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The Theory of Economic Integration

Bela Balassa

Routledge Revivals

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First published in 1962, *The Theory of Economic Integration* provides an excellent exposition of a complex and far-reaching topic. Professor Balassa has been remarkably successful in covering so much ground with such care and balance, in a treatment which is neither in any way abstruse nor unnecessarily technical. His book will interest economists in Europe by reason of its subject and treatment, but it is also a valuable and reliable textbook for students tackling integration as part of a course of International Economics and for those studying Public Finance.

He distinguishes between the various forms of integration (free trade area, customs union, common market, economics union, and total integration). In addition, he applies the theoretical principles to projects such as the European Common Market and Free Trade Area, and to Latin American integration projects.

In offering this theoretical study, the author builds on the conclusions of other writers, but goes beyond this in providing a unifying framework for previous contributions and in exploring questions that in the past received little attention – in particular, the relationship between economic integration and growth (especially the interrelationship between market size and growth, and the implications of various factors for economic growth in an integrated area).

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Bela Balassa

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THE THEORY OF ECONOMIC INTEGRATION

BY

BELA BALASSA J.D., Ph.D.

Associate Professor
Yale University

London
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TO MY PARENTS

PREFACE

This book finds its origin in my long-standing interest in problems of economic integration in Europe. I soon realized that a discussion of present-day integration projects, in Europe or elsewhere, would bear little fruit without considering the theoretical issues involved. At the same time, a perusal of recent writings on the customs union issue has shown that—following the time-honored tradition of international trade theory—these contributions concentrated on problems of resource allocation in a static framework and paid little attention to the dynamic effects of integration. Yet the economic consequences of a fusion of national markets can be but imperfectly explained under static assumptions, since in the European area, and especially in Latin America, the impact of integration on economic growth assumes great importance.

These considerations induced me to focus my attention on the theoretical problems in the integration of independent national economies, and to endeavor to present a unified theory of economic integration that would include, over and above the received theory, the dynamic aspects of economic integration, and would bring together the theoretical problems involved in co-ordinating economic policies in a union. In the course of the discussion, distinction will also be made between various forms of integration, such as a free trade area, customs union, common market, economic union, and total integration. In addition, at various points of the argument, the theoretical principles will be applied to present-day integration projects, such as the European Common Market and Free Trade Association, and the proposed Latin American unions.

The book is designed for economists, but I assume that the nonprofessional reader with interest in international problems will also find it useful. He will want to skim certain sections that require greater familiarity with economic theory. The selected bibliography is designed to assist the reader in further study and research.

I am heavily indebted to Gottfried Haberler and Harry G. Johnson whose comments and criticism not only helped to remove several errors and obscurities in the argument but also stimulated the reworking of substantial portions of the text. William Fellner, Charles P. Kindleberger, Egon Sohmen, Robert Triffin, and Jacob Viner read several chapters of a previous draft and offered valuable suggestions. Further thanks are due to Lloyd G. Reynolds for his freely given advice during the preparation of this work and to Gerald M. Meier for an attentive final reading of the manuscript.

I also want to state my indebtedness to friends and acquaintances in Europe and Latin America for the interest expressed in this work and for valuable suggestions and information. I cannot forgo mentioning François Perroux of the Institut de Science Economique Appliquée; Claudio Segré of the European Economic Community and L. Duquesne de la Vinelle (formerly with the E.E.C.); Raymond Bertrand of the Organisation for European Economic Co-operation; Richard Thorn of the International Monetary Fund, European Office; and Nuno Fidelino de Figueiredo of the United Nations Economic Commission for Latin America. None of them should be held responsible, however, if the author did not take their good advice.

A grant from the Ford Foundation assisted me in the initial stage of research, while financial assistance given by the Stimson Fund helped at later stages. Some findings of the study have appeared in article form in *Economia Internazionale, Kyklos, Revista de Ciencias Económicas* and *Weltwirtschaftliches Archiv;* the publishers of these journals kindly gave permission for the use of published material. I also want to express my appreciation to Stanley Besen who was very helpful in checking references and statistical information, and to Suzanne Addiss and Rosemarie Arena who did a valiant job of typing and retyping. Mrs. Arena also attempted to remove numerous blemishes of style.

