EUROPEAN INTEGRATION by JACQUES PELKMANS

CHAPTER 1 What is Economic Integration?

Economic integration has attracted increasing attention since the early postwar period. Under the names of 'regional economic integration', or 'economic regionalism', it is distinguished from the worldwide integration of national economies.[1] Although the study of economic integration has been inspired, if not dominated, by the European example, less advanced forms of economic integration can now be found in all continents. For analytical purposes economic integration should be defined independently from the European experience. Section 1.1 defines economic integration and points out its fundamental significance. Sections 1.2 and 1.3 briefly discuss the relevance of political integration and various institutional ambitions – especially the 'Community method' – to economic integration in Europe. Conceptual refinements of economic integration are introduced in 1.4 (market integration) and 1.5 (the stages of economic integration). The 'stages' approach remains a basic tool for understanding economic integration, although the substance and significance of stages have been amended over time.

Economic regionalism divides the world into preferred and discriminated partners. Therefore, the compatibility of regional integration and the GATT/WTO (1.6) is crucial. Finally, there is the increasing similarity between economic integration and economic federalism, the more ambitious economic integration becomes. For the European Union this implies that the economics of federalism (a specialisation developed in public economics) may hold lessons for the economics of integration (1.7).

1.1 Definition and significance

Economic integration is defined as the elimination of economic frontiers between two or more economies. In turn, an economic frontier is any demarcation over which actual and potential mobilities of goods, services and production factors, as well as communication flows, are relatively low. On both sides of an economic frontier, the determination of prices and quality of goods, services and production factors is only marginally influenced by the flows over the frontier. There is no *a priori* reason for assuming that economic frontiers coincide with territorial frontiers: countries are demarcated by territorial frontiers and economies by economic frontiers. Thus, local economies need not always add up to one regional economy, if economic frontiers between different local communities persist. Likewise, economic frontiers between regions may inhibit national economic integration. European economic integration is driven by efforts to reduce or eliminate the public role of territorial frontiers with European neighbours as economic frontiers. But as the definition implies, this is a necessary, not a sufficient condition for economic integration. Demarcations within and between national economies may remain, perhaps as a result of natural barriers (e.g. mountains, sea) the costs of which have not been sufficiently reduced by infrastructural and transport provisions, or perhaps as a result of great disparities in the levels of development, or perhaps as a result of business collusion in a region or country. Even discrepancies in the availability, speed and quality of information might sometimes serve as an economic frontier.

The fundamental significance of economic integration is the increase of actual or potential competition. From the vantage point of one region or country this competition is engendered both by participants originating elsewhere in the country (in case of interregional integration) or group of countries (e.g. in the European Community) and by their own participants reaching out beyond the traditional confines of the economy.

Competition by market participants is likely to lead to lower prices for similar goods or services, to greater quality variation and wider choice for the integrating area, as well as to a general impetus for change. Product designs, services methods, production and distribution systems and many other aspects become subject to actual or potential challenge. They may induce changes in the direction and intensity of innovation and in working habits. However, as will be shown in chapter 4, economic integration will also expose regional or national governments to competition, with interesting consequences.

In a fantasy world without nation-states, at least without governments, economic integration would boil down to pure market integration, presumably apolitical. In the real world, economic integration is always to some extent political. When modest ambitions prevail, the politics of economic integration will largely remain domestic, apart from coalition formation and negotiation of the classical intergovernmental type. Higher ambitions of economic integration tend to be accommodated by, or to result from, political integration processes.

1.2 Economic and political integration

The relation between economic and political integration may differ from case to case. Clearly, interregional economic integration within one country assumes a close correspondence between (national) economic and political integration. Nevertheless, the Sun-belt in the United States after the Civil War (1861-5) remained less than fully integrated in the US economy for perhaps as long as 80-90 years. Similarly, the Mezzogiorno (Italy, south of Naples) failed to be integrated economically long after political unification of Italy was completed (1870). The processes of economic and political integration in the European Union have been linked from the start. Apart from historical reasons, the perception of threat from communism and the Cold War played a major role in blending economics and politics. Efforts to forge union in Western Europe have been numerous and several attempts preceding the EEC treaty of 1957 were overtly political (see chapter 2). Thus, the European Coal and Steel Community (ECSC) was founded in 1951, following a dramatic appeal by French foreign minister Robert Schuman in May 1950 to place the two most important sectors for war-making at the time – coal and steel – under one supranational authority so as to preclude another French–German war. European security was therefore the main aim of the ECSC, and sectoral market integration merely the means. In 1952–3 proposals both for a European Political Union and for a European Defence Community were submitted to, for example, the French parliament, and almost accepted. The EEC treaty of 1957 contains traces of the desire for political integration as the preamble avows to strive for 'an ever closer union among the peoples of Europe'.

