Introduction to International Relations
Lecture 15: Economic and Political Integration

Professor Branislav L. Slantchev
Department of Political Science, University of California – San Diego

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Overview. We now continue our discussion of institutions by examining some ways countries have banded together to create regimes that would help them overcome collective action problems and promote free trade. We discuss free-trade areas and then move on to the larger issue of supranationalism, the relinquishment of national sovereignty to a higher authority. We trace the evolution of the European Union from its humble beginnings to a customs union, and, more recently, to a common market. We conclude with some thoughts about the relationship between the EU and U.S.

When we discussed trade regimes, we concentrated on multilateral trade and the institutions that evolved to facilitate it (GATT, WTO). We also mentioned regional free-trade areas (e.g. NAFTA) in which a group of states agrees to remove trade barriers within their area. While these international organizations (IO) promote free trade, some of them involve what some would consider fairly serious infringements on state sovereignty. For example, in some important IOs, power is held by appointed bureaucrats (or by representatives elected by the member states) and decisions are made by voting. This means that sometimes, such IO could force a member state to implement a policy against its will. **Supranationalism** refers precisely to such a subordination of state authority to some international institution. We now expand on the idea of regional integration in which the struggle between *nationalism* and *supranationalism* has come to a head.

Recall that free trade can be viewed as a collective good, and hence subject to the free-rider problem: When there are many participants, each individual actor's defection may seem insignificant, which only increases the temptation to do it. When enough actors defect from the agreement, the collective good will be under-provided (or not provided at all) and the free trade regime will collapse, hurting all countries involved.

As we have seen, states may seek to create institutions that are designed to alleviate some of the informational and enforcement problems inherent in an anarchic world populated by self-interested actors. Recall that one major inducement for free riding is the non-excludable nature of the public good: Once provided, it cannot be denied to any actor even if that actor did not participate in its production. This means that if such a good could be made *excludable*, the threat of exclusion could serve as an inducement to avoid the temptation to free ride.

One approach to dealing with the free rider problem, then, is to reduce the number of parties involved in the production of the public good (making monitoring easier) and then transform the public good into a private one (making enforcement easier). Smaller groups tend to have more things in common, and so fewer sources of conflict. If a handful of actors could form their own "club" that denies benefits to non-members, then cooperative behavior could be sustained at least between the members. At a cost of some loss of sovereignty, members could secure for themselves large benefits.

This coordination could be *wide* (including more members) and *deep* (extending to more areas and requiring larger sacrifices of autonomy). The common wisdom is that there is a trade-off between width and depth: The wider the institution, the more difficult it is to enforce provisions that require larger sacrifices, and the more daunting the coordination problems that require many to agree on the same provisions. As a result, wider institutions would tend to be shallower. On the other hand, narrow institutions may be able to sustain very deep cooperation.

We can order various institutions designed to overcome collective action problems and liberalize economic exchange along the depth dimension: how much sovereignty do members have to give up in order to participate? At the shallowest end is the **free-trade area**, which comprises several, usually neighboring, states that agree to remove trade barriers among them. This allows them to cooperate in a smaller group and maintain outside trade relationships according to bilateral treaties or WTO rules. There is no requirement that these relations with non-members have to be synchronized among the members. The maintenance of a free trade area does not require a formal organization to supervise it.

Contrast this to a **customs union**, which is a free-trade area where members also agree on a common policy toward non-members. That is, each member foregoes the ability to control tariff and NTBs on goods imported from non-member countries. Instead, all members jointly determine a common tariff to be imposed on such goods. The customs union involves more integration, coordination, and correspondingly a higher loss of sovereignty for the members. That is, it is deeper than a free-market area and usually much narrower as a result.

The highest state of *economic integration* is the **common market**, which adds the free movement of labor and capital to the customs union freedom of goods and unified external tariffs. A common market is deepest and involves the largest loss of sovereignty, eventually requiring the relinquishment of important policy tools for controlling financial flows and stimulating the economy. Common markets are very rare.

1 Regional Trading Blocs

The history of regional trading blocs began in the 19th century in Europe. At this point, central Europe was populated by a host of German states and mini-states, most of whom had various tariffs that impeded trade. In 1834 Prussia, the dominant northern state, initiated the *Zollverein*, a customs union with several neighboring states. Prussia's goals were not just economic but also political: by strengthening the economic ties of participants and excluding Austria and its friends, Prussia sought to increase its own influence at the expense of Austria's, its competitor for dominance among the German states. The process, aided by two wars, culminated with the political unification of Germany.

By the beginning of World War I, Europe was largely a free-trade area with mostly unimpeded movement of goods, money, and people across borders. The catastrophic war and the subsequent Great Depression resulted in a return to protectionism that persisted until the end of the Second World War, when the Western European states embarked on a huge experiment in integration under the protection (and with the help) of the United States. We discuss the process in the next section but for now we note that what began as a system that would facilitate cooperation on economic matters between the former rivals gradually evolved into the supranational institution of the European Union (EU).

Unlike the broad EU that encompasses economic, social, political, and environmental goals, the **North American Free Trade Agreement** (NAFTA) is much less ambitious. NAFTA is a free-trade area that comprises the U.S., Canada, and Mexico. It came into being in 1994 by immediately eliminating certain tariffs and then gradually reducing others over a period of time. The treaty does not supersede national law and is without a supranational organization.

It is difficult to separate NAFTA's impact from a host of other macroeconomic factors, but generally economists agree that it may have contributed more to trade diversion than expansion. That is, it has increased within-area trade mostly at the expense of trade with non-members. In addition, many observes have noted that while the agreement provides Canada and Mexico with access to the vast American market, it is less clear what economic benefits the U.S. has obtained. On the other hand, the political benefits have been perhaps more obvious: NAFTA has created a regional balance to the EU, which may explain the sudden successful conclusion of the Uruguay Round of the GATT talks after years of obstructionism by the Europeans.

NAFTA's touted successor, the **Free Trade of the Americas** (FTAA) is designed to unite all states in the Americas (except Cuba) into a free-trade area by 2005. It is much more ambitious than NAFTA but negotiations have stalled for now due to major disagreements about the pacing of integration and handling of intellectual property rights.

There is a lot of vocal criticism of free trade by groups that view it as part and parcel of globalization. Some arguments are rather curious. For example, a common refrain is that third-world countries are hurt by the trade barriers instituted by rich countries to protect their own less competitive sectors. If this is true (and it is in many cases), then one should be promoting the WTO, not opposing it, for this organization's goal is to eliminate precisely these practices. In the end, it would appear that much of the protest is driven by Western workers who are afraid of competition with the developing world. On the other hand, competition to attract foreign investment through cheap labor does seem to place workers in a gigantic Prisoner's Dilemma whereby each country tries to make itself attractive by lowering labor costs (which means worse working conditions and lower pay), and as a result workers everywhere end up with a much lower standard of living.

Despite the opposition to free-trade, free trade agreements (FTA) have considerably increased in number. Many are not regional. For example, the U.S. has bilateral FTAs with Israel (since 1985), Jordan, and Australia, in addition to Chile and Central American countries. NAFTA accounts for 21% of global trade, while the European Economic Area (EU and European Free Trade Association, EFTA) accounts for 42%. The Southern Cone Common Market (Mercosur) created in 1994 tripled trade among its founding members (Brazil, Argentina, Uruguay, and Paraguay), causing Chile and Bolivia to seek entry along with the Andean nations. Since Mercosur members trade twice as much with the U.S. as with each other, the FTAA would expand trade in the region considerably.

One, of course, has to wonder whether the creation of many regional blocs would eventually result in protectionism on a gigantic scale, with each bloc closing itself from the others. While the multilaterally-minded WTO does not frown on regional agreements provided that these do not specifically discourage trade with nonmembers. It is worth noting that the success of regional agreements may well undermine the WTO because it would eliminate the need to depend on global solutions that are difficult to negotiate and even harder to police.

2 The European Union

The European Union's *internal market* of 450 million people accounts for about 42% of world trade and is the largest free trade area in the world. The internal market comprises the EU itself plus EFTA (Iceland, Liechtenstein, Norway, and Switzerland). The roots of the European integration lie in the conclusion of the Second World War, with the idea being to foster the links between the countries and prevent such an appalling destruction from ever happening again. To most people, this meant keeping Germany tame. On May 9, 1950 (Europe Day), French Foreign Minister Robert Schuman proposed the vision of what has now become the EU.

The first step was modest: a merger of the coal and steel industries of Western Europe. The European Coal and Steel Community (ECSC) was created in 1951 and integrated the industries of the Benelux countries,[1] West Germany, France, and Italy by placing the decision-making power in the hands of a supranational organization called the "High Authority."

Even though Britain did not join, this was a crucial step in the **functionalist** process that the ECSC founders hoped to jump-start. The essence of this approach is that it envisions technological and economic development resulting in creation of supranational structures designed to deal with specific functions (e.g. mail delivery). The economic integration generates a political thrust that spurs deeper integration in social and political spheres, eventually producing cooperation on a large scale and across many issues.

Although economic cooperation succeeded within the ECSC, military and political cooperation ran into serious difficulties. Very early in the Cold War, and partially as a result of the Korean War, the U.S. concluded that European security could not be guaranteed without the rearmament of West Germany and its integration into the Western camp. America pressed with the idea, and even though the six members signed a treaty in 1952 to create the European Defense Community, the French parliament refused to ratify it. The goal of keeping Germany down by refusing it sovereignty over coal and steel production (vital resources for manufacture of weapons and prosecution of war) was easier to achieve than the creation of a unified military command that might eventually be placed under a German general. The French were simply not ready to give up so much

[1] This is a common name for Belgium, Luxembourg, and the Netherlands, a group of countries that often act together in political matters.

national authority to a supranational entity.

In 1957, the six members of the ECSC signed the **Treaty of Rome**, which integrated their atomic energy sectors (EURATOM), and created the *European Economic Community* (EEC). Shortly after the signing of the treaty, the EEC became a free-trade area as tariffs were lifted along with all restrictions on the movement of goods within it. The area was extended to the EFTA members. The treaty also committed the members to deepening cooperation by creating a customs union by 1969. (Recall that in addition to maintaining free trade among themselves, the members of a customs union also adopt a unified set of tariffs with respect to trade with nonmembers.) The customs union was fairly successful, and by 1968 the ECSC, EURATOM, and EEC merged to become the *European Community* (EC).

Finally, the six signatories agreed to pursue a **common market**, which would add the free movement of labor and capital to the customs union. This goal remains only partially achieved today even though the EEC adopted the *Common Agricultural Policy* (CAP) in the 1960s as a first step in the process. Agriculture is perhaps the most difficult sector in which to achieve free trade. Many governments aim for self-sufficiency in food, and in some countries the agriculture sectors field powerful political lobbies because of the importance of their products. Hence, many governments seek to subsidize their farmers and otherwise protect them from foreign competition.

The CAP established that a subsidy extended to farmers by any one EC country should be extended to farmers in all other EC countries. Countries for whom agricultural exports where relatively unimportant (Germany) disliked subsidizing others where they were more important (France, Ireland, Greece, Spain, and Portugal). While the CAP principle did provide for a common market by equalizing agricultural policy within the community (as a result, two-thirds of the EU budget today go to subsidize inefficient European farmers), it also caused the most serious frictions between the Europeans and the U.S. because American farmers justifiably complained that they were unable to compete fairly in Europe due to CAP protectionism.