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Dans la hiérarchie des mots obscurs et sans beauté dont les discussions économiques encombrent notre langue, le terme d'intégration occupe un bon rang.

—François Perroux, *L'Europe sans rivages* (Paris: Presses Universitaires de France, 1954), p. 419

The term *economic integration,* whatever might have been its earlier history, only recently became a slogan for action, or what the French call more respectfully, *une idée force.*

—M. A. Heilperin, "Economic Integration: Commercial and Financial Postulates," in *European Integration,* ed. C. C. Haines (Baltimore: Johns Hopkins Press, 1957), p. 126

The Concept and Forms of Integration

In everyday usage the word "integration" denotes the bringing together of parts into a whole. In the economic literature the term "economic integration" does not have such a clear-cut meaning. Some authors include social integration in the concept, others subsume different forms of international cooperation under this heading, and the argument has also been advanced that the mere existence of trade relations between independent national economies is a sign of integration.[1] We propose to define economic integration as a process and as a state of affairs. Regarded as a process, it encompasses measures designed to abolish discrimination between economic units belonging to different national states; viewed as a state of affairs, it can be represented by the absence of various forms of discrimination between national economies.[2]

[1] For a critical survey of these definitions and references, see Bela Balassa, "Towards a Theory of Economic Integration," *Kyklos,* No. 1 (1961), pp. 1–5.

[2] It should be noted that this definition is based on the implicit assumption that discrimination actually affected economic intercourse. The suppression of tariff barriers between Iceland and New Zealand, for example, will not integrate the two economies in the absence of a substantial amount of foreign trade, since without trade relations there was no effective discrimination anyway.

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

Economic integration, as defined here, can take several forms that represent varying degrees of integration. These are a free-trade area, a customs union, a common market, an economic union, and complete economic integration. In a free-trade area, tariffs (and quantitative restrictions) between the participating countries are abolished, but each country retains its own tariffs against nonmembers. Establishing a customs union involves, besides the suppression of discrimination in the field of commodity movements within the union, the equalization of tariffs in trade with nonmember countries. A higher form of economic integration is attained in a common market, where not only trade restrictions but also restrictions on factor movements are abolished. An economic union, as distinct from a common market, combines the suppression of restrictions on commodity and factor movements with some degree of harmonization of national economic policies, in order to remove discrimination that was due to disparities in these policies. Finally, total economic integration presupposes the unification of monetary, fiscal, social, and countercyclical policies and requires the setting-up of a supra-national authority whose decisions are binding for the member states.[3]

Adopting the definition given above, the theory of economic integration will be concerned with the economic effects of integration

[3] Social integration can also be mentioned as a further precondition of total economic integration. Nevertheless, social integration has not been included in our definition, since—although it increases the *effectiveness* of economic integration—it is not necessary for the lower forms of integration. The removal of trade barriers in a free-trade area, for example, is an act of economic integration even in the absence of developments in the social field.

in its various forms and with problems that arise from divergences in national monetary, fiscal, and other policies. The theory of economic integration can be regarded as a part of international economics, but it also enlarges the field of international trade theory by exploring the impact of a fusion of national markets on growth and examining the need for the coordination of economic policies in a union. Finally, the theory of economic integration should incorporate elements of location theory, too. The integration of adjacent countries amounts to the removal of artificial barriers that obstruct continuous economic activity through national frontiers, and the ensuing relocation of production and regional agglomerative and deglomerative tendencies cannot be adequately discussed without making use of the tools of locational analysis.[4]

The Recent Interest in Economic Integration

In the twentieth century no significant customs unions were formed until the end of the Second World War, although several attempts had been made to integrate the economies of various European countries.[5] Without going into a detailed analysis, political obstacles can be singled out as the main causes for the failure of these projects to materialize. A certain degree of integration was achieved during the Second World War via a different route, when—as part of the German *Grossraum* policy—the Hitlerites endeavored to integrate economically the satellite countries and the occupied territories with Germany. In the latter case, economic integration appeared as a form of imperialist expansion.

The post–Second World War period has seen an enormous increase in the interest in problems of economic integration. In Europe the customs union and later the economic union of the Benelux countries, the European Coal and Steel Community,[6] the European Economic Community (Common Market),[7] and the European Free Trade

4 On the interrelationship of location theory and the theory of economic integration, see my "Towards a Theory of Economic Integration," pp. 6–8.

5 For a description of these plans, see H. D. Gideonse, "Economic Foundations of Pan-Europeanism," *Annals of the American Academy of Political and Social Science*, May, 1930, pp. 150–56, and *Customs Unions: A League of Nations Contribution to the Study of Customs Union Problems* (Lake Success, N.Y.: United Nations, 1947), pp. 21–28.

6 Established on February 10, 1953, between the Benelux countries (Belgium, the Netherlands, and Luxemburg), France, the German Federal Republic, and Italy.

7 Established on January 1, 1958, between the countries of the European Coal and Steel Community. At the same time, these countries created the European Atomic Energy Community (Euratom) for the exploitation of nuclear energy.

Association (the "Outer Seven")[8] are manifestations of this movement. Plans have also been made for the establishment of a free-trade area encompassing the countries of the Common Market and the Outer Seven, but negotiations in the years 1957–60 did not meet with success. However, concessions offered in early 1961 by the United Kingdom with regard to the harmonization of tariffs on non-agricultural commodities give promise for the future enlargement of the Common Market in some modified form.[9]

Besides the European area, Latin America shows the greatest progress in economic integration. The United Nations Economic Commission for Latin America prepared plans for creating a free-trade area to include all Latin-American economies,[10] with a view to eventually transforming this free-trade area into a full-fledged customs union. The proposal was not accepted, but agreements have actually been reached in two groupings of these countries. In 1960, six South American states[11] and Mexico concluded an agreement (the Montevideo Treaty) to establish the Latin American Free Trade Association, while four Central American countries signed a treaty creating the Central American Common Market.[12]

The establishment of a customs union is in progress in the West Indies, too. On the Asian continent the possibilities for integration have been considered in Southern Asia, while in Africa different groupings of the newly independent states prepared proposals for eventual economic integration. Such plans have been discussed in regard to the North African Arab countries, between Ghana, Guinea, and the Mali, and between a number of former French dependencies.

The considerations that have prompted these plans for the integration of independent national economies are by no means uniform; various factors must be given different weights in the movement toward economic integration in Europe and on other continents. Leaving aside political considerations for the moment, we shall presently review some of the economic factors operating in Europe and in underdeveloped countries.

8 Established on July 1, 1960, between Austria, Denmark, Great Britain, Norway, Portugal, Sweden, and Switzerland. In March, 1961, Finland joined as associate member. This change came too late, however, to be considered in the present discussion.

9 The economic effects of a prospective accommodation between the Six and the Seven will not be dealt with in the present study. The author hopes to explore this problem at a later date.

10 South America, Central America, and Mexico.

11 Argentina, Brazil, Chile, Paraguay, Peru, and Uruguay.

12 El Salvador, Guatemala, Honduras, and Nicaragua.

The interwar period has witnessed a considerable degree of disintegration of the European and the world economy. On the European scene the mounting trade-and-payments restrictions since 1913 deserve attention. Ingvar Svennilson has shown that, as a result of the increase in trade impediments, the import trade of the advanced industrial countries of Europe shifted from the developed to the less developed economies of this area, which did not specialize in manufactured products.[13] This shift implies a decline in competition between the industrial products of the more advanced economies and a decrease in specialization among these countries. But lessening of specialization was characteristic not only among the more advanced European economies but also of the European economy as a whole. This development can be demonstrated by trade and production figures for the period of 1913–38. While the volume of commodity production in Europe increased by 32 per cent during those years, intra-European trade decreased by 10 per cent.[14] The formation of a European union can be regarded, then, as a possible solution for the reintegration of European economies.

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

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

Last but not least, it is expected that integration will foster the growth of the European economies. This outcome is assumed to be the result of various dynamic factors, such as large-scale economies on

[13] *Growth and Stagnation in the European Economy* (Geneva: United Nations Economic Commission for Europe, 1954), p. 197.