There is little doubt that the implicit desire to pursue political integration via the economic means specified in the Rome Treaty was a major reason for the United Kingdom, Denmark, Norway and some neutral, non-socialist countries not to join the final EEC negotiations in 1956 (see chapter 2).

Although these conclusions are hardly contested, their meaning for the nature and process of economic integration is unclear. Political motives may explain the institutional set-up of the original EEC. But the subsequent development of the Community was almost entirely driven by market integration and selective common economic policies, not by foreign policy cooperation, or matters of security or defence until the late 1980s and early 1990s. Also, key political issues in the domestic political processes of the Member States such as employment, inflation, social security, domestic security or societal values were hardly affected by the European Community (EC)[2] for several decades.[3] In actual practice, therefore, it is

[1] Note that 'regions' in this terminology refers to groupings of countries or continents. However, in the present book, 'regions' is used for parts of countries, unless stated otherwise.

[2] As explained in chapters 2 and 3, the EC and the European Union (EU) are not synonymous. In this book the EU will generally be used to indicate the Union both past and present, although formally the Union has only existed since the Maastricht Treaty. EC is only used where legally this is required.

[3] A significant exception was that only democratic European countries with an acceptable human rights record can become EEC members.

exceedingly hard to trace how and to what extent the political aims of the Community have influenced the nature and process of economic integration in the EC. Some landmark decisions in EU history are impossible to explain, however, without recourse to elusive, but persistent feelings of pursuing common political aims, especially in times of perceived crisis (see chapter 2).

1.3 Institutional aspects of economic integration**

This book will not analyse the institutions and decision-making methods of the European Union (EU). A summary is provided in Appendix 1.1 to this chapter. But in two related aspects the 'Community method' implies unique properties which have probably helped the EC to pursue economic integration further than anywhere else in the world and hence ought to be mentioned specifically: supranationality and pooling of sovereignty. Virtually all efforts in the world economy to pursue economic integration in a group of countries, including multilateral reduction of economic frontiers worldwide, are subject to severe constraints imposed by national sovereignty. Countries may, of course, voluntarily limit their exercise of certain sovereign rights in treaties or agreements, for example, to liberalise trade in a group or worldwide. But such treaties will always be conditional and all important decisions other than implementation will be taken unanimously. In other words, a country can always exercise a veto or opt out.

Also, judicial review of suspected infringements of the commonly agreed rules will either not exist or not be binding. Lacking judicial review, all that remains are political or bureaucratic dispute-settlement procedures which carefully avoid touching the sovereignty of the countries involved. The Community method moves distinctly beyond this conditional approach. The ECSC and EEC treaties, and the two revisions of the latter,[4] assign certain competences exclusively to the Community level; both also establish a common Court, the rulings of which override national law or court rulings. This ambitious approach affects national sovereignty, of course, but it does not imply a 'loss' of sovereignty: through 'pooling', sovereignty is jointly exercised in the relevant policy areas. The preparedness to go so far removes a major and obstinate political barrier to pursuing economic integration. But it is a two-edged sword, as the ambition may, at times, develop from a facilitating factor into a source of profound political discord. This may happen when domestic politics in one or more Member States develop extreme sensitivities to the visible adjustment costs of integration. It is also bound to occur when some countries do not wish to accept the full regulatory or policy consequences of the integration they pledged to pursue. The discord may even go so far as to disrupt economic integration.

Supranationality is closely intertwined with the pooling of sovereignty. The former is associated with the establishment of common institutions, such as the High Authority (in the ECSC), the Commission (in the EEC and Euratom treaties) and the EC Court of Justice, in all of which powers are vested far beyond those normally assigned to international secretariats. For instance, the European Commission has the sole right of initiative in proposing EC legislation. In other words, although the Council of Ministers will dispose, it cannot propose draft legislation. In addition, the Commission has considerable monitoring powers as the 'guardian of the treaty', for implementation and as the executive branch at the EC level for selected EC policy areas (e.g. competition). The other important aspect of supranationality is the possibility of being outvoted in the Council of Ministers, by simple or qualified majority voting. On the face of it, this is merely a matter of degree, since qualified majority voting is not entirely unknown in international organisations. There is a significant qualitative difference, however. Its importance in the Union derives from two characteristics. First, the economic importance and range of policy areas subject to (qualified) majority voting has always been much larger than in any other international body, and the two treaty revisions have drastically increased the weight of these policy areas. Second, unlike in other international bodies, the Union has no general opt-out provisions and no recognised right of exit ('secession'), while the (Maastricht) Treaty itself does not have an expiry date,[5] all elements which greatly increase the sensitivity to possibilities of being outvoted.

It is not the task of this book to verify the impact of these institutional properties on economic integration in general. It will be obvious to the reader that, when political views differ fundamentally among Member States, even these properties will be undermined. However, as will be shown throughout the text, the Community has actually been able to accommodate a considerable divergence of perspectives and yet achieved far-reaching progress in economic integration. Moreover, the stability of the accomplishments has proved to be robust, despite several upheavals, crises and several enlargements from six to fifteen Member States. It is hardly conceivable that such impressive results could have been had without the 'Community method', facilitated by a political climate in which ambitious integration was an avowed aim.

At the same time, one should acknowledge that in the actual operation of the Community the notions of pooled sovereignty and supranationality have become blurred. In this respect two relevant characteristics of today's process are intergovernmentalism and cooperative federalism. Both properties are blended with the old ones into a complex and subtle system of decision making that probably increases the legitimacy of the European integration process. Intergovernmentalism refers to classical bargaining and coalition formation among national governments seeking consensus, if not explicit unanimity. As a result of a strong tendency in the Council of Ministers to work intergovernmentally, the scope for (qualified) majority voting in the original Rome Treaty was hardly used. The so-called Luxemburg compromise of 1966[6] led some Union countries to practise a veto policy and thereby weaken this aspect of supranationality. Only after 1985 did majority voting actually become prominent: the old majority-voting articles were regularly applied, once consensus proved impossible, and several important policy areas – including many internal market issues – were newly subjected to majority procedures. Intergovernmentalism also raised its head where powers had been assigned to the European Commission. By what has become known as 'comitology', the Commission sought to, or was forced to, consult the Member States on numerous details of implementation decisions. Having become constricted in a huge web of advisory and other committees composed of civil servants from the Member States, the actual exercise of Commission competences became more and more dependent on processes akin to intergovernmental bargaining.

The developments are also related to substance, and not merely to procedure. In an economic perspective, the institutional design of the Community is critical for the efficiency and effectiveness of the public economic functions exercised at EC level. Chapter 4 discusses not only the economic rationale for assigning certain economic functions to the Community level, but also to some extent how these functions ought to be exercised. Least-cost methods of joint regulation and adequate solutions for accountability and legitimacy of public policy will foster efficiency and effectiveness. In this sense intergovernmentalism has a Janus-face. In some cases it may result in inefficient decision making and excessive Member States' control of the Commission, thereby undermining an asset of the Community method. In other cases, it may justifiably express concerns of accountability (at least, to Member States' administrations) or legitimacy, serve as a channel to reveal the spectrum of preferences, and improve information flows about experiences and problems. If construed in the latter way, it may help the Community achieve better rules and policies. There is, in other words, an efficiency case for the enmeshing of Member States with Union powers and their exercise. Nevertheless, the case has to be made every time because it is easily abused by the Member States.

Cooperative federalism constitutes a radical extension of the view that Member States' involvement with Union competences need not necessarily be interpreted as a mere breakdown of supranationality. Quite the contrary, once a high degree of market integration has been accomplished, the Union level may find it more effective to share the enforcement and executive functions with the institutions of the Member States. In cooperative federalism, this is combined with firmly agreed common principles, Commission monitoring, the Commission's 'guardian' function and the EC Court as guarantees for market integration and the desired minimum of communality. At the same time, Union policies and regulation can be based on principles respecting the remaining autonomy of Member States as much as possible, while inducing the same Member States to cooperate among themselves and/or with the Commission so as to facilitate the achieved market integration.

It may be very misleading to assess institutional aspects of European integration without explicit reference to the achieved degree of economic integration. It

[4] The Single European Act, in force since July 1987, and the Maastricht Treaty, in force since November 1993. See chapters 2 and 3.

[5] The ECSC treaty does expire in 2002. However, it will be absorbed into the EC treaty, as part of the Maastricht Treaty on European Union (see chapter 14).

** See 'How to Read this Book' on page xiv.

[6] After an institutional and political crisis about proposed new powers for the Commission and the right of veto in case of a 'vital' interest, Member States 'agreed to disagree' on vetoing in 1966. Of course, the core of the problem was that this right was self-proclaimed and its interpretation would be unilateral by the Member State invoking it.

is precisely due to the Community method that the *acquis communautaire* – the accomplishments at EC level in Community law and jurisprudence – is robust and not subject to erosion. Intergovernmentalism and far-reaching involvement of the Member States do not change that. Rather, the latter two characteristics may cause difficulties for new areas or for certain aspects of implementation. Nonetheless, intergovernmentalism is not necessarily too high a hurdle. The EC treaty has been revised twice and this constitutional process is, by definition, a matter of intergovernmentalism par excellence, made more difficult still by ratification in all the Member States. Yet, major breakthroughs were adopted (see chapter 3).

1.4 Market integration and other forms

Economic integration refers both to market integration and (economic) policy integration. Market integration is and remains the essence of economic integration, as is clear from the definition of the latter. Most economic policies directly relate to market conduct, or to structure, performance or distributive outcomes of markets. *Market integration* is a behavioural notion indicating that activities of market participants in different regions or Member States are geared to supply-and-demand conditions in the entire Union (or other relevant area). Usually, this will also show up in significant cross-frontier movements of goods, services and production factors. Potential, but not actually observed, flows may also be important in constraining suppliers' price conduct or in consumer behaviour. In a market of perfectly homogenous goods or services or one type of financial capital, market integration can be measured by the degree of price convergence.

Compared to market integration, *policy integration* is a less precise concept. It may cover very different types of economic policies, using different kinds of instruments. Moreover, the degree of 'binding' and commonness may vary, from consultation and cooperation via coordination to common policies or fully fledged centralisation. To make matters even more complicated, some elements of policy will be expressed in specific regulation and others in powers leaving a large degree of discretion, the use of which may vary over time and also involve non-regulatory means such as budgetary expenditure. Policy integration cannot, therefore, be measured in any straightforward way. Indeed, whereas there is a strong presumption that market integration (if not distorted) is generally welfare-increasing, more policy integration may or may not be good for aggregate welfare.

Another important distinction is that between positive and negative integration, originated by Tinbergen (1954). *Negative integration* denotes the removal of discrimination in economic rules and policies under joint surveillance. *Positive integration* refers to the transfer to common institutions, or the joint exercise, of at least some powers.[7] In practice, negative and positive integration will go together. The often heard claim that less ambitious forms of economic integration can rely solely on negative integration is not borne out in actual practice. Of course, weak and incomplete preferential trade arrangements will at most allow joint monitoring and perhaps an attempt at dispute settlement. If these (very modest) common powers are not exercised, one can scarcely expect regional trade liberalisation to work well. The EU engages in ambitious forms of economic integration and they require an appropriate combination of positive and negative integration. However, there are no unique solutions or hard and fast rules. This is true even for economic federalism, a level of accomplishment the Union has not fully achieved: the combinations of negative and positive integration in the Canadian, the US and the EU internal markets – as achieved today – are all distinct (Pelkmans & Vanheukelen, 1988).

1.5 The stages of economic integration

The complexity of economic integration, and the radically diverging degrees of intensity, have led analysts to distinguish several stages of economic integration. The stages approach dates back to Balassa (1961) and its usage is widespread. Though the original Balassa stages have to be amended in various ways, the approach is indispensable for an understanding of the literature and of key issues in policy making. In addressing the drawbacks one can gain some insight into the learning process which the study of European economic integration has gone through since the early 1960s. Table 1.1 provides the five Balassa stages and briefly describes a few of their characteristics.

The stages are presented sequentially for analytical reasons. However, there is no compelling reason to follow the sequence rigidly. For instance, the EEC

[7] The words positive and negative do not have any normative value with respect to 'welfare' or otherwise.

Table 1.1 The Balassa stages of economic integration

Stage	Definition	Characteristics/comments
Free trade area (FTA)	• tariffs and quotas abolished for imports from area members • area members retain national tariffs (and quotas) against third countries	essence of GATT definition: no positive integration
Customs union (CU)	• supressing discrimination for CU members in product markets • equalisation of tariffs (and no or common quotas) in trade with non-members	essence of GATT definition: no positive integration
Common market (CM)	• a CU which also abolishes restrictions on factor movements	is 'beyond' GATT: definition should also include services; no positive integration
Economic union	• a CM with 'some degree of harmonisation of national economic policies in order to remove discrimination ... due to disparities in these policies'	positive integration introduced: extremely vague
Total economic integration	• 'unification of monetary, fiscal, social and counter cyclical policies' • 'setting up of a supranational authority where decisions are binding for the Member States'	centralist: vision of unitary state: supranationality only introduced here

Source: Balassa, 1961

started with a customs union, not a free trade area. The sequence is helpful for understanding the additionality in each stage when increasing ambitions for economic integration.

It is important to reflect upon the limitations and problems of this classical view. First, in the world economy today there are a number of preferential trading arrangements whose ambitions do not even match the first stage of Table 1.1. These preferential arrangements may be limited in the scope of products covered, and tariffs (and quotas) for intra-group imports are not fully removed. GATT allows this for developing countries, not for developed ones. A special case is sectoral integration such as the ECSC for coal and steel, or the 1965 US/Canada automotive agreement. For developed countries such sectoral initiatives require a waiver, that is, a derogation from GATT.

Second, although the FTA and the CU definitions capture the essence of the GATT definitions and are therefore widely used, the absence of positive integration deprives these notions of practical applicability. This drawback is less severe in the case of an FTA as an FTA does not even have a common external tariff. A simple FTA is the one between the EC and the respective EFTA (European Free Trade Association) countries, established in 1972: positive integration is confined to origin and other customs matters. However, the Stockholm Treaty (1960) establishing EFTA does include modest forms of joint management and, for example, occasional harmonisation in selected cases (Curzon Price, 1974). Recent free trade areas among developed countries go much further in product scope (e.g. including some aspects of services) and in approximation of certain forms of economic regulation. This is true for the CER agreement between Australia and New Zealand[8] and NAFTA.[9] The free trade area that goes furthest is the European Economic Area (EEA), concluded between the EC and most EFTA countries in 1992: the EEA is a hybrid of a free trade area for industrial goods and for services with far-reaching approximation (i.e. making more uniform) of economic regulation (see chapter 18).