The conflict between sovereignty and supranationalism resolved itself in the Treaty of Rome's provision that any change must be approved by all members. That is, each individual member had veto power over any decisions. On one hand this provided some security against the EC infringing on any policy area that a member state deemed important enough to invoke its veto. On the other hand, it made further progress very difficult by its insistence on unanimity. The national vetoes were abolished twenty years later but not before the French could wield their own to block the accession of the U.K.

Britain's relations with the EC were turbulent. At first, Britain did not want to become a member of the EEC because it worried that this would jeopardize its preferential trade agreement with the U.S. When the British plan for a free trade area was rejected by the original six, Britain created its own European Free Trade Association with Austria, Denmark, Norway, Portugal, Sweden, and Switzerland in 1960. The idea was to provide an alternative to the EC: free trade but without uniform external tariffs or a supranational authority.

Soon, however, the British realized that they would have to join the EC sooner or later, and that unless they join the EC sooner, they would forego the ability to influence its structure and evolution. In 1961, Britain (along with Denmark and Ireland) applied for membership but its entry was vetoed by the French president Charles de Gaulle who feared that the British would put a stop to his attempt to use the EC to amplify France's say in world affairs, and that American influence would insinuate itself into continental Europe through the British as well.

French resistance could not keep the U.K. out forever, and in 1973 Britain, Denmark and Ireland joined the EC. Although Norway was also admitted, its citizens rejected accession in a referendum a year later. The British smartly did not hold their own referendum until two years later, after they had renegotiated entry terms, making them more palatable to the public. In 1981, Greece became the 10th member, and five years later, Spain and Portugal joined as well.

In the late 1970s and early 1980s, the European economies were mired in slow growth, rising inflation and unemployment, the so-called "Eurosclerosis" that many felt was due to market restrictions and enormous social welfare programs. Competition with the Americans and the Japanese was also difficult without some consolidation of European firms, which was impossible without liberalizing capital and labor flows within the EC. The next big step came in 1987 when the **Single European Act** (SEA), which modified the Treaty of Rome to further the creation of the common market, came into force. The SEA eliminated national vetoes in many areas related to the common market and set 1992 as the target year for its creation. The SEA also increased the legislative powers of the European Parliament (see below), and committed members to effecting a *monetary union* by establishing a central banking system and introducing a single European currency.

In 1992, the **Treaty of Maastricht** turned the European Community into a Union by paving the way for a monetary union, common foreign and defense policy, and social policy. These were now serious erosions of national sovereignty and it is not surprising that this treaty had many difficulties in getting accepted. Britain negotiated opt-out clauses for the Economic and Monetary Union (EMU) and the social charter that provided for the standardization of workers' rights. Denmark also rejected the treaty in a referendum and its citizens only approved it once the country was granted opt-out clauses too. Despite only narrowly squeaking through in France (50.4% against 49.7%) and vocal opposition in Germany, the treaty finally went into effect and the EC became the EU in 1993.

In 1995, Austria, Finland and Sweden joined the EU and as a result of the Schengen Pact, internal borders came down. The EU members (except U.K. and Ireland) removed border controls except at EU's external borders. The Amsterdam Treaty of 1997 attempted to strengthen the common defense policy by providing for EU's capacity to embark on military action, and began the preparation for the eastward expansion. It abolished more national vetoes, and strengthened laws on employment and discrimination. The widening of the Union continued in 2004 when Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia joined, bringing the total to 25 countries. Bulgaria and Romania are set to join the EU in a few years as well.

1952	1973	1981	1986	1995	2004
Belgium	Denmark	Greece	Portugal	Austria	Cyprus
Italy	Ireland		Spain	Finland	Czech Republic
France	U.K.			Sweden	Estonia
Luxembourg					Hungary
Germany					Latvia
Netherlands					Lithuania
					Malta
					Poland
					Slovakia
					Slovenia

Table 1: Chronology of European Union Enlargement.

The **monetary union** is the most troubling loss of national sovereignty to those who care about those things. What began as an informal cooperation between several European countries after the collapse of the Bretton Woods regime expanded into the Exchange Rate Mechanism (ERM). The ERM created a special currency called the ECU (European Currency Unit) based on the average weighted value of all EC currencies. National central banks then had to maintain the value of the national currency relative to the ECU. The ERM was supposed to harmonize currency values as a prelude to the single currency but in 1992 the British pound came under attack. The Bank of England tried to defend it by spending billions and the government raised base rates to prompt traders to buy pounds but on 9/16 (Black September) the U.K. had to give up and was forced out of the ERM. As the pound was allowed to float, Italy followed, and Spain devalued as well. A similar attack on the French franc a year later cost the Bank of France all of its reserves and only the intervention of the German Bundesbank (to the tune of $30 billion Deutschmarks) saved the French from having to devalue their currency dealing an even more serious blow to the ERM.

Still, in 1999 the European Central Bank (ECB) became operational and in 2002, the single currency, the **euro**, became the official currency and legal tender in 12 countries. Over the next few months, the national currencies were phased out. Sweden, Denmark, and the U.K. elected to say out. This was a bold step: the participating countries surrendered monetary authority to the ECB and thereby relinquished important policy tools for maintaining economic health.

On one hand, removing monetary policy from the hands of politicians is good. Since the government has incentives to manipulate the money supply for political ends, it cannot credibly promise not to do so, and as a result it becomes very difficult to control inflation: when everyone expects that the government would expand the money supply, inflationary expectations are written into the contracts and as a result the prophecy becomes self-fulfilling. That is why monetary authority usually resides in quasi-independent central banks that are supposed to be somewhat insulated from political pressure and can therefore credibly commit to maintaining low-inflation policies. Delegating monetary authority to ECB with a clear mandate to do so could improve the credibility that national governments find it hard to provide on their own. On the other hand, a central bank that is committed to inflation is not regarded well by everyone. For example, labor usually wants a central bank that is willing to use monetary policy to stimulate growth and employment. Further, since the EU is still unevenly developed, it is not clear how the ECB is going to handle regional differences that result in divergent demands on its monetary policies.

The EU is a complex quasi-democratic bureaucracy with four main organs. The *Council of Ministers* comprises the relevant ministers of the member countries, the composition depending on the issue under discussion. On security matters, it consists of the foreign ministers, on monetary issues, it consists of economic and finance ministers, on farm policy, it consists of the ministers of agriculture. Most decisions require supermajority (70% of the votes) and some crucially important decisions (e.g. new membership) require unanimity. The ministers' first loyalty is to their home country, and hence the Council cannot be regarded as a supranational authority. It is, however, perhaps the most influential organ of the EU and has provided the direction for the institutional evolution of the organization. This arrangement reflects the resistance of the EU member states to giving up their sovereignty.

The *European Commission*, on the other hand, consists of bureaucrats who owe allegiance first to the EU itself, which is why the 15,000 staff residing in Brussels are usually the favorite target of suspicion by those who resent the loss of national sovereignty to the supranational authority of the EU. The decisions of the commission are binding on the member states, but the commission mostly restricts itself to making proposals to the Council of Ministers. The commission consists of one representative from smaller countries and two from larger ones. The President of the commission is quite influential, almost on par with his national analogues. In 1999, the Commission suffered a severe blow to its prestige when revelations of fraud, nepotism, and corruption forced the resignations of all 20 commissioners, including the president, before the Parliament sacked them. Still, these Eurocrats, unlike national leaders, cannot be replaced by voters, which makes them less accountable and even more suspicious.

The *European Parliament* is the only democratically-elected EU body and its role is still quite limited relative to the powers of the Council of Ministers and the European Commission. The Amsterdam and Maastricht treaties did expand its role somewhat by including provisions for amendment commission proposals to the Council of Ministers, as well as amend or reject positions taken by the council. However, the Parliament does not have veto power in the crucial areas of economic and monetary integration. This Parliament is not a true legislature and should not be confused with U.S. Congress, for example. It's more like a debating society. The hope is that one day it will become a supranational legislative body.

The *European Court of Justice* wields the supreme legal authority in the EU. It provides interpretations of the laws and treaties, and ensures their uniform implementation across member states. Since its judgments are binding, it represents yet another supranational authority whose decision impinge on the sovereignty of the member states. The ECJ can overrule national law when it conflicts with EU law. It is also somewhat unique (i.e. unlike the U.N. Tribunal) in that individuals, not just nations, are allowed to bring cases before it.

How does the EU relate to the U.S.? The U.S. was an early champion and consistent supporter of European integration because it was seen as facilitating the defense of Western Europe from the Soviets. Further, since integration was expected to result in economic prosperity, the U.S. spent a lot of money (Marshall Plan) rebuilding Europe and making it part of the global economy as quickly as possible. While there is no doubt that the Europeans would have recovered eventually on their own, and while there can be little doubt that the U.S. benefitted from the speedy recovery, one must not neglect the crucial role of American aid in the postwar years and the manner in which it was distributed: the Americans basically gave the money to the Europeans and let them decide how best to spend it. Because of the free security provided by the U.S., Western Europe was able to forego expensive military investments and concentrate on rebuilding. (A similar story happened in Japan.)

Up until recently, the U.S. promoted and assisted deepening integration. But now the EU has a reached a point that may prompt some reassessment of American priorities. The EU and the U.S. are the largest traders and bilateral trading partners in the world. (Transatlantic flows amount to about $1 billion a day.) They share a common interest in economic stability, peace, promotion of democracy, and expansion of trade. However, the fault lines that had usually been papered over during the Cold War have begun emerging and lay exposed for everyone to see in the run-up to the Iraq War.

The big unsolved problem for the EU is its common foreign policy. This would only be exacerbated by the admission of the ten new countries, most of which, along with the U.K., tend to be more pro-American than the French and the Germans. This is important because most Europeans tend to regard the EU as a counterweight to American dominance in world politics. But without a military, the EU is impotent and hence it is difficult to take it seriously on such matters. "The hour of Europe has come," said Jacques Poos, the Luxembourg foreign minister, in 1991 after a diplomatic mission to Serbia. Then the hour was quickly gone as the EU proved incapable of preventing genocide in former Yugoslavia. It took another U.S. intervention to stop the massacres there.[2]

[2]The Srebrenica massacre occurred right under the noses of the Dutch troops that were supposed to prevent it.

The Europeans realize that they would have to create a military arm if they wish to have a say in international security matters but this is contentious. First, the perennial problem of nationalist suspicions that has prevented the relinquishment of this particular (and most visible, perhaps most important) feature of sovereignty. Second, the reliance on America has created a national mood that generally opposes military spending in any form and has come to regard the military as obsolete. Third, the new members (fresh NATO members as well) would be loath to antagonize the U.S., and so are likely to oppose overtly anti-American policies. Given the enormous American lead in matters military, the European dream of being a counterweight to America is a mirage and will remain so for the foreseeable future.

On the other hand, perhaps we should encourage European militarization because eventually we might have to deal with strong countries like China, and it is most likely that Europe would stand with America, not against it, when push comes to shove. One would do well to remember what the archetypal French nationalist Charles de Gaulle (who worried most about French sovereignty) said when the former Secretary of State Dean Acheson offered to show him the photographs of the missile sites in Cuba during the 1962 crisis:

> A great country such as yours does not act without evidence. You may tell your President that France will support him.

This was at a point where Europeans worried most about annihilation without representation (that the U.S. would drag them into a nuclear war with the USSR without even consulting with them first). We have come a long way since but may yet hope to recover such support.