[14] United Nations Economic Commission for Europe, *Economic Survey of Europe since the War* (Geneva, 1953), p. 214.

a wider market, lessening of uncertainty in intra-area trade, and a faster rate of technological change. In this regard, the increased interest in economic growth has further contributed to the attention given to possibilities of economic integration.

Turning to underdeveloped countries, economic development appears as the primary consideration. Countries following the advice given by protagonists of the balanced-growth doctrine may strive for economic integration in order to ensure a sufficiently large market for the parallel development of new industries. In carrying out programs for industrialization, the exploitation of economies of scale unattainable in the small national markets will assume importance. It is also alleged that establishing a union furthers economic development by increasing the bargaining power and reducing the external vulnerability of the member countries. Finally, the increased interest in integration in the underdeveloped countries may be attributed in part to a desire to imitate the European example and to deliberate efforts to counteract possible trade-diverting effects of the European Common Market.

To summarize, economic integration in Europe serves to avoid discrimination caused by trade-and-payments restrictions and increased state intervention, and it is designed to mitigate cyclical fluctuations and to increase the growth of national income. In underdeveloped countries, considerations of economic development are of basic importance; further contributing factors are imitative behavior and the endeavor to protect these economies from possible adverse effects of European economic integration.

Integration and Politics

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

From the economic point of view, the basic question is not whether economic or political considerations gave the first impetus to the integration movement, but what the economic effects of integration are likely to be. In some political circles the economic aspects are deliberately minimized and the plan for economic integration is regarded merely as a pawn in the play of political forces. Such a view unduly neglects the economic expediency of the proposal. Even if political motives did have primary importance, this would not mean that the economist could not examine the relevant economic problems without investigating elusive political issues. By way of comparison, although the formation of the United States was primarily the result of political considerations, nobody would deny the economic importance of its establishment.

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

The "Liberalist" and the "Dirigist" Ideal of Economic Integration

The recent interest in economic integration has prompted various proposals concerning the means and objectives of integration. Two extreme views—an all-out liberalist and a dirigist solution—will be contrasted here. The champions of economic liberalism regard regional integration as a return to the free-trade ideals of the pre–First World War period within the area in question and anticipate the relegation of national economic policy to its pre–1914 dimensions.[15] If this approach is followed, integration simply means the abolition of impediments to commodity movements. At the other extreme, integration could also be achieved through state trading and through the coordination of national economic plans without the lifting of trade barriers. This alternative discards the use of market methods and relies solely on administrative, nonmarket means. It can be found in the integration projects of Soviet-type economies; the operation of the Council of Mutual Economic Assistance, comprising the Soviet Union and her European satellites, is based on the coordination of long-range plans and bilateral trade agreements. A similar method, but one which put more reliance on market means, was used by Germany during the last war. In this study we shall examine problems of economic integration in market economies and shall not deal with Nazi Germany and Soviet-type economies. Nevertheless, we shall see that dirigistic tendencies appear in the writings of some Western authors, too.

Among the proponents of the liberalist solution, Allais, Röpke, and Heilperin may be cited. They regard economic integration as identical with trade (and payments) liberalization. Allais asserts that "practically, the only mutually acceptable rule for close economic cooperation between democratic societies is the rule of the free market."[16] Röpke is of the opinion that European economic integration is nothing else than an attempt to remedy the disintegration of the post–1914 period that destroyed the previous integration of national economies.[17] A less extreme position is taken by Heilperin, who rejects the consideration of regional development plans and subsidies to industries for reconversion purposes but accepts state responsibility for investment decisions in certain areas.[18] To the majority of observers, however, the liberalist ideal of integration is a relic from the

[15] Opposition to economic integration comes also from the side of free-trader economists. On this controversy, see my "Towards a Theory of Economic Integration," pp. 11–14.

[16] Maurice Allais, "Fondements théoriques, perspectives et conditions d'un marché commun effective," *Revue d'Economie Politique*, January–February, 1958, p. 65. Allais's position does not exclude some degree of harmonization of the fiscal and social security systems in order to avoid distortions in competitive cost relationships. Cf. his *L'Europe unie—route de la prospérité* (Paris: Calmann-Lévy, 1960), pp. 106–7.

[17] Wilhelm Röpke. "Integration und Desintegration der internationalen Wirtschaft," in *Wirtschaftsfragen der freien Welt* (Erhard-Festschrift) (Frankfurt, 1957), p. 500.