In the case of customs unions, however, the absence of positive integration is simply misleading. It is possible to conceive of a customs union as a tariff union[10] only. Even in that event, however, tariff classifications have to be unified, customs rules harmonised

[8] CER, also called ANZCERTA, is the Australia/New Zealand Closer Economic Relations Trade Agreement, in force since 1983. For a summary see GATT (1994) *Trade Policy Review–Australia*, Vol. 1, pp. 30–33.
[9] NAFTA is the North American free trade area, between Canada, the USA and Mexico, concluded in 1992. For an authoritative survey, see Hufbauer & Schott, 1992. In fact, both CER and NAFTA contain some elements of a common market in that they deal with intellectual property rights and the right of establishment (without going very far, as yet).
[10] Assuming quotas to be reconverted into tariff equivalents.

to a large extent and the issue of the distribution of tariff revenues has to be addressed. In actual practice, many more elements of trade policy will be under pressure to be approximated, made compatible or transferred to common institutions. So, positive integration is already of some importance in a tariff union. This might include anti-dumping, the conclusion of trade treaties and negotiations in GATT. The EC customs union, as well as the older Benelux customs union, have gone much further than a mere tariff union. The Community included a common agricultural policy so as to allow for intra-union agricultural trade to be free (see chapter 11). It also established a common competition policy for intra-EC trade not to be distorted by adverse business conduct (see chapter 12). Furthermore, the Community relied upon open-ended provisions for the approximation or uniformity of economic regulation (see chapters 4 and 5) and some indirect taxation (see 5.4.3).

Third, also the Balassa CM suffers from the absence of positive integration. It ignores the cross-border provision of services, too. Taking Balassa literally, the CM would neither imply approximation of national economic regulation nor any transfer of regulatory powers to the Union, nor any harmonisation of direct or indirect taxation, let alone any transfer of tax powers, or, for instance, Union competences for a common competition policy.[11] The shortcomings of this CM concept are so serious that an adapted definition should be used to prevent misunderstandings: a common market attains the free movement of products, services and factors of production accompanied by the necessary positive integration for the common market to function properly. The stages theory does not answer the question what that 'necessary positive integration for the common market to function properly' is. This question will be tackled in chapter 4, with the principle of subsidiarity, a derivative of the economic theory of federalism. Chapters 7 and 9 deal with the free movement of services and productive factors respectively, in the light of this adapted definition of a CM.

Fourth, there is a conceptual problem about how to distinguish Balassa's common market and economic union. Balassa's economic union comes close to our adapted definition of a CM, combining positive and negative integration. The Balassa definitions in Table 1.1, however, lead to an unhelpful dichotomy between, on the one hand, the CM as confined to free movements without attention to discrimination and distortions, and, on the other hand, the 'higher' stage of economic union, where the liberalisation leading to free movements is duly accompanied by positive integration with a view to reducing or preventing discrimination and distortions. Unless one is willing to make extreme assumptions about the role of governments in the economy, it is inconceivable that the Balassa CM can exist in its own right.[12] In actual practice, therefore, his third and fourth stages should be taken together, as is done in our definition of the CM. It prompts the question whether there remains a place for such a thing as an economic union in Union practice. This is not a semantic problem. The Maastricht Treaty includes an 'economic union', without defining it, however. Chapter 17 explains the importance of this economic union and provides a conceptual discussion.

Fifth, defining the final stage as total economic integration is unwarranted. The framework of reference would appear to be that of a unitary state, which is unlikely to be appropriate both on economic and political grounds. One could envisage several partial 'unions' beyond the economic union, such as a tax union, a social union, a monetary union and a political union (with the relevant budgetary and economic policy aspects). Whether and why they should be embraced can be analysed with the help of the economic theory of federalism, given alternative political assumptions about the readiness to pool sovereignty. Such an approach rejects the Balassa presumption of 'unification' and seeks to justify the proper degree of (de-)centralisation within such 'unions' on economic grounds.

Sixth, the introduction of supranationality only in the final stage cannot be justified either on economic or on empirical grounds.

1.6 Economic integration and the GATT

Table 1.1. lists three forms of economic integration:

- FTA and CU, recognised in international economic law for centuries (see e.g. Viner, 1950) and codified in the GATT, Art. 24;

[11] In Balassa (1976) the author reviews his former classification and acknowledges especially the problem of including the appropriate degree of positive integration for the CM.

[12] Moreover, as chapter 16 will show, a pure CM à la Balassa would be unstable for reasons having to do with financial capital mobility and the autonomy of national monetary and exchange rate policies.

- the common market and economic union not specified in international economic law; the terms are widely used, but the definition of economic union especially varies greatly;
- total economic integration, a term fallen into disuse; however, of the 'partial' unions 'beyond' an economic union mentioned above, the monetary union is often considered as a stage by itself – its essential characteristics are clearly defined, although the desirable budgetary and other policy integration is somewhat controversial; terms such as a 'social union' (applied in the German unification in 1990), a tax union and (the economic elements of) a political union would seem to be more arbitrary.

The present section will briefly elaborate on the status of FTA and CU in the GATT. Section 1.7 will relate the higher stages to economic federalism.

The two most important elements of the GATT are the principle of non-discrimination and the drive for multilateral trade liberalisation. The first one is a legal obligation whereas the second is an avowed aim, guided by reciprocity (an agreed balance of concessions among the contracting parties) as a negotiation principle and the 'most favoured nation' principle as an assurance of multilateral non-discrimination for any concession made.[13] FTAs and CUs are inconsistent with the principle of non-discrimination, as they are by definition preferential. They may be inconsistent with the drive for multilateral liberalisation, as they are instances of 'regional' integration.

The GATT provides various possibilities for *legal compatibility* of FTA and CU with the non-discrimination and MFN principles. Under article 25, para 5, a 'waiver' can be obtained from those obligations: this procedure was used in 1952 to obtain GATT acceptance for the ECSC treaty. A much more common procedure is to refer to Art. 24 (para. 4 to para. 9). It is in this article that FTA and CU are defined and minimum conditions for GATT compatibility are prescribed.

Additional reading

Article 24, para. 8 says: 'A free trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce ... are eliminated on substantially all the trade between the constituent territories in products originating in such territories'.

This is essentially the same as the FTA in Table 1.1 but some interesting specifications are added. First, rather than quotas, the GATT speaks of a much more encompassing category of 'other restrictive regulations of commerce'. In actual GATT practice, this has covered little more than quotas and import licences for product trade. There is no economic reason why 'other restrictive regulations' could not include a host of other economic regulations which somehow restrict exchange in the FTA. As noted, some recently concluded or upgraded FTAs tend to go far beyond the traditional FTAs in these respects. At the same time, many FTAs have kept numerous exceptions in place, given the vagueness of the GATT definition. Second, there are ways FTAs can remain economically incomplete, even when only tariffs and quotas are considered:

1. 'Substantially all the trade' should be covered: it has been commonly accepted that agriculture is excluded (e.g. in EFTA) or only included selectively (e.g. the Union's FTAs with Mediterranean countries), since the GATT obligations on agriculture were minimal before the conclusion of the Uruguay Round; however, many FTAs also employ 'exclusion lists' (e.g. the ASEAN Free Trade Area).
2. Interim agreements (para. 5, Art. 24) are also possible, provided they lead to an FTA (or CU) within a 'reasonable' time; since many FTAs among developing countries in the 1960s and 1970s failed to progress, this provision has not been taken seriously; the EU has broadly complied with announced timetables for FTAs.

Third, developing countries have obtained a special 'enabling clause' (part IV) of 'special and differentiated treatment' in the GATT. The relation between part IV and Art. 24 is controversial (McGovern, 1986, pp. 267–8) and this has given developing countries de facto unlimited discretion to conclude incomplete preferential agreements or any kind of (partial) FTAs. It would seem that this discretion has reduced under GATT/WTO agreements, concluded in Marrakesh.

Finally, there is reference to products 'originating' from FTA countries. In other words, since products

[13] The reader is referred to authoritative works on the GATT, e.g. Jackson (1990), or McGovern (1986); for the Marrakesh (Uruguay Round) package, see GATT (1994).

from third countries are subjected to national trade policies in an FTA, and since these will differ, the FTA will need certificates of origin. Without such administrative controls, trade would be deflected via low-tariff FTA members, before enjoying zero-tariff access to high-tariff FTA members. The certificates enable customs officers to prevent this trade deflection. These certificates will accompany any intra-FTA import and export of goods. There is an administrative and an economic problem here. The former may become a burden for complex goods with multi-country origin, which is a frequent phenomenon in today's world trade with refined specialisation and global networks of subcontractors. The latter may arise from attempts to reduce the complications of establishing origin, whenever origin from FTA members is not close to 100 per cent. In these cases, usually a simple cut-off rule is applied, say, intra-FTA free trade applies to all goods with at least 50 per cent origin in FTA members. However, such simple origin rules can conceal protectionist attitudes, if the cut-off share is high (e.g. 65% for cars in NAFTA), if the methods for establishing the origin share are costly and discretionary, or if there is no cumulative origin for the FTA as a whole but only origin per individual FTA member. Of course, the inclination to employ these technicalities for restrictive trade purposes will be higher, the wider the absolute and relative discrepancies are among the national trade policies in the FTA.

