Factors in European Economic Integration: A Non-Partial Re-Appraisal

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INTRODUCTION

In 1992 the march to European Economic Integration will reach its climax. A single European market is projected to be achieved by that date. 1992 has become a fixation, not only for European policy makers, businesses and academics but also to outsiders the world over. There is an air of excitment among Europeanists, mixed expectation among businesses and apprehension among outsiders.

In the field of international economic policy, economists have found themselves on difficult terrain. Factors predominant in international economic policy are of a political nature. The late Harry Johnson described these factors as "irrational or non-economic".* However, to expect states to adhere strictly to the prescriptions of economists is on the one hand arrogant and on the other ignorant of the importance of these same non-economic or irrational factors in the life of nations. Economists also complain that in the field of international economic policy they are, to use Harry Johnson's words again, "left without a theory capable of explaining the variety of important observable phenomena such as the nature of tariff bargaining, the commercial policies adopted by countries, the conditions under which countries are willing to embark on custons unions".** But that is the economists fault, or, rather, the fault of economic theory, since a theory is as good as its ability to explain observable phenomena. Despite the general impression, economic considerations have played a minor role in European economic integration. Economists, however, do not like minor roles, so the economics literature perpetuated the charade that the whole issue is one of economic loss and gain. Non-economic literature has, for obvious reasons, been inhibited.

What is lacking is a comprehensive picture: a picture of European economic integration, where economic issues are highlighted within the background of non-economic factors, such as political, strategic and historical factors. This article attempts to paint such a picture.

*Johnson, H.G., An Economic Theory of Protectionism, Tariff Bargaining and the Formation of Customs Unions, Journal of Political Economy, Vol. 73, pp. 256-83.

**Ibid.

HYPOTHESES

This paper advances the following hypotheses:

1. Non-economic factors were the decisive factors in the making of European economic integration. These non-economic factors are of a political/strategical nature.

2. Economic theory, or that part related to economic integration, namely customs union theory, has not provided clear-cut guide lines for policy makers

3. Ex ante applied economic studies did not play a role in influencing decision marker, or in influencing pro integration economists.

METHOD

As this paper deals with the issue of European economic integration as it stood then during the 1950s and early 1960s and not now, hence testing of the first hypothesis will have to be made in the main within the conditions that were ruling then and not now. This also goes, although to a lesser degree, for the second hypothesis concentrating on the theoretical know-how that was available then. The third hypothesis presents no particular problem, for the results of ex ante studies were known then. However readers must bear in mind while reading this paper that we are concerned here with ex ante and not with ex post studies. Also it is important to determine how much note was actually taken of the results of applied economic studies that were attempting to determine the feasibility of European economic integration.

The method, as outlined above, indicates at least in part a contemporary historical research. But in fact this is not all. Benefits from hindsight will be utilised in the direction of validating the above hypotheses.

I. Integrationists and Free Traders

When, in the immediate post war years, West European statesmen and economists contemplated integrating West European economies, were the reasons clear cut and unambiguous? What was the role of economists and their tools of analysis? Were there any precedents, the experience of which can be considered and appreciated? With hindsight were expectations fulfilled? These questions will be answered, though not necessarily in the same order as they are put here.

Between 1800 and 1947 about twenty customs unions were formed.(1) By far the most important and most frequently cited as a precedent is Zollverein. It was formed by the German States in 1834 as a step towards their political union, finally achieved in 1870. Its significance for future European unity attempts is that it demonstrated that the basis for political unity is economic unity. Another type of integration was the imperial tariffs preferences applied by the then European imperial powers to trade between themselves and their colonies. Others might consider that trade within the USA was analagous to international trade where States of the Union traded with each other as if they were partners in a customs union. However, none of these precedents are really relevant. The economic conditions of West European States in the second half of the twentieth century and their trading relations are in no way comparable to those that prevailed in Europe, or for that matter outside it, during the nineteenth century. The cumulative effect of the industrial revolution, the growth of the European economies and the rapid expansion of international trade have greatly increased the trading links of European economies with the outside world.