[18] M. A. Heilperin, "Freer Trade and Social Welfare," *International Labour Review*, March, 1957, pp. 173–92.

past, and its application to present-day economic life appears rather anachronistic. As Jean Weiller put it, "It would be a great error to believe that the decision to create a regional union would re-establish the conditions of an economic liberalism, extirpating with one stroke all so-called dirigistic policies."[19]

It can rightly be said that considerations such as the avoidance of depressions, the maintenance of full employment, the problems of regional development, the regulation of cartels and monopolies, and so forth, require state intervention in economic life, and any attempts to integrate national economies would necessarily lead to harmonization in various policy areas. This idea is not new. The need for the coordination of fiscal, monetary, social, and countercyclical policies was stressed in the League of Nations study on customs unions published immediately after the end of the Second World War.[20] In fact, the question is not whether government intervention is needed or not in an integrated area, but whether economic integration results in a more intensive participation of the state in economic affairs or in a more intensive reliance on market methods.

Some authors advocate an intensification of state intervention in economic affairs. The need for economic planning in a union is emphasized, for example, by André Philip and by other French Socialists. In Philip's opinion, "there is no alternative to a directed economy," since "the market can be extended not by liberalising but by organising."[21] Although not an advocate of centralized planning, the stepping-up of state intervention is also recommended by Maurice Byé, who contrasts his "integration theory" with Heilperin's "market theory."[22] Considering the pronouncements of French economists and industrialists, it can be said that, by and large, the French view of economic integration contains more dirigistic elements than, for example, that of most German economists and entrepreneurs.

The defenders of dirigistic tendencies fail to consider, however, the lessening of planning and government intervention—and the beneficial effects thereof—in Europe since the end of the Second World

19 Jean Weiller, "Les objectifs économiques d'une coopération durable," *Economie Appliquée*, October–December, 1953, p. 579.

20 *Customs Unions*, pp. 63–74.

21 "Social Aspects of European Economic Co-operation," *International Labour Review*, September, 1957, p. 255.

22 "Freer Trade and Social Welfare, Comments on Mr. Heilperin's Article," *International Labour Review*, January, 1958, pp. 38–47.

War. Although this change does not indicate a return to the pre-1914 situation, it brought about an increased use of the market mechanism and contributed to the spectacular growth of the European economy during the 1950's. It appears, then, that a reintroduction of dirigistic methods would slow down, rather than accelerate, future growth. State intervention may be stepped up in some areas, such as regional development planning, and will also be required to deal with transitional problems, but it is expected that an enlargement of the economic area will intensify competition and lead to less interference with productive activities at the firm level. Therefore, those who regard the European Common Market as a *marché institué*[23] err in the opposite direction from the holders of old-fashioned liberalist views.

It has been widely accepted that a higher degree of government intervention is likely to be necessary in Latin-American integration projects. This reflects the proposition that present-day underdeveloped countries need more state interference in economic affairs than do advanced economies, since, in the former, market incentives are often not conducive to development. Nevertheless, the role of private enterprise is emphasized in most discussions of Latin-American integration,[24] and the sphere of government decision making may well diminish as development proceeds.

Economic Integration and Welfare[25]

It can be said that the ultimate objective of economic activity is an increase in welfare. Thus, in order to assess the desirability of integration, its contribution to welfare needs to be considered. But the concept of welfare is fraught with much obscurity. First, the non-economic aspects present some ambiguity; second, even restricting the meaning of the concept to "economic welfare" in the Pigovian tradition, we are confronted with the well-known difficulties of interpersonal comparisons if we try to say anything over and above the Pareto condition: an increase in one man's welfare leads to an increase in

23 Henri Guitton, "L'Europe et la théorie économique," *Revue d'Economie Politique*, January–February, 1958, pp. 324–39.

24 Cf., e.g., United Nations, Department of Economic and Social Affairs, *The Latin American Common Market* (prepared by the Secretariat of the Economic Commission for Latin America, 1959), pp. 31, 125, and V. L. Urquidi, *Trayectoria del Mercado Común Latinoamericano* (Mexico, D.F.: Centro de Estudios Monetarios Latinoamericanos, 1960), p. 123.

25 The reader with little background in economic theory should skim this section.

social welfare only if there is no reduction in the welfare of any other members of the group. In the case of integration, economic welfare will be affected by *(a)* a change in the quantity of commodities produced, *(b)* a change in the degree of discrimination between domestic and foreign goods, *(c)* a redistribution of income between the nationals of different countries, and *(d)* income redistribution within individual countries. Accordingly, distinction is made between a real-income component and a distributional component of economic welfare. The former denotes a change in potential welfare (efficiency); the latter refers to the welfare effects of income redistribution (equity).

With regard to potential welfare, separate treatment is allotted to changes in the quantity of goods produced and changes in their distribution. First, there is an increase (decrease) in potential welfare if —owing to the reallocation of resources consequent upon integration —the quantity of goods and services produced with given inputs increases (decreases) or, alternatively, if the production of the same quantity of goods and services requires a smaller (larger) quantity of inputs. If we regard inputs as negative outputs, we may say that a rise in net output leads to an increase in potential welfare. A higher net output entails an increase in potential welfare in the sense that a larger quantity of goods and services can now be distributed among individuals so as to make some people better off without making others worse off. Second, potential welfare is also affected through the impact of economic integration on consumer's choice. Restrictions on commodity movements imply discrimination between domestic and foreign commodities; a tariff causes consumers to buy more of lower-valued domestic and less of higher-valued foreign goods. The removal of intra-union tariffs will do away with discrimination between the commodities of the member countries but will discriminate against foreign goods in favor of the commodities of partner countries. In short, economic efficiency means efficiency in production and efficiency in exchange,[26] and an improvement in one or both constitutes an increase in potential welfare.

Given a change in potential welfare (the real-income component), we also have to consider the distributional component in

[26] This distinction corresponds to "production maximization" and "optimization of trade" in J. E. Meade, *Problems of Economic Union* (Chicago: University of Chicago Press, 1953), pp. 9 ff, and to "production effects" and "consumption effects" in H. G. Johnson, "The European Common Market—Risk or Opportunity," *Weltwirtschaftliches Archiv*, Vol. LXXIX, No. 2 (1957), p. 273.

order to determine changes in economic welfare.[27] It can easily be seen that an evaluation of changes in income distribution would require interpersonal comparisons of welfare. The new welfare economics, however, does not admit the possibility of making interpersonal comparisons. As a possible solution, it has then been suggested that changes in welfare could be determined in terms of potential welfare; that is, the *possibility* of making everybody better off (or, at least, no one worse off) would be taken as equivalent to an increase in economic welfare.[28] This proposition can be criticized primarily on the grounds that the hypothetical situation *after* compensation is irrelevant if compensation actually does not take place.[29] Nevertheless, changes in the real-income component give a good approximation of changes in welfare *within a country*, since compensation is politically feasible, and in case of integration this would actually be carried out to some degree in the form of assistance to relocating workers or reconverting firms. In addition, a nation can be regarded as an entity, where a redistribution of income accompanying an increase in real income can be accepted—provided that the redistribution does not run counter to generally accepted ideals of equity.

The distributional component cannot be neglected if economic integration redistributes income between countries, especially between the member states of a union, on the one hand, and the nonparticipating economies, on the other. It is not possible to claim an increase in world welfare in every case when the increase in real income in the participating countries will be greater than the loss to third countries. This proposition would hold true only if international comparisons of welfare could be made or if we disregarded differences in the marginal utility of income between countries. The

27 The distinction between efficiency and equity was first advanced by Cournot, in whose opinion "it is not enough that national income increases and that [some people] gain more than the others lose: the principles of equity . . . do not permit that acts of the public authority should have for their tendency to increase the natural inequality of conditions." See Augustin Cournot, *Researches into the Mathematical Principles of the Theory of Wealth* (New York: Macmillan Co., 1927), p. 170. Similar propositions were advanced by A. C. Pigou and his followers. Cf., e.g., *The Economics of Welfare* (London: Macmillan & Co., Ltd., 1920), *passim*.

28 An excellent review of the controversy about the concept of potential welfare is given in J. de V. Graaf, *Theoretical Welfare Economics* (Cambridge: At the University Press, 1957), chap. v. For a recent application of the concept to trade-induced changes in welfare, see H. G. Johnson, "International Trade, Income Distribution, and the Offer Curve," *Manchester School of Economic and Social Studies*, September, 1959, pp. 241–60.

29 Cf. J. E. Meade, *Trade and Welfare. The Theory of International Economic Policy*, Vol. II (London: Oxford University Press, 1955), p. 78.

first possibility was ruled out above, and the equality of the marginal utility of income is no less implausible. According to some, the marginal utility of income in an underdeveloped economy might be two or three times as high as in the rest of the world.[30] If such a view were accepted, a union of developed economies which would register gains in the real-income component might still reduce world welfare by redistributing income from "poor" to "rich" countries.

In the preceding discussion we have followed the customary exposition of welfare economics in using the concept of potential welfare in a static sense. Thus an increase in potential welfare was taken as equivalent to an improvement in the allocation of resources at a point of time. Static efficiency, however, is only one of the possible success criteria[31] that can be used to appraise the effects of economic integration. Instead of limiting our investigation to a discussion of efficiency in resource allocation under static assumptions, greater attention should be paid to the impact of integration on dynamic efficiency. I have elsewhere defined dynamic efficiency as the hypothetical growth rate of national income achievable with given resource use and saving ratio.[32] In technical terms, whereas static efficiency would require that the economy operate on its production-possibility frontier,[33] dynamic efficiency can be represented by the movement of this frontier in the northeast direction.[34] The concept of dynamic efficiency can be used in intercountry comparisons to indicate which economy is capable of faster growth under identical conditions with regard to resources and saving, or, alternatively, it can be applied for comparing the growth potentialities of an economy at different points of time. In the present context, we wish to compare the hypothetical growth rate attainable *before* and *after* integration, under the assumption of given initial resources and saving ratio.

30 Cf., e.g., Marcus Fleming, "The Optimal Tariff from an International Standpoint," *Review of Economics and Statistics*, February, 1956, p. 8.

31 For a discussion of various possible success criteria, cf. Bela Balassa, *The Hungarian Experience in Economic Planning* (New Haven: Yale University Press, 1959), chap. i.

32 The term "given resource use" is employed here as a shorthand expression for given material resources and the use of given amounts of human labor. Cf. *ibid.*, p. 10.

33 The production-possibility frontier describes the society's production potential at a point of time with given inputs. If the society is at its production frontier, a reallocation of resources cannot lead to an increase in the output of any desired commodity without reducing the output of another desired commodity. For a full statement of the conditions for static efficiency, see n. 23 in Chapter 3.

34 Cf. R. Dorfman, P. A. Samuelson, and R. M. Solow, *Linear Programming and Economic Analysis* (New York: McGraw-Hill Book Co., Inc., 1958), chap. xii.

Given the static efficiency of an economy, the main factors affecting its dynamic efficiency are technological progress, the allocation of investment, dynamic interindustry relationships in production and investment, and uncertainty and inconsistency in economic decisions. In addition to these factors, the actual growth of national income would also be affected by an increase in the proportion of national income saved and/or by interference with the individual's choice between work and leisure. Changes in the latter variables will be disregarded here, partly because we assume that they are but rarely affected by economic integration,[35] partly because their effects cannot be evaluated in welfare terms, given the disutility of increased saving and/or work. Under these assumptions an increase in the rate of growth can be considered as equivalent to an improvement in dynamic efficiency and represents a rise in potential welfare.

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

Some Fundamental Problems of Integration

The choice of dynamic efficiency as the main success criterion for evaluating the economic effects of integration entails an examination of the impact of integration on resource allocation and growth. In addition, we also have to consider the policy measures necessary to exploit the potential benefits of integration in the framework of a union. The distinction between problems of resource allocation, growth, and economic policies gives the main breakdown of this study.

The first part of the book examines the impact of economic integration on the allocation of resources within the union and in the nonparticipating countries. First, it is assumed that trade barriers are abolished while restrictions on the movements of factors are maintained within the integrated area. In connection with the freeing of commodity movements, the theory of customs unions and the problems of establishing a free-trade area will be dealt with. In a later chapter the removal of obstacles to factor mobility is postulated. Here we

35 See, however, p. 181 below.

shall evaluate the economic effects of factor movements in a common market.

