Beyond EMU: Is there a logical integration sequence?

Patrick M. Crowley

May, 2001

ALL COMMENTS WELCOME

Paper to be presented at the ECSA-US Conference in Madison, WI, May 30-June 2, 2001.

Abstract

Even before the EMU process is complete in 2002, there are already initiatives being suggested to further integrate the European Union, both from an economic and political perspective. Many of these initiatives focus on harmonization of, for example, indirect taxes or corporate taxes in the economic realm or in terms of creating an EU defense capability in the political realm. To date, the integration dynamic has been from a customs union to a common market and then to monetary union. This paper studies whether after EMU is successfully completed if fiscal integration should be the next logical step in the economic arena, or should efforts be made to foster more integration in labor markets, for example. Also, the paper considers various scenarios as to the final outcome of EMU and asks whether the answer to these questions of integration sequencing depends on the final EMU configuration. In terms of analysis, the paper uses the historical path of development adopted by other federations, as well as theoretical considerations from both the economic and political science literature.

Affiliations:

Texas A&M University, College of Business, Corpus Christi, Texas, USA.
Fellow, Athenian Policy Forum.

Contact details:

Patrick Crowley,
College of Business,
Texas A&M University,
Corpus Christi,
Texas, 78412
USA.
Tel: (361) 825-6011
Fax: (361) 825-5609
email: Patrick.Crowley@iris.tamucc.edu

JEL Classification:

F15, F31

Acknowledgements

I would like to thank my research assistant Josh Osborne at Texas A&M for excellent assistance over the past 6 months, Dean Abdelsamad for funding my research this year.

I. Introduction

There are now many examples of economic integration around the world, ranging from rather loose arrangements, such as in South-East Asia (ASEAN), to advanced forms of economic integration (such as the EU). When we talk of economic integration, certainly in the way we teach the subject to students, we usually have in mind a set sequence of events, and most likely our own "national" experience with integration informs our observations. The template most of us think of when referring to economic integration is in fact a template usually referred to as the Balassa stages of integration.

In this paper a truly multi-disciplinary approach is taken, in that it incorporates elements of history of economic thought, international economics, political science and comparative regional analysis. The Balassa stages of economic integration are reviewed and analysed and then used as a theoretical starting point for a comparative review of economic integration. Following the review and analysis in section II, some caveats and observations are made about the actual integration dynamics observed in various parts of the world in section III using a scientific approach. Section IV applies the framework to the EU at its current stage of economic integration and looks at the various options the EU has for further integration. Section V concludes.

II. The Theory and Nature of Economic Integration

In this section we first review, from an history of economic thought perspective, the early literature on economic integration. This is important (see Blaug (2001) for a justification for this approach), as it informs the researcher as to the context of the theory of economic integration and allows some insight into the conceptual gaps that exist in the literature.

a) A history of economic thought perspective

The theory of economic integration was developed by Balassa (1961), Tinbergen (1954), Meade (1953 and 1955), among others. In Tinbergen's analysis of economic integration the classic distinction was made between positive and negative integration, where positive integration refers to the creation of policies and institutions which enable international economic activity, while negative integration refers to the dismantling of barriers which inhibit such activities. Notwithstanding the pejorative nature of the labelling used by Tinbergen, such a distinction is now somewhat dated, as Laffan, O'Donnell and Smith (2000) recognise, as both types of integration are likely implied, to some degree, by any new economic integration initiative. In fact it is now far more common for both economists and political scientists to be more concerned with whether economic integration implies (more) centralisation to regional or supranational institutions, or whether reciprocity, coordination or harmonization will suffice. Also, to take up the pejorative nature of the "negative" and "positive" labels which Tinbergen attached to his taxonomy of economic integration, many supporters of integration in the Americas, for example, would only favour negative integration and would discourage positive integration, giving the labels a rather odd resonance when applied to the world in which we now live. Of course Tinbergen was writing in the 1950s, when the power of nation states was unquestioned, and when it was accepted that national economies needed a certain degree of protection from outside forces.

Over the last fifty years there have also been two waves of economic integration, as Robson (1998) points out. The first wave of economic integration started with the open questioning of the effects of Article 24 of the GATT, which was originally put in place to protect British trade with its colonies and commonwealth, and the optimism instilled before and after the founding of the European Economic Community. The classic analysis of Viner (1950) was really the starting point for analysis of a free trade area or customs union, and his usage of terms such as trade creation and diversion do reflect the real concern that economists of the day had with maintaining trade-preference arrangements across huge distances. Also, the theoretical debate in journals such as the Journal of International Economics (see Viner (1965)), encouraged a lively program of research in the area. The lack of progress on initial steps to further integrate Europe, and the decline of Britain as an economic power really curtailed any extension of the research program. The second wave of economic integration, as most economists and political scientists are aware, occurred after 1980, and particularly over the last decade. Paul Krugman's seminal piece on monopolistic competition and international trade found in Krugman (1979) and then linked with economies of scale and placed in a regional context in Krugman (1991) probably are the genesis for the explosion of interest in this area in the international trade literature. The move towards a single market in Europe and the Maastricht Treaty then also gave an impetus to both political scientists and economists to begin research agendas that addressed problems in more advanced economic integration agreements[1].

There are also some semantics to be dealt with here. Economic integration does not usually implicitly refer to regional integration any more, as since Tinbergen's analysis significant steps have been taken in a multilateral setting to promote international integration first through the General Agreement on Trade and Tariffs (GATT) and now through the World Trade Organization (WTO). Indeed the tension between the two approaches has recently sparked significant debate in economics, not least through the attacks mounted on regional economic integration by economic heavyweights like Jagdish Bhagwati (see Bhagwati, Greenaway, Panagariya (1998) for an excellent exposition of the theoretical underpinnings of this viewpoint). For the rest of this paper, the term economic integration refers to regional economic integration.

b) The stages of economic integration

Balassa's five stages of economic integration (Belassa (1961)) were a free trade area, customs

[1] Two early and influential papers on these subjects are Flam. (1992) and Eichengreen (1993).

union, common market, economic union and total economic integration. As Laffan, O'Donnell and Smith (2000) note, Balassa's view of a common market underestimated the amount of positive integration necessary in practice, and similarly overestimated the amount of centralisation necessary for an economic union or monetary union. In fact Balassa's vision of total economic integration coincided with a federation or confederation, so could not have envisaged the European Union as we now know it. Balassa's stages have since been expanded and now usually include the following steps: free trade area, customs union, common market, economic union, monetary union and political union (see Molle (1997) for example). Even this is not a complete sequencing of the true stages of economic union, as fiscal union or some kind of fiscal arrangement (such as the Stability and Growth pact) does not fit into this taxonomy[2].

Other taxonomies loosely based on the Balassa sequencing have also been proposed, such as the one included in Emerson (1991). Emerson looks at hierarchies of trade and monetary regime choices with particular reference to Eastern Europe. He classifies the openness of trade, currency convertibility and exchange rate arrangements according to the degree of liberation that has taken place in trade, capital account convertibility and exchange rate arrangements. Despite this alternative classification, the one usually used is directly based on the original Balassa stages, so that is the one we focus on here. Table 1 presents an extended version of the Balassa process, with examples at each stage of economic integration - these examples reflect countries that have been in such a situation, or are currently in such a situation:

[2] Below, we rectify this by adding fiscal union to the Balassa stages.

Table 1

Extended Balassa Stages of Economic Integration

Level of integration	Description	Characteristics	Examples
0	Regional autarky	- bilateral trade agreements	Japan (before ASEAN)
A	FTA	- tariffs and quotas removed internally - national tariffs retained against outside	NAFTA
B	Customs union	- tariffs and quotas removed internally - common external tariff	Mercosur
C	Common market	- free movement of factors of production, goods and services	EU (before EMU)
D	Economic union	- harmonization or coordination of some national policies - transfer of some policies to supranational level	Competition policy in the EU
E	Monetary union	- single currency - single central bank	ECB in the EU
F	Fiscal union	- harmonization of taxes - fiscal sovereignty	EU to some degree
G	Political union	- effective and democratic body at supranational level	Does not exist out of a regional integration project

Note: E and F are actually interchangeable, as for example various authors place these two levels of integration in different orders (see Molle (1997) and contrast with the order of chapters in Robson (1998))

Several things are noteworthy about the table. First there is an implicit assumption in the literature and in the way that most people read the table that the levels of economic integration imply a sequential process. Of course, this is not the case. The first two levels of integration, A and B, relate only to trade in goods and services, and either can be used as a basis for further integration to a common market. So for example, NAFTA is not a customs union, but there is no theoretical reason why the regional trade agreement cannot skip the customs union stage and become a common market or a monetary union, or economic union for that matter. But note that a common market (C) does imply either A or B, but a monetary union does not necessarily imply any other stages of integration. Indeed, dollarisation in countries like Ecuador, represents a form of monetary union, but that does not imply or give a country the right to eliminate tariffs and quotas with the USA. Furthermore, even in the context of a regional trade agreement such as NAFTA, monetary union does not imply a common market, economic union or a customs union.

Indeed it is apparent that new "models" of integration are now emerging. Two examples spring to mind here: i) the Central and South American countries where Ecuador has gone for full blown dollarisation, Panama has always had a fixed exchange rate with legal tender laws for the US dollar and Argentina has a currency board against the US dollar. In the context of the Free Trade Agreement of the Americas (FTAA) this likely implies very different levels of integration with the old NAFTA bloc and implies different integration dynamics for these three countries, and ii) when the CEE countries join the EU, they are expected to be able to assimilate into EMU almost immediately, but they will not be allowed full membership of the common market (labour movements are likely to be restricted) - this will clearly lead to a different integration dynamic than we have seen previously.

So are there any pre-conditions for any given form of economic integration? The sequence of economic integration, taking a backwards-looking view of integration is described in table 2 below:

Table 2

Pre-Conditions for Economic Integration

Level of integration	**Description**	**Dependent upon**	**Examples**
C	Common market	A or B (necessary, between but not within)	EU or NAFTA (not for all factors)
D	Economic union	None (necessary)	Competition policy in the EU
E	Monetary union	None (necessary)	German reunification WAMU Hawaiian adoption of the US$
F	Fiscal union	None (necessary for harmonisation) G (sufficient for fiscal sovereignty)	EU to some degree
G	Political union	F (necessary)	Switzerland USA Canada

Table 2 highlights several issues. First, it suggests that there are few pre-conditions, in theory, for adoption of any of the given stages of integration. Second, the table illustrates that certain levels of integration, notably a common market (C) and the political union (G) do imply prior "stages" of integration have been accomplished. Clearly a common market, defined as an area where all factors of production, goods and services can move freely implies that goods and services can move across borders without any constraints[3]. Likewise, a political union implies that the parliament or government has some fiscal sovereignty, so some form of fiscal union is desirable. Interestingly though, a political union does not imply that a monetary union has occurred - there are no examples of this (that I know of), but in fact central bank independence on a national basis couched within a political union would contain no contradictory features from an economic policy perspective - in fact it is the mirror image of the current

[3] If a common market is defined as an area where factors of production can freely move, then clearly the implications are different. In the EU context a common market is used interchangeably with the single market concept.

situation in EMU, as in EMU monetary policy is operated from a supra-national level, but fiscal policy is determined in the national arena - here fiscal policy is operated from a supra-national level but monetary policy is determined domestically[4]. The third feature of the table shows that there is one sub-category of fiscal union (fiscal sovereignty at a supranational level) that would require at least some elemental form of political union - in other words one form of F would in fact require G as a pre-requisite!

The above only goes to illustrate that the Balassa stages of economic integration are only one sequencing of the various facets of what are the components of regional economic integration. But although a backwards-looking analysis of necessary pre-conditions for every component of Balassa's stages shows how "earlier" stages are usually not a pre-requisite in theory, it does not illustrate how "spillover effects", which refers to different phenomena in political science and economics, might push any regional integration agreement towards "deeper" levels of economic integration. To a political scientist, spillover effects refer to the phenomena whereby a policy prompts policy initiatives in other areas. To an economist, spillover effects refer to the phenomena whereby "public policies in one jurisdiction necessarily have effects that significantly affect others" (quoted from Robson (1998) p125) - these are often referred to as cross-border externalities. An example of a "political science" spillover effect would be the need for greater coordination of fiscal policies after the establishment of EMU as embodied in the Stability and Growth pact. An example of an "economic" spillover effect might be increased shopping in France by UK citizens because of lower excise taxes on certain goods, given the existence of the single market. Of course some spillover effects are both political and economic in nature, and an example of such a case might be the establishment of an EU competition policy given the existence of the single market. Despite the confusion that originates from separate development of conceptual terms in the two disciplines, it is clear that one level of integration might push participants towards another level of integration. This is explored,

[4] The G7 policy initiatives of the 1980s are probably the closest we have come to an arrangement whereby fiscal policy is coordinated/integrated coupled with monetary policy independence.

again using the modified Balassa stages, in table 3 below:

Table 3

Possible "Spillover" Consequences of Integration

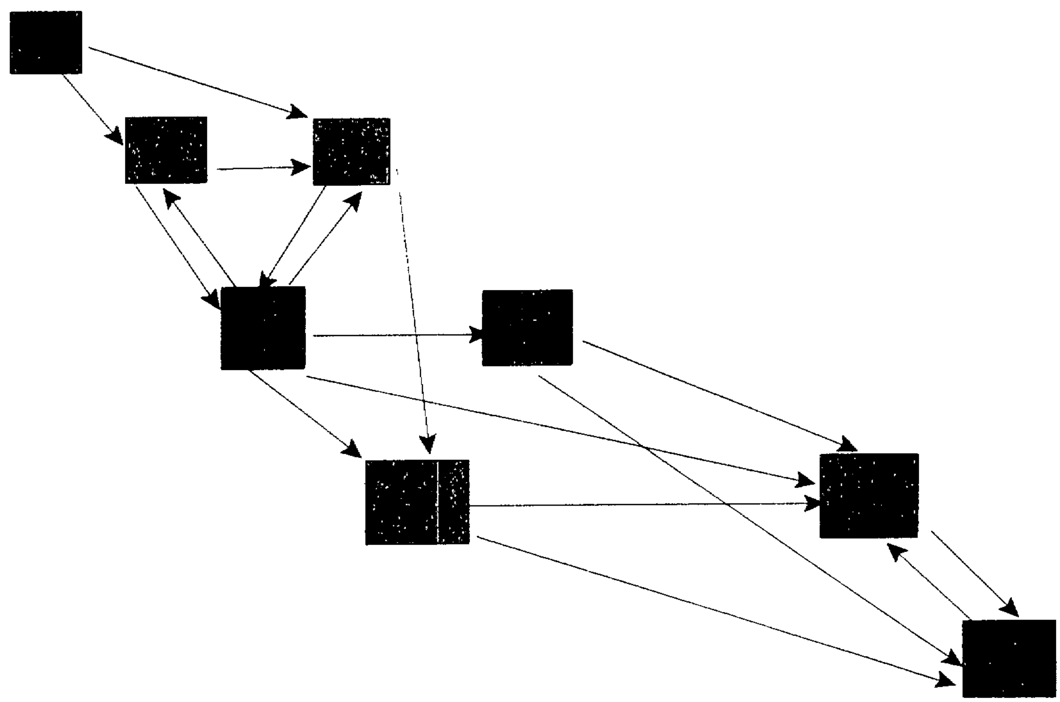
Level of integration	**Description**	**Spillover characteristic...**	**...leads to level of integration**	**Examples**
0	Regional autarky	- need/desire for uniformity in bilateral trade agreements (political/economic) - desire for reap comparative advantages (economic)	B (or A) A or B	Mercosur, FTAA NAFTA, Asean
A	FTA	- desire to reduce trade deflection effects - factor price equalization	B C	(NAFTA) NAFTA
B	Customs union	- desire to reap greater factor of production efficiencies - desire for greater stability in trade flows	C E	Mercosur SACU
C	Common market	- harmonization or coordination of policies which affect enterprise location/FDI - negative externalities - elimination of costs associated with price supports (CAP) - price transparency in the single market	D and F D E E	CEAO (West Africa), EU EU EU EU
D	Economic union	- coordination of national economic policies to avoid centre/periphery effects - level playing field in competition - democratic deficit	F F G	EU EU, NAFTA EU
E	Monetary union	- coordination of fiscal policy with single monetary policy - democratic deficit	F G	Ecofin, Eurogroup in EU EU
F	Fiscal union	- appropriate level of provision of public services - appropriate redistributive mechanism	G G	Canada Germany

Note: G = political union

Table 3 stresses the linkages between the stages of economic integration using spillover criteria. Combining this with the earlier analysis in table 2, it suggests that there are both backwards and forward linkages between the different types of economic integration. Figure 1 below summarises these linkages using what mathematicians call a network map. Each "node" represents a stage of economic integration, and the arrows between each node either represent pre-conditions or spillover dynamics.

Figure 1

Network mapping of linkages between integration stages



If the arrows in the figure point to an earlier stage of integration this implies conditionality on that previous level of integration, and if the arrow points to a later stage of integration, then spillover effects tend to push the regional integration project towards this later stage. Clearly if there are arrows pointing both ways between any two boxes then the former is a pre-requisite for the latter and through spillovers the former tends to promote the latter. In the context of network maps, one might label this relationship as "mutual interdependency".

One of the striking things about the network mapping is that only in the early stage and later stages of integration is there any mutual interdependency (two way mapping). These stages are the trade integration and common market stages and the fiscal and political union stages. The analysis implies that other stages of integration, if achieved are due to spillover-type effects, or political decisions to move to a specific stage of integration.

One other interesting feature of the network mapping is that monetary and economic union do not seem to be strongly related, and yet, of course, the EU decided to package these two together in EMU. From a theoretical perspective then, there is apparently little to connect the two - and indeed this perspective was very prominent in the economics literature surrounding the Stability and Growth pact, as well as criticisms made by Crowley (1996), Buiter (1997), Eichengreen and Von Hagen (1997) and others. Only in the minds of the designers of EMU was there a link between the two[5].

An important caveat is in order here. Politically-motivated considerations, rather than economic considerations, may also drive the integration dynamic. In particular the popular appeal to the "two-level" games framework is thought to also drive integration, as politicians seek to tie domestic policy to internationally-determined criteria. One example of this would be the way in which economic convergence was achieved according to the Maastricht criteria, which allowed certain member states to enter EMU.

Figure 1 also implies a different taxonomy for economic integration. The depth of economic integration is signified to a certain degree by how far down the diagram the form of integration is. Table 4 therefore details this taxonomy:

[5] In the document used by the Commission to sell EMU to finance ministers (European Commission (1990)), the Commission acknowledges (p11) this, but goes on to justify economic union on the basis of deepening the single market ("impulsion"), the threat of errant governments in terms of fiscal profligacy ("cooperation") and political expediency ("cohesion").

Table 4

Revised Integration Taxonomy

Level of integration	Description	Includes
0	Regional autarky	Autarky Bilateral trade agreements
1	Trade integration	Free Trade Area (A) Customs Union (B)
2	Scale integration	Common market (C) Economic union (D)
3	Policy integration	Monetary union (E) Fiscal union (F)
4	Political integration	Political union (G)

III. Homogeneity, Process Path-dependence and exogenous factors

If economic integration is to be thought of as a process, then like all scientific processes, it has to have both initial conditions and various factors that promote a certain type of dynamic. Particularly in the case of economic integration, process path-dependency is likely to be an important consideration. In the analysis below, initial conditions for integration are likely to be important in determining the integration dynamic, and in a) these "homogeneity" factors are explored using existing regional integration agreements. Section b) then goes on to consider the actual integration dynamic - which includes such factors as changing membership etc. Section c) then considers how exogenous factors may engender more impetus to the integration dynamic.

a) Homogeneity (initial conditions)

Given our analysis in section II, it is tempting to assert that apart from the "endpoints" of economic integration, the remainder is a "smorgasbord" from which countries or member states can choose according to political expediency. But this belies the fact that in reality much economic integration can be viewed as a process, a process that is responsive to political perceptions of factors such as the ease of implementation and the consequences of not proceeding with further stages in terms of loss of impetus, or the alienation factor if the initiative is blocked (for example in the case of the UK and EMU).

Apart from politics, another factor which might impinge upon the degree of acceptance for integration and the path taken to given ends might be historical and cultural commonality - this may foster greater trust and understanding that the means seek to attain common ends. Clarkson (2000), based on Helleiner (1994) suggests this in comparing the three major continental regional integration projects, and his schema is extended and reproduced for our purposes below, but in this case including two further trading blocs, Mercosur and WAMU:

Table 5

Comparing Regional Integration Projects

Region	**Degree of "economic" integration**	**Establishment of regional institutions**	**State/Market relationship**	**Commitment to harmonisation/ cooperation**	**Exchange rate management?**
Europe	Medium	Advanced	Social market	High	Yes
North America	High	Limited	Neoliberal	Left to market	No
Eastern Asia	Low	Extremely limited	Developmental	Low	No
South America	Low/medium	Medium	Developmental	Low	No
North Africa	Low	Medium	Developmental	Medium	Yes

Notes: "economic" integration refers to industry integration and the formation of a single market

Table 5 reveals several interesting features. First, that the approaches in NAFTA and the European Union are radically different - as Clarkson puts it, comparing the two is like comparing "apples and oranges" in the sense that on a certain level comparisons can be made (both apples and oranges are fruit) but on another level the comparison doesn't work too well (apples and oranges are different types of fruit). Clarkson mentions that both continents experienced a long history riven with conflict, and both continents have a shared history of conflict with the largest country in the bloc (Germany for the EU and the US for NAFTA), but culturally and politically the two could not be more different. Europeans sought to establish a forum where Germany could participate as an equal partner in economic and political development, whereas after the war, the victorious USA really did not actively pursue any "special" relationship with either Mexico or Canada, so the Canadian-US FTA (CUFTA) and its successors NAFTA and soon-to-be FTAA were born much later. This also probably explains the reticence on the part of the USA to pursue deeper integration - it has little concern as to what either of its NAFTA partners thinks about its political or economic intentions or ambitions - therefore a deeper form of integration which might tie or bind US policy to a particular treaty or supra-national institutional interpretation is likely to be an anathema to its politicians. Following this line of argument, the FTAA, signed in Quebec City in May of 2001 essentially extends NAFTA to other Central and South American countries, signifying that there is really no "special" relationship with Mexico because of its geographical position (- ironically some politicians would claim that NAFTA caused Mexico to become a policy problem!)[6]. In counterfactual terms it is interesting to mull over what would have happened to CUFTA if Mexico had not been brought in to create NAFTA in 1994 - perhaps the shared cultural and historical background (European settlers, settling the west, and for the most part a common language) would have engendered a greater desire for a deepening of arrangements in CUFTA rather than the widening that will occur from NAFTA to the FTAA.

Turning to the EU, it is clear to both insiders and outsiders that history and culture also affects the present situation in Europe, as i) the UK with its separate experience in the early part of the 20th century plus its physical separation from the rest of Europe (see Bryson (1995) for an amusing US perspective on this) and a different experience with the EU and current "outsider" status in EMU, reflects a radically different cultural and historical background; ii) the treatment of the Central and Eastern European (CEE)

[6] Interestingly, Mexicans used to designate "North America" as anything north of the Rio Grande - since NAFTA this is increasingly used to in a self-inclusive manner.

countries by the EU - neither Greece nor Portugal were put through the same lengthy and rigorous process for membership of the EU as the CEE countries have been subjected to, and yet neither of these two countries had an economic or political record that was beyond reproach. Clearly the shared history of Western Europe binds the current EU together, and even though the CEE countries are deemed to be European, they represent a "differentiated" Europe; and iii) the refusal of most Europeans to perceive of the EU as anything other than European - both Turkey and Russia, albeit for apparently different reasons, are unlikely to be allowed into the EU in the near future.

Two other factors evident from table 4 are also noteworthy. First, ASEAN is another different model of integration, with a much looser form of integration and a large membership. Although ASEAN plans to implement an FTA by 2005, most commentators doubt that this will occur by then - nevertheless cooperation in the area will likely increase in the light of the common experience offered by the South East Asian crisis.

Second, Mercosur, the Southern American integration project, that to a large extent mimicked the EU, has, to date, not been wholly successful. Recent reports suggest that in fact economic integration is about to go into reverse as both Argentina and Brazil appear to have problems in implementing further trade liberalization due to the domestic political ramifications - and particularly as Brazil maintains a crawling peg exchange rate while Argentina, now mired in recession, is sticking to its currency board arrangements against the dollar[7]. Although Mercosur institutions have been established, their influence is very limited and policymaking initiative largely remains in the hands of the constituent countries. But from a qualitative perspective note that apart from Brazil, the Mercosur members have very similar historical experiences and cultural roots. The Mercosur suggests that a specific model does not necessarily translate well elsewhere in the world, and in turn suggests beyond a certain point the specificity of arrangements for

[7] The Argentinian finance minister recently announced that the currency board will consider introducing the euro as one of the components of a basket of currencies that might supplant the dollar as the anchor for the peso exchange rate.

any regional integration project must be determined by the combination of particular state interests that bring the countries to the table, along with their preferences for supra-national delegation versus coordination and harmonisation. And further it suggests that differing exchange rate arrangements can affect progress on another policy front (- a matter that is pursued below).

The case of North Africa is also interesting. These countries all have a similar culture and shared history as they are nearly all ex-French colonies. Hence their arrangements, as both Robson (1997) and El Nabi (1995) describe, are somewhat unique. They have embarked on a monetary union and an overlapping but slightly different membership is now pursuing a common market. A previous customs union was established (OACU), with fiscal compensation payments (a form of fiscal union), but economic difficulties in the early 1990s unfortunately caused the arrangements to lapse. Clearly their common heritage and shared culture made it much easier to enact a monetary union, tied to the franc (and now the euro).

The qualitative analysis above suggests that the initial conditions for any regional integration project differ substantially from continent to continent, and that any attempt to impose a template from one region onto another region is likely to fail. This is because it does not account for the specificity of the regional integration arrangements under consideration in terms of history, culture, and the willingness to delegate policy responsibilities to a supranational level.

b) Process Path-dependency

Clearly not only do initial conditions differ between the regional integration projects because of historical and cultural reasons, but also path dependency matters in the sense that Figure 1 illustrates that it is not necessary to use the same integration path. Further, there are two other points to be made about figure 1. First, and perhaps most importantly in both European and North American contexts, members have been added along the way. This must lead to a change in preference among the participants in the project. Many examples of this exist in the European context, from the UK's obstinacy over the budget, to the emergence of a lobby group of "olive" member states from the Mediterranean regions, and the addition of CEE countries is clearly going to significantly change the balance of power again in EU institutions and decision-making. The decision to add new members can change the integration dynamic and cause the direction of the process to shift from its original course[8]. It has now been clear for some time in the EU that there are a "hard core" of member states (notably Germany, Austria, the Benelux members states and France) who are keen to see a deeper level of integration achieved more rapidly. As more member states are added to the EU, member states that will need to acclimatize to EMU, a common market and the political bargaining that takes place in the EU will not be anxious to move forward too swiftly. In fact, letting the six CEEs join together might create a significant voting bloc to stall any future initiatives, regardless of how the integration dynamic plays out after EMU[9].

The second point that stems from figure 1 relates to the move from autarky to either an FTA or a CU. In the figure, the presumption was made that an autarkic state with bilateral trade agreements may would probably make a first move towards a trade agreement rather than to any other type of integration treaty. But this may not be so, and one example of this type of behaviour exists and is well documented[10]. The West African states have operated a monetary union for some time now (WAMU), using the French franc as a nominal exchange rate anchor for their collective currency, the CFA. Although WAMU was supposed to complement a customs union (OACU) and fiscal union, the CU collapsed in the 80s during the debt crisis, and they became largely autarkic. The WAMU shows that from autarky, countries can move to a much deeper stage of integration, bypassing the intermediate stages in Balassa's process.

---

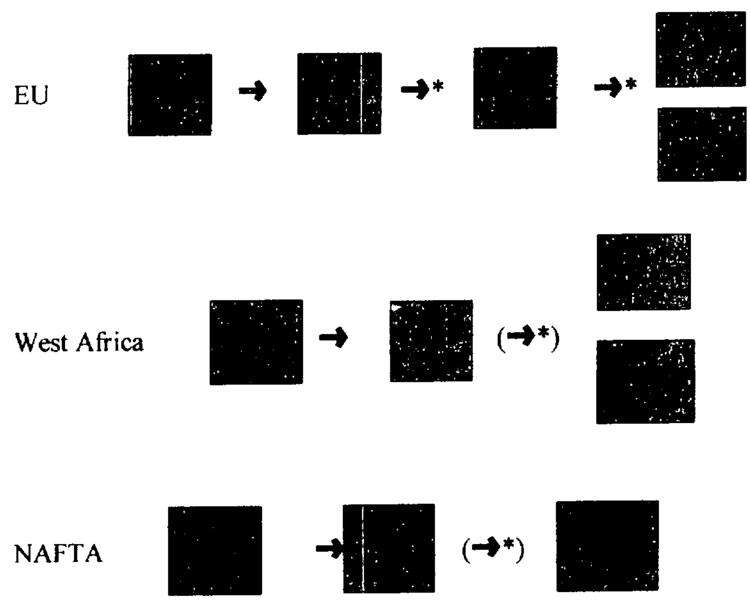
[8] For example, as de Witte (2001) notes, the German call in mid-2000 for an EU "constitutional treaty" was only met with a positive reaction by the original founding six member states of the EU!

[9] See Wallace (1999).

[10] Unilateral adoption of another currency is another example of monetary union - but as it usually does not form part of a regional integration agreement, we focus on the one example of a regional integration agreement where this has happened.

Figure 2

Nodal Map of Integration Stages for the EU and West Africa



Notes: * = members added to integration project between these stages
( ) = partial

Figure 2 illustrates three different routes through the integration stages. All three routes have one thing in common - they all contain the objective at some point of the creation of a common market. All three examples of attaining a common market (C) use a different route, and interestingly in all three cases commentators have noted that the definition of a common market has not yet been met.

All the regional integration projects clearly have different initial conditions, in the form of cultural and political homogeneity - but we have also suggested that path-dependence also exists. What are the factors that affect which path is taken? This is a difficult question to answer satisfactorily, if at all, so rather than embark on a "wild goose chase" in the fog, we will address a somewhat different question, but one which does indirectly address the path-dependency issue. The real question countries and states need to address when moving to a specific level or type of integration, is: "What is being given up, or how are domestic policymakers hands tied by adopting this form of integration?". Table 4 attempts to provide some answers to this question.

Table 6

Implied Changes and Commitments from Integration

Level of integration	Description	Initial change implied	Ongoing commitment
A	FTA	- reduction in tariffs and quotas in politically sensitive areas - possibility of trade diversion - dislocation due to structural economic changes - loss of influence over corporation location	- extending to other areas such as services - monitoring state aid - allocating resources to dispute settlement boards - to retain corporate competitiveness - to monitor trade deflection
B	Customs union	- as above - potential loss of income for high tariff countries	- as above
C	Common market	- migration, and associated factor price equalisation - greater capital mobility/instability	- oversight of fair competition
D	Economic union	- consultation where coordination is concerned - changes to domestic policies where harmonization is concerned - loss of national jusrisdiction/administration (cost savings) where supranational transfer is concerned	- compliance with agreements over coordination/supranational transfer - reporting requirements
E	Monetary union	- loss of exchange rate policy - loss of independent monetary policy	- trade gains - reporting requirements
F	Fiscal union	- loss of independent fiscal policy - loss of "low tax" status	- reporting requirements
G	Political union	- loss/subjugation of independent political framework for policy-making - smaller state bureaucracy - dual representation	- more complicated electoral system - delineation of federal vs state responsibilities

Several points arise from table 6. First, the "deeper" forms of integration (forms D, E, F and G) imply substantial loss of national autonomy, although D appears to be least objectionable from the point of view of protection of domestic interests. This might explain why, with the notable exception of the EU, Mercosur and WAMU nearly all other regional trade agreements focus solely on the earlier stages of integration. Second, as Krugman (1991) makes clear, a common market would imply that specialised labour would move to the highest paying countries instead of corporations moving to the lowest cost countries: so clearly in terms of potential economic dislocation an FTA or CU is less severe for an economy than implementing a full common market[11]. Third, out of E, F and G, E (monetary union) is likely the easiest to accomplish because it gives up a policy prerogative that is usually delegated to a government agency rather than decided by political representatives. Certainly, mainstream economic literature stresses the potential inflation advantages of central bank independence and perhaps even growth advantages (- although there is almost no evidence to support this latter claim). Lastly, although D could conceivably operate most efficiently with supranational institutions, these are not necessary for its effective operation, whereas for E, F and G, clearly supranational institutions would likely be necessary. As national governments have a certain reticence about establishing supranational institutions, because of "political" spillover, these stages will probably be deemed less palatable to most national governments. A good example of this logic might be the Stability and Growth pact (see Artis and Winkler (1997), Fritz and Weber (1999) and Crowley (2001)). Here a potential spillover from E to F was recognised but a way was found to avoid supranational institution building by agreeing on a pact to coordinate fiscal policy.

Although recognition of spillovers clearly gives rise to certain policy problems in this context (how to enforce the Stability and Growth pact), non-recognition can also be equally problematic. An example of

[11] Interestingly, Canada is a good counter-example to this logic: Canada still does not constitute a single market, even though it is a single currency area and has a fiscal and political union, because of provincial trade barriers that were erected to protect goods markets such as brewing. Attempts to remove provincial trade barriers were made by Prime Minister Mulroney as part of the Charlottetown accord in 1991, but these were rejected by the referendum over issues relating to Quebec and the Constitution.

this might be the problem of the asymmetry surrounding the arrangements for the ECB, given that it effectively has no single democratic institution to be accountable to (see Crowley and Rowley (1988) for a description as to possible solutions to this problem, and see Buiter (1999) and Haan and Eijfinger (2000) for extensive discussions on ECB accountability).

To summarise, in comparative terms within the context of the stages of regional integration, the above reasons go a long way towards explaining i) why most of the regional integration agreements in the world are FTAs or CUs, ii) why fiscal, monetary and political union are not seen as desirable to many countries, and iii) why if one of ii) has to be chosen, then monetary union would most likely be least problematic, and easiest to achieve.

c) Exogenous factors

In this section we briefly return to a theme that was presented at the beginning of the paper, namely that of the multilateral trading system and the loophole in Article 24 of GATT that allows regional integration agreements to exist. Clearly, frustration with the GATT process particularly during the Uruguay round, led to many countries deciding that regional trade liberalisation was a better option than the multilateral process. Thus today, the numerosity and depth of regional integration agreements, to some extent, owes its existence to the slow progress made on a multilateral context, and in this sense the process has been exogenously determined by external factors. From a political perspective on might add that the conservatism of the 1980s fostered a greater desire to implement more open trade regimes to reap the benefits of a more competitive environment, and if the multilateral process could not provide this environment quickly enough, then regional agreements could be implemented very quickly given a mutual willingness to do so.

IV Implications for the EU

Having nearly completed EMU, the EU is looking beyond 2002 and is dealing with the expansion of the EU to the CEE countries. This is a challenging task, but it will modify preferences towards integration in the EU, leading to a different path in the future. The question then becomes what effect will EMU have on the EU integration dynamic, and what is the need for further integration? Further, as the title of this paper asks, is there any logical sequence for further integration?

Taking the extended Balassa template, given that EMU is successfully achieved, figure 1 points to fiscal or political union as the next obvious stages of integration. But what about sequence? Belassa's schema implies that fiscal union should occur first, but figure 1 suggests there are actually three possible routes:

i) EMU endpoint: EU integration ends at EMU and although there are some efforts to coordinate and harmonize some aspects of fiscal policy, fiscal policy independence is retained by member states, perhaps with the eventual scrapping of the Growth and Stability pact.

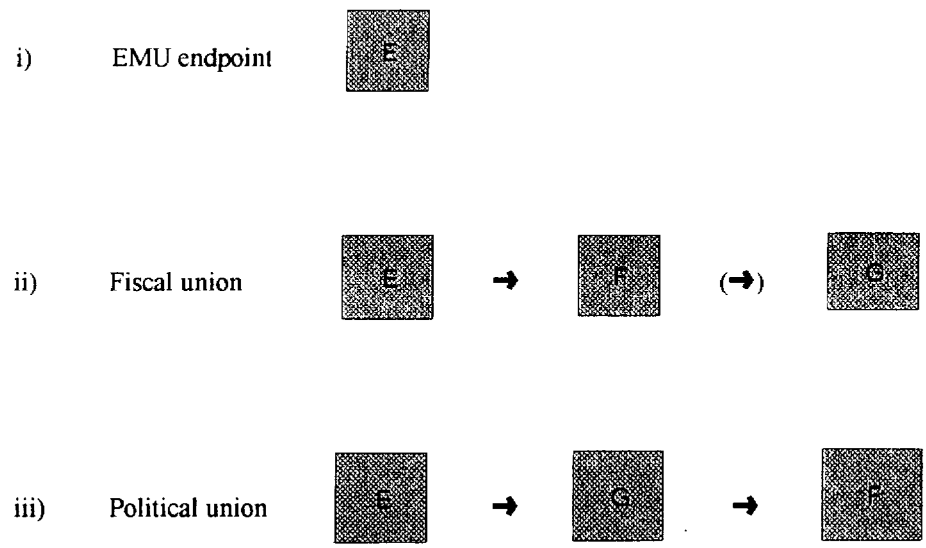
ii) Fiscal union: move to fiscal union (F), and then there are two possibilities - a) the Growth and Stability pact is maintained, and fiscal coordination and harmonisation become the "finality" of the EU integration process, and b) that due to spillovers, fiscal union leads to political union (G).

iii) Political union: move directly to political union (G), by giving the European parliament more powers and perhaps (following suggestions by Joschka Fischer and Tony Blair that were incorporated in the Treaty of Nice) the incorporation of national parliament representatives in a second EU chamber, which would grant more legitimacy to supranational democracy. Following political union, figure 1 suggests that supranational fiscal sovereignty would be easier to acquire through this route.

Figure 3 illustrates these three possibilities.

Figure 3

Integration dynamic for the EU post EMU



Notes: ( ) = no necessity that this will occur

Figure 3 illustrates the three possible outcomes for integration within the EU given that EMU is successfu The diagram illustrates that if fiscal union is blocked by member states, but there is a possibility for some degree of political union, then this (option iii) above) may be the best way to achieve fiscal union in the long run, as a legitimate political union should then be able to acquire fiscal responsibilities at a supranational level much more easily than using the usual Balassa stages of integration which would impl option ii) above (see Wessels (1997) for more on the political implications of EMU).

The only paper (that I am aware of) that addresses the issue of the need for further economic integration after EMU is Costa and De Grauwe (1999). Costa and De Grauwe take a much narrower vie of the integration process beyond EMU and focus on the political "spillovers" as well as single market issues that will arise after EMU implementation. Costa and De Grauwe analyse labour mobility, tax harmonisation, industrial location, transportation and legislation regarding takeovers as possible areas where EMU will put further pressure for integration or at least harmonisation or cooperation. Here industrial location and associated agglomeration effects, as well as legislation regarding takeovers will be put aside, because they largely fall under the rubric of single market issues, and they are ongoing issues which may have been exacerbated or highlighted by EMU. Transportation is certainly important and with the single market it is clearly becoming more important to have at minimum harmonisation of national standards under some umbrella EU transport policy - but again this comes under the rubric of economic union - an integration initiative that is ongoing. So this leaves labor mobility and tax harmonisation. Labour mobility once again comes under the rubric for the single market, the EU version of a common market, but nevertheless does have an important interrelationship with EMU so like tax harmonisation is considered below.

According to the theory of optimum currency areas (developed by Mundell (1961), Kenen (1969) and McKinnon (1969)), labour mobility is important if a single currency area is not optimal (see De Grauwe (1992), Artis and Zhang (1997), Bayoumi (1994), Bayoumi and Eichengreen (1993, 1994), LaFrance and St-Amant (1999) for a detailed review of the OCA literature and Björksten and Syrjänen (2000)). But on the other hand EMU might turn out to be optimal *ex-post*, as Frankel and Rose (1999) have pointed out[12]. So all we can say at this juncture is that labor mobility *might* turn out to be important. So what is the evidence about labour mobility in the EU? The evidence is that labour mobility in the periphery is greater than in the "core", so in a sense this does bode well given that agglomeration effects should eventually lead to more activity in the core. Also further evidence suggests that low-skilled labour mobility in the core is much lower than high-skilled labour mobility - the economic rationale being social security[13]. As taxes fall on income of low-skilled labour in the core, this should increase net wages and

[12] Economists usually refer to an optimal currency area (OCA) that occurs *ex-post* as an endogenous OCA.

[13] Social security in the core countries is very well developed and eliminates any financial incentives for low-skilled labour to move.

prompt an increase in labour mobility, but there is significant resistance to this process, so it may take some time to occur.

Suppose that EMU does not become an endogenous optimal currency area, and so labor mobility becomes an issue - which form of integration is this likely to engender? If labour becomes more mobile in the EU then clearly fiscal issues will be of prime concern - ensuring social security contributions and pension contributions are portable - plus harmonization of tax systems. If these issues become crucial for the success of EMU, then figure 3 above suggests that integration dynamic ii) is most likely. If EMU is not an optimal currency area and the strains are significant, then it might be that other initiatives are taken which tends, through spillovers, to promote political union.

When it comes to fiscal harmonisation, Costa and De Grauwe (1999) make the point that taxation on very mobile taxable items will be much more likely to be harmonised or coordinated than taxation on a less mobile tax base[14]. This harmonisation will also likely lead to tax competition on mobile factors but less competition and therefore an array of different rates (and public service offerings) on less mobile factors[15]. This analysis points to little cooperation or harmonisation on income taxes and withholding taxes, but more pressure to harmonise and maybe set a common rate for VAT and corporation taxes. In terms of our analysis above in figure 3, this fits in with integration dynamic ii) again.

The crux of the issue surrounding the integration dynamic outlined above is that in fact EMU points to only weak integration beyond EMU in the fiscal area - in other words the political "spillovers" are not likely to cause a fiscal union where policy responsibilities are transferred to a supranational level[16].

---

[14] Or to quote Costa and De Grauwe (1999), "the pressure to harmonise tax rates increases with the mobility of the good and the factor that is taxed" (pp35).

[15] Costa and De Grauwe claim this could lead to lower taxes on capital and higher taxes on labour, but do not offer any evidence for this. Clearly Tiebout factors will also come into play.

[16] During the UK election (May 23, 2001), Frits Bolkestein, the EU internal market commissioner declared that "harmonisation of income taxes is out". A few days later similar gestures were made by Tony Blair, UK Prime Minister, with regard to corporation taxes in response to suggestions by French Prime Minister Jospin that taxes in the EU should be harmonised.

Further, in terms of the integration dynamic, they will likely lead to the "finality" of integration in the EU without any further tendency towards political union. An integration dynamic that is institutional in its scope and embraces the notion of political union before fiscal union will be much more likely to lead to a fiscal union that encompasses fiscal sovereignty at the supranational level leading to a deeper level of integration in Europe. Part of this depends on whether EMU is an endogenous optimal currency area - if it is, then unless a separate initiative for political union is launched, the integration dynamic alone is unlikely to produce political union - if it is not, then the integration dynamic is more suggestive that a political union might be achieved.

V General conclusions

In this paper, the Balassa stages of economic integration were reviewed and analysed from both a historical, economic and political context. The implied sequence of integration was also placed in the context of the liberalisation of the world trading system, and examples were given of regional integration projects and different integration dynamics. The Balassa framework was found to be useful but flawed from a dynamic perspective, and a new taxonomy was developed which encompasses a variety of integration dynamics.

The sequence of economic integration was analysed using two different approaches - a backward-looking economic conditionality approach, where each stage of the integration was conditioned on other stages - and a forward-looking politico-economic spillover approach which looked at how which further stage(s) of integration are suggested at any specific stage of integration.

Comparisons were then made between the economic integration projects that exist today. Discussion of the starting points and the dynamics of each integration project included cultural and historical commonalities, political preferences and regional context. Further, using the notion of process path-dependency, each stage of economic integration was analysed and it was determined that monetary union was the easiest to implement and likely implied less political spillover effects at the supra-national level.

The framework used to link the different stages of economic integration was then applied to the EU, given a successful implementation of EMU. The analysis uncovered three possible options, all with different implications for the endpoint of the integration dynamic in the EU. The main finding was that there is no logical reason why fiscal union needs to occur directly after EMU - the alternative being a dynamic that pushes for political union first and then this might legitimate fiscal sovereignty at a supranational level.

References

Artis, M. and Winkler, B. (1997), "The Stability Pact: Safeguarding the Credibility of the European Central Bank", *CEPR Discussion Paper* 1688, CEPR, London, UK.

Artis, M. and Zhang, W. (1998), "Core and Periphery in EMU: A Cluster Analysis", *EUI Working Paper RSC No.* 98/37.

Balassa, R. (1961), *The Theory of Economic Integration*, Irwin, Homewood, USA.

Bayoumi, T. (1994), "A Formal Model of Optimum Currency Areas", *IMF Staff Papers*, Vol.41, No.4, pp537-554.

Bayoumi, T. and Eichengreen, B. (1993), "Shocking Aspects of European Monetary Unification", in Giavazzi, F. and Torres, F., *Adjustment and Growth in the European Monetary Union*, Cambridge University Press, Cambridge, UK.

Bayoumi, T. and Eichengreen, B. (1994), "One Money or Many?: Analyzing the Prospects for Monetary Unification in Various Parts of the World", *Princeton Studies in International Finance* 76, Princeton University, USA.

Beetsma, R. and Uhlig, H. (1997), "An Analysis of the Stability Pact", *CEPR Discusssion Paper* 1669, London, UK.

Bhagwati, J., Greenaway, D. and Panagariya, A. (1998), "Trading Preferentially: Theory and Policy", *Economic Journal*, Vol. 108, pp1128-1148.

Björksten, N. and Syrjänen, M. (2000), "How Problematic are Internal Euro Area Differences?", *EUI Working Papers*, RSC 2000/14.

Blaug, M. (2001), "No history of ideas here please, we're economists", *Journal of Economic Perspectives*,

Breuss, F. and Weber, A. (1999), "Economic Policy Coordination in the EMU: Implications for the Stability and Growth pact", *EUI Working Papers/RSC* 99/26.

Bryson, B. (1995), *Notes from a Small Island*, McClelland and Stewart, Toronto, Canada

Clarkson, S. (2000), "'Apples and Oranges'. Prospects for the Comparative Analysis of the EU and NAFTA as Continental Systems", *EUI Working paper* RSC 2000/23.

Costa, C. and De Grauwe, P. (1999), "EMU and the Need for Further Economic Integration", in Meeusen, W. (ed), *Economic Policy in the European Union*, Edward Elgar, Cheltenham, UK, pp27-48.

Crowley, P. (2001), "The Institutional Implications of EMU", *Journal of Common Market Studies*, September, forthcoming.

Crowley, P. and Rowley, R. (1998), "European Integration and Monetary Unification: Configurations, Fiscal and Monetary Policy Design and Institutional Development", *Journal of European Integration*, Vol XXI, No. 3, pp

De Grauwe, P. (1992), *The Economics of Monetary Integration*, Oxford University Press, Oxford, UK.

De Witte, B. (2001), "Après Nice: Time for European Constitution?", *ECSA Review*, Spring, pp10-11.

Eichengreen, B. (1993), "European Monetary Unification", *Journal of Economic Literature*, Vol 31, pp1321-1357.

Eichengreen, B. and Wyplosz, C. (1998), "The Stability Pact: More than a Minor Nuisance?", Economic Policy 26, pp65-114.

El-Agraa, A. (1997), "Regional Integration arrangements worldwide", in El-Agraa, A. (ed), *Economic Integration Worldwide*, St. Martin's, New York, USA, pp12-33.

El-Agraa, A. (1999), *Regional Integration*, Macmillan, London, UK

El Nabi, I. (1995), *Economic Integration in Africa - A Critical Assessment*, Khartoum University Press, Khartoum, Sudan.

European Commission (1990), "Economic and Monetary Union: The Economic Rationale and Design of the System", Working Document of the Commission, Presented to Finance Ministers, March 31-April, 1990, Brussels, Belgium

Flam, H. (1992), Product Markets and 1992: Full Integration, Large Gains?, *Journal of Economic Perspectives*, Vol 6 No. 4, pp7-30.

Frankel, J. and Rose, A. (1997), "Is EMU more justifiable ex post than ex ante?", *European Economic Review* 41, pp753-760.

Haan, J. de, and Eijffinger, S. (2000), "The Democratic Accountability of the European Central Bank", *Journal of Common Market Studies*, Vol 38, No. 3, pp393-408.

Helleiner (1994), "Regionalization in the International Political Economy: A Comparative Perspective", University of Toronto - York University Joint Centre for Asian Pacific Studies, Toronto, Canada.

Kenen, P. (1969), "The Theory of Optimal Currency Areas: An Eclectic View", in (eds), Mundell, R. and A. Swoboda, *Monetary Problems of the International Economy*, University of Chicago Press, Chicago, USA.

Krugman, P. (1979), "Increasing Returns, monopolistic competition, and international trade", *Journal of International Economics*, Vol. 9, pp469-479.

Krugman, P. (1991), *Geography and Trade*, MIT Press, Cambridge, USA.

Laffan, B., O'Donnell, R. and Smith, M. (2000), *Europe's Experimental Union*, Routledge, London, UK.

LaFrance, R. and St-Amant, P. (1999), "Optimum Currency Areas: A Reviews of the Recent Literature", Paper presented at the Canadian Economics Association meetings, Toronto, Ontario, May 28-30.

Martin, F. (1992), "Local and regional impacts of a FTA: Canada, US, Mexico", in Bertin, G. and Raynauld, A. (eds), *Economic Integration in Europe and North America*, Clement Juglar, Paris, France, pp23-52..

Mayes, D. (1997), "The Problems of the Quantitative Estimation of Integration Effects", in El-Agraa, A. (ed), *Economic Integration Worldwide*, St. Martin's, New York, USA., pp74-96.

McKinnon, R. (1969), "Optimum Currency Areas", *American Economic Review*, No. 53, pp717- 55.

Meade, J. (1953), *Problems of Economic Union*, Allen and Unwin, London, UK.

Meade, J. (1955), *The Theory of Customs Unions*, North-Holland, Amsterdam, Netherlands.

Molle, W. (1997), *The Economics of European Integration*, Ch 2 (Basic Concepts and Structures), Ashgate.

Mundell, R. (1961), "A Theory of Optimum Currency Areas", *American Economic Review*, Vol. 51, pp657-675.

Robson, P. (1997), "Integration in Sub-Saharan Africa", in El-Agraa, A. (ed), *Economic Integration Worldwide*, St. Martin's, New York, USA, pp348-367.

Robson, P. (1998), *The Economics of International Integration*, Fourth edition, Routledge, London, UK.

Salmon, P. (1992), "Leadership and Integration", in Bertin, G. and Raynauld, A. (eds), Economic Integration in Europe and North America, Clement Juglar, Paris, France, pp367-386.

Tinbergen, J. (1954), *International Economic Integration*, Macmillan, London, UK

Viner, J. (1950), *The Customs Union Issue*, Carnegie Endowment for International Peace, New York, USA.

Viner, J. (1965), "Letter to W.M. Corden dated 13 March 1965", *Journal of International Economics*, Vol. 6, pp107-108.

Wallace, H. (1999), "Whose Europe is it Anyway?", *European Journal of Political Research*, Vol 35, pp287-306.

Wessels W., (1997), "An ever closer union? A dynamic macro-political view on integration processes", *Journal of Common Market Studies*, Vol. 35, No. 2, 267-99