The same GATT article says:

> A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories so that
>
> (i) duties and other restrictive regulations of commerce ... are eliminated with respect to substantially all the trade between the constituent territories of the union ... and
> (ii) ... substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union.

The first three comments on the FTA, given above, equally apply to the CU. In addition, the following should be noted. With respect to extra-CU trade – that between the CU and third countries – the notion of a single customs territory is the crucial difference with an FTA. Item (ii) is not very precise in speaking about 'substantially the same duties and other regulations of commerce'.[14] However, the EC's customs union simply installed a common external tariff (CET).

About 'other regulations', one may note that even the ambitious EU had major difficulties in unifying its external trade policy. A notorious problem (until 1992) related to national quotas for third-country imports, especially in clothing and cars (see 6.5.3 and chapter 13). Once quotas are national, it may pay for traders to go for trade deflection, even in a CU. Thus, for proper quota enforcement at the national level, the CU will be forced to impose certificates of origin for intra-CU trade. In these products, the CU then functions as if it were an FTA. The GATT does not clearly prohibit this inconsistency.

On the whole, however, the EC has made clear and simple choices: it set out to arrive at a CET, proclaimed a common commercial policy and covered all intra-CU trade (see chapter 5).

CUs and FTAs differ with respect to the compatibility test the GATT has come to apply over the years. The crux of the matter for other GATT contracting parties is, of course, that CUs and FTAs should not raise barriers for trade with third countries, as Art. 24, para. 4 prescribes. In para. 5, the FTA test to satisfy this prohibition is simple: no higher level of duties or more restrictive regulation of commerce may be imposed than was previously applied by the FTA countries. But this straightforward test cannot apply to CUs as they will move to a CET, coming from different *ex ante* tariffs, and possibly to other common regulations, with different national ones before. Thus, the GATT says that the duties and other regulations established by the CU must not 'on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce' previously applied by the CU Member States. This *general-incidence clause* moves the test away from a factual verification of the CET and other measures themselves, and concentrates on the effects of the CU on trade with third countries. This economic test can, in principle, be implemented with the help of the economic analysis of customs union (see chapter 6). Without anticipating this analysis, a warning can be formulated about the EC's technique to establish the CET as the arithmetic average of *ex ante* national tariffs. Art. 19, EC. Though seemingly neutral with respect to non-EC countries, this average does not tell the GATT much about the general economic incidence of the CET as compared to the general incidence of *ex ante* tariffs. And even if all CU members had across-the-board tariffs of 10 per cent before the CU, and hence the CET would be 10 per cent, too, this does not mean that the general-incidence clause is satisfied. It is this crucial insight that forms the basis for CU theory.

The other problem of FTAs and CUs for the GATT is whether regional (product market) integration facilitates or undermines multilateral trade liberalisation. Rather than being building blocks to free trade under the multilateral GATT rules, could a proliferation of FTAs and CUs not prove to be stumbling blocks for achieving or even maintaining multilateralism? In so far as the EU is concerned, this question is taken up in chapter 13.

1.7 Economic integration and economic federalism

The higher or more ambitious the stages of economic integration, the closer is their resemblance to economic federalism. Since all federations in the OECD[15] are not only CUs in the sense of GATT but also common markets, as well as economic and monetary unions, some guidance may be had from a comparison with economic federalism.

There is one important caveat, however. Federations are mature political unions with federal government. In such a polity, the 'stage of economic integration' is essentially a product of the degree of *decentralisation*, as determined by a combination of historical tradition, political feasibility and economic costs and benefits. Whatever the chosen degree of decentralisation of public economic functions, the integrity of the federation and its economy are not at issue.[16]

Processes of economic integration among independent countries, even when they increasingly 'pool' their sovereignty, are governed by a radically different political logic. All major steps are subject to unanimity in the group and heavy ratification procedures in each one of the Member States. Political sensitivities may, and do, crop up over time and threats of retrogression are difficult to fend off if the domestic politics in a Member State go against the government or a groundswell of public opinion undermines the legitimacy of integrationist accomplishments. Stability can be greatly strengthened, and legal mechanisms and political legitimacy can be fostered, by giving electoral political status to common leaders, but the nature and extent of these solutions may themselves be politically controversial. In other words, the integrity of the 'union' economy is itself the issue *par excellence* and the integrity of the federation is not yet accomplished (and may never be).

All federations in the OECD have achieved a common market in the sense that internal factor movements are free and a degree of positive integration helps to make the CM function reasonably well. But this neither implies a counsel of perfection nor one of uniformity between the constituent states, regions or provinces. In terms of 'completeness' of a CM, one might pose questions about the interstate trade of financial services (banking and insurance, especially) in the CM of the USA, or about the inter-provincial trade of, for example, beer in the CM of Canada. Many federations encounter problems in the free movement of professionals, because the lack of uniformity (e.g. in diplomas) is not always compensated for by smooth mutual recognition.