Be that as it may, attempts at European economic integration are a post World War II phenomenon. In 1948 the Benelux countries formed the Benelux Cutoms Union.(2) This excited western liberal economists, long adherents of the free trade cause. They joined forces with statesmen and politicians who are proponents of European unity. Various proposals for European economic integration were drummed up. Initially, at least, there were no clear cut and unambiguous arguments justifying such a union, but, rather, several arguments, most of which either rested on flimsy grounds, or were downright wrong. Proponents of European unity argued that the only way to prevent another war in Europe was European unity. They further argued that individual European States have little, if any, hope of regaining their former grandure vis-a-vis the new and essentially non-European super powers, the USA and the Soviet Union. Both arguments are rather weak. The first argument indicates a lack of awareness of the decisive consequences of the Second World War, as by 1945 a divided Europe had become dominated by the two super powers. Neither the former axis powers (Germany and Itlay), nor, for that matter, the old Western allies (Britain and France) had any longer the ability or the will for freedom of action, let alone instigating a new European war. The second argument brushes aside historical, sociological and political factors making for disunity among European States. With hindsight these disunifying factors have proved to be powerful enough.

Economists joined in the foray. They threw in for good measure an old hat of an argument that countries do not go to war with their best customers.

The argument goes that if European countries, through economic integration, become each other's best customers, then they are unlikely to go to war with each other in the future. This argument is one of many that testify to the widespread ignorance of history, even recent history, among many economists. Countries could and did go to war with their best customers. By 1941 the Soviet Union was one of only three countries (the other two were Sweden and Romania) who supplied Germany with almost all its imported raw materials. That did not prevent Germany from invading the Soviet Union. Again Japan's trade in the 1930s was mainly with Asian countries and the USA. In spite of this Japan began its long road to war from Manchuria to Pearl Harbour.[3]

Liberal economists then advanced a more formal argument in favour of customs unions. It rested on the usual welfare gains consequent on free trade. Liberal trade theory maintains that free trade will maximise international welfare. As each country specialises, when tariffs and other trade restrictions have been removed, in the production of the good(s) that it is most efficient at, production will increase and costs will decrease in countries applying free trade conditions. Thus all countries will benefit from increased production. However, since universal free trade is unlikely to materialise in the near future, then a customs union or a free trade area arrangement among a group of countries on a regional basis must be a step in the right direction. In other words something is better than nothing. In 1931 J. Viner wrote "customs unions probably constitute a step toward free trade".[4] But it was G. Haberler who was more certain when he stated that "the economic justification for the formation of customs unions was considered to be identical with the old classical arguments for free trade".[5] Even as late as 1950 Haberler declared, "From an economic standpoint, based on free trade reasoning, customs unions are to be whole-heartedly welcomed."[6] When Haberler spoke he did so for the rest of free traders who constituted then and still the bulk of Western liberal economists. They all had, in one way or another, their share in that monumental misconception. But just about then a fellow free trade campaigner underwent a change of mind. Jacob Viner broke into new ground in his now classic, "The Customs Union Issue".[7] In this book Viner advanced two new concepts: Trade Creation and Trade Diversion. He used these two new concepts in his analysis of the change in the pattern of trade consequent on the formation of customs unions.* Probably the easiest and best way at this stage to explain the two concepts is with the aid of the following table.

*The general concensus that it was Viner who pioneered the modern theory of customs union has been challenged by D. O'Brien in his article, "Customs Union: Trade Creation and Trade Diversion in Historical Perspective", History of Political Economy, Vol 8, 1976, p. 540-563. O'Brien maintains that the concepts of trade creation and trade diverion are clasical in origin and rightly belong to nineteenth century economists.

Cost of Producing Commodity X in Three Countries

Country	Production Cost
A	100
B	80
C (stands for the rest of the world)	60

Let us assume that the price of commodity X is determined solely by production cost. The only source of divