O_1K_0 and K_0O_2 (giving a total capital stock of O_1O_2 as shown on the horizontal axis). Lines MPK_1 and MPK_2 show the marginal productivity of capital in the two nations (or equivalently, the national demand functions for capital), and R_1 and R_2 show the return on capital in the two countries before capital market integration, with $R_1 > R_2$. The areas defined by the MPK curves, the axis and the individual capital endowments, $O_1A_1B_1K_0$ and $O_2A_2B_2K_0$, show the outputs of the country 1 and 2 respectively. $A_1B_1R_1$ and $O_1R_1B_1K_0$ represent the sizes of labour and capital income in country 1, and $A_2B_2R_2$ and $O_2R_2B_2K_0$ show the corresponding magnitudes in country 2. When capital markets are integrated, capital flows freely from the low return country 2 to the high return country 1 until returns are equalized at R* at the intersection of MPK_1 and MPK_2; country 1 ends up using domestically capital O_1K^* (although it owns OK_0), total output equal to $O_1A_1EK^*$ and labour income A_1ER^* (higher than before by $R_1B_1ER^*$. In country 2, output falls to $O_2A_2EK^*$, labour income falls to A_2ER^* and capital income rises to $O_2R^*CK_0$ (upon adding the capital earnings from capital owned by country 2 but used in 1). Thus the net effect of integration is a gain represented by B_1EB_2, which is the sum of the extra labour income in country 1, B_1EC, and the extra capital income in country 2, B_2EC. Clearly, although the overall integration has a positive effect on welfare, it creates winners and losers in each country, who may resist it with various degree of success depending on their political influence. Similar conclusions about increased output and its differential distribution are derived when we consider the labour market and allow immigration from a low wage to a high wage country.

Figure 3: The effects of Factor Mobility



Net welfare gains from capital market integration: $B_1EC + B_2EC$

Over the long–run, integration implies that firms have access to a larger union–wide market and that they face stiffer competition than when they were confined to their national market only. As a result of more competition, costs and profit margins are squeezed and prices fall. Firms that survive become bigger and better able to exploit economies of scale driving prices further down to the benefit of consumer. The benefits of the restructuring process, however, are at risk from two sources. National governments bowing to political pressures may subsidise and otherwise assist failing firms delaying the efficient restructuring of the economy. Secondly, the emergence of fewer but bigger firms may lead to price collusion negating the benefits of lower prices for consumers. It is for these reasons that the EU has introduced strict rules forbidding state aid and enforcing competition. Since integration encourages a more efficient allocation of resources, human and non–human, labour and capital are allocated more efficiently across different countries boosting the rate of economic growth.

7 Monetary union

Monetary union or monetary integration is an arrangement between participating countries where the exchange rates are permanently and irrevocably fixed, so that a single currency can be used by all members. Several benefits are associated with the adoption of a single currency. (a) The elimination of exchange rate fluctuations and the ensuing uncertainty which discourages trade and investment. (b) Reduction in transaction costs relating to conversion fees and commission charges incurred when exchanging different currencies. (c) Seignorage gains from establishing the single currency as an international reserve currency; these arise from the willingness of the rest of the world to hold the single currency as an asset which then allows the monetary union to import more than it exports. (d) Reduction in the opportunity cost of keeping foreign reserves, since the union needs fewer reserves to manage its currency than the sum of reserves needed by each member–state acting independently.

(e) Greater effectiveness in pursuing aggregate stabilisation policy. While many small open economies acting on their own cannot implement successful short-run aggregate demand management policies because of their dependence on international trade, a union can succeed by coordinating policy among member–states. (f) For countries characterized by high inflation before the formation of the monetary union (like Italy or Greece) adopting a single currency managed by a central bank which is committed to price stability introduces a credible anti–inflationary assurance (or so the argument ran before the debt crisis of 2010).

However, such benefits may be accompanied by severe costs: giving up monetary policy independence and adopting the single currency imply that a country can no longer use the exchange rate to counteract demand and / or supply shocks. When domestic prices and wages are slow to adjust to such shocks, using the exchange rate can be used to adjust domestic demand and supply to re–establish macroeconomic equilibrium quickly. With a floating exchange rate system, the exchange rate will adjust to maintain balance of payments equilibrium; monetary policy becomes effective to affect the domestic economy, but fiscal policy becomes ineffective (because capital will move in and out of the country responding to domestic and foreign interest rate differentials). On the other hand, under a fixed exchange rate regime the authorities must respond to a surplus by reflating and to a deficit by deflating; thus monetary policy becomes ineffective, while fiscal policy is now effective. These considerations point to the "impossible trinity" of having simultaneously a fixed exchange rate, independent monetary policy and perfect capital mobility.

Whether or not a group of countries will benefit from forming a monetary union has been examined by the "Optimal Currency Area" (OCA) literature. This starts from the observation that the larger the area using the same currency, the larger its benefits; but as the area grows larger it includes more diverse countries, which increases the costs of using the currency. Specifically, in the face of an adverse external shock that affects different countries differently (small economic losses for some but large for others), a single central bank cannot differentiate its policy responses according to the needs of the different countries. Asymmetric costs may deter the formation of a currency union. A group of countries can form a successful OCA when the following conditions are satisfied: (a) The labour force is mobile across the different countries. (b) The countries have diversified economies and produce and export similar goods. (c) The countries are open to international trade with each other. (d) They have adopted a mechanism of fiscal transfers that compensate each other for adverse economic shocks. (e) They share common preferences on how to respond to an external shock. (f) Perhaps more importantly, since none of the previous criteria may be fully satisfied, the countries have a sense of solidarity that their fates bound them together and so accept the costs of asymmetric shocks.

When countries lose the exchange rate as a policy instrument they can use fiscal means to counteract any adverse shocks to aggregate demand, especially if fiscal transfers are not feasible – see (d) above. Despite the efficacy of discretionary fiscal policy in a system of fixed exchange rates, its use by member–states of an economic union with a single currency is controversial. Acting independently, a member–state running persistent large budget deficits adding to national debt may face severe difficulties. To bail out the highly indebted country the central bank may increase the money supply, bringing inflation and depreciation of the single currency. Alternatively, debt accumulation may lead to higher interest rates for all country members crowding out private investment. If capital markets are efficient and assess the default risks of different governments, they will demand significantly higher interest on the debt of the profligate government without a general interest rate increase. But if high indebtedness leads to fears about the financial stability of other countries, the commitment of the central bank to low inflation may no longer be believed, implying that the policy of no bail outs for fiscal profligacy lacks credibility.

Accordingly, the risk of default is lower than otherwise. This generates a moral hazard problem where a member–state has an incentive for spending profligacy. Note that there may even be an adverse selection problem where only the worst offenders (those who run the biggest budgetary deficits, like Italy and Greece) are interested in joining the monetary union. In the present state of the play, these questions seem far from settled.

Cross–References in this volume:

Court of Justice of the European Union, European Nationality, Externalties, Decision making fairness vs. Efficiency, Decision Rules, Fiscal Federalism, Free Movement of Goods, Legal Federalism, Median Voter, Neo-Functionalism, Power Indices, Qualified Majority, Simple Majority, Social Europe, Subsidiarity.

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The stock of scholarly work on the economic, political and legal aspects of European integration is enormous and, in view of the fast pace of the changes recent change, expanding rapidly. The following list is only a small sample of some of the most popular texts

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For annual scholarly updates on EU developments the reader is referred to the Supplement of the Journal of Common Market Studies, an academic publication dedicated to EU issues,

The interested reader may also consult the EU website: http://europa.eu/index_en.htm (in English)