In terms of uniformity, it is crucial to appreciate that federalism aims to find optimal combinations of unity and diversity. Hence, where positive integration to make a CM function properly would impose uniformity, the regional preferences for diversity may be suppressed. As a result, any federal CM exhibits numerous trade-offs between the benefits of reducing regulatory discrepancies in the CM and the benefits of satisfying regional preferences. The comparison of the CMs of different federations therefore shows different solutions for various aspects. What is achieved by mere liberalisation and strict case law in one federation, might be accomplished through almost complete regulatory uniformity (harmonisation or even centralisation) in another one. Great divergencies in regional fiscal autonomy can also be observed, with Switzerland and the USA being rather decentralised and Germany and Belgium, for example, relatively centralised.

A comparison of federations with respect to economic union would require an authoritative analytical framework, which – as noted – is not available (see, however, chapter 17). It is worth noting that all federations are also monetary unions[17] with centralised monetary policy functions. Only the USA

[14] Note that the adjective 'restrictive' before regulations – used in item (i) is dropped; were it not, the GATT rules might be abused as an excuse to endow the CU with restrictive regulations vis-à-vis third countries.

[15] Canada, the USA, Australia, Germany, Switzerland, Austria and Belgium. In some respects one could add Spain and Italy.

[16] With the possible exception of Quebec in Canada. However, despite recurrent threats secession has never actually taken place.

[17] In the UK, Scotland has maintained its own bank notes but its issuing authority has no policy discretion. In the case of German unification, the 'Ostmark' disappeared when monetary union was initiated in 1990.

has maintained a network of regional central banks in the Federal Reserve System, without, however, compromising the centralisation of monetary (and exchange rate) policy. The respective monetary unions differ with respect to their budgetary regimes, especially regional borrowing autonomy, and the relationship between federal taxation, the (re-)distribution of revenues and regional spending. Monetary unions in federations also diverge in their attachment to price stability and the (political) independence and accountability of the central banks. Finally, it should be realised that federal monetary unions invariably function against the backdrop of elected federal governments and federal budgets which amount to an appreciable share of total government spending in the economy. Of course, the latter two characteristics are thus far absent in the European Union, even though (in 1996) it is already in stage 2 of the road towards its Economic and Monetary Union (see chapter 17).

1.8 Summary

Economic integration is the elimination of economic frontiers between two or more economies. The fundamental significance of economic integration is the increase of actual or potential competition, and the benefits flowing from this.

Economic integration in Europe should be understood against the backdrop of recent history, political aims and institutional aspects, especially the 'Community method'. The original Community method combined supranationality and the pooling of sovereignty. Later, this was blended with intergovernmentalism and cooperative federalism, magnifying the role of the Member States in decision making as well as implementation and enforcement, respectively.

Besides the distinction between market and (economic) policy integration, negative and positive integration are also useful concepts when understanding economic integration processes.

The Balassa stages of economic integration remain a basic tool of study. Important insights can be gained from several amendments prompted by the absence of positive integration in Balassa's stages of the customs union and the common market. This may also blur the difference between the common market and economic union. Balassa's highest stage is misconceived, inspired as it is by a centralist, rather than a federal, state model.

Economic regionalism is inconsistent with the GATT's non-discrimination principle. The legal compatibility of free trade areas and customs unions with GATT hinges on certain specific constraints (in Art. 24, GATT). In addition, the free trade area test checks whether any more restrictive measure is introduced whereas customs unions are subjected to an economic incidence test.

Understanding the higher stages of economic integration is facilitated by studying the economics of federalism. The two have in common the idea that 'welfare' is best served by the optimal combination of unity and diversity.

1.1 APPENDIX

European Institutions : a brief guide

Nowadays, simple and clear introductions into the institutions and legislative processes of the European Union are widely (and often freely) available in many countries of the world. The following description is kept to a minimum and merely serves as a reminder.

Before doing so, a few warnings. The EU system is one of multi-tier government. Thus, despite some popular suggestions to the contrary, Member States themselves are just as much part of the EU as the common bodies at EU level are part of the EU. It is also worthwhile repeating the distinction between EC and EU (see also Figure 2.1 in section 2.5). EC stands for European Community, legally based on the (main and) first pillar of the European Union (or Maastricht) treaty, which also incorporates two (far less comprehensive and less binding) 'pillars', one on foreign policy and security and another one on justice and home affairs (mainly, person controls). In this book EU will be used to denote the Union in general; EC will be used when it is legally necessary in view of the powers in the EC treaty. When referring to the pre-Maastricht period (see chapter 2, and appendix 2.1), it is sometimes necessary to refer to the Rome Treaty, or EEC (European Economic Community). The reader should also not forget that the EU system comprises two other treaties: the ECSC (European