Whereas the first part of the study deals with problems of resource allocation in a static sense, in the further chapters dynamic considerations are introduced. These include a general discussion of the interrelationship between market size and economic growth, followed by an examination of theoretical problems and empirical evidence on internal and external economies. The closing chapter of Part II inquires into the impact of integration on market structures, technological change, risk and uncertainty in foreign trade, and investment activity.

The policy aspects of economic integration are the subject of the third part of the study. Separate chapters are devoted to the analysis of regional problems in a union, the harmonization of social policies, fiscal problems, and monetary unification. In connection with the discussion of monetary unification, we will consider balance-of-payments problems and the coordination of policies for stability and growth in an economic union.

APPENDIX

The Sectoral Approach to Integration

In this chapter, distinction has been made between various forms of economic integration, the main characteristics of which will be examined in the subsequent chapters. All these forms require concerted action in the entire field of economic activity, be it the abolition of customs barriers or the coordination of fiscal policies. Another approach to economic integration would be to move from sector to sector, integrating various industries successively. The application of this method had already been commended in the interwar period, and it found many champions in the period following the Second World War. Proposals were made to integrate various sectors such as the iron and steel industry, transportation, and agriculture. The Stikker Plan advocated the integration of national economies by removing barriers, industry by industry.[36] Supporters of this view contended that national governments were more inclined to make limited commitments with

[36] Cf. D. U. Stikker, "The Functional Approach to European Integration," *Foreign Affairs*, April, 1951, pp. 436–44.

reasonably clear implications than to integrate all sectors at the same time. The flexibility of this method was also extolled, and it was hoped that integration in one sector would encourage integration on a larger scale.

From the theoretical point of view, various objections can be raised against the sectoral approach. Whereas the simultaneous integration of all sectors allows for compensating changes, integration in one sector will lead to readjustment in this sector alone, the reallocation of resources in other sectors being impeded by the continued existence of tariffs and other trade barriers—hence the losses suffered by countries whose productive activity in the newly integrated sector contracts will not be compensated for until the next phase. More generally, under the sectoral approach every step in integration results in a new and temporary equilibrium of prices, costs, and resource allocation, and this "equilibrium" is disturbed at every further step. Production decisions will then be made on the basis of prices that are relevant only in a certain phase of integration, and shifts in resource allocation will take place which may later prove to be inappropriate. On the other hand, the adjustment of relative prices and the reallocation of resources proceed more smoothly if all sectors are integrated at the same time, since some industries are expanding, others contracting, and unnecessary resource shifts do not take place.

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

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

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

These theoretical objections suggest the inadvisability of integration sector by sector. This conclusion does not mean, however, that integration in one sector may not be beneficial if political obstacles hinder integration in all areas. The European Coal and Steel Community is a case in point. At the time of its inception, the realization of a European Common Market was not yet possible, but the governments of the participating countries were prepared to accept a limited measure of integration. The establishment of the Coal and Steel Community has been conducive to the expansion of production and trade in the partaking industries,[37] and the Community demonstrated the possibility of integration in Europe, thereby contributing to the establishment of the Common Market.

It has also been argued that the difficulties of adjustment in production and trade in the Coal and Steel Community have been less than expected because the considerable increase in the national incomes of every participating country has made adjustment easier.[38] This does not, however, rule out the possibility of maladjustments in other industries which will not be corrected until trade barriers are removed in all sectors. In addition, the Coal and Steel Community has encountered serious difficulties with respect to transportation policies, fiscal and social problems, etc., which have been due—to a great degree—to the fact that integration extends over only one sector.[39]

[37] See below, p. 52.

[38] William Diebold, *The Schuman Plan* (New York: Frederick A. Praeger, 1959), p. 627.

[39] See *ibid.*, chap. viii–x; Louis Lister, *Europe's Coal and Steel Community* (New York: Twentieth Century Fund, 1960), chaps. 12–13; and Maurice Byé, "Les problèmes posés par la Communauté européenne du charbon et de l'acier," *Revue Economique*, November, 1960, pp. 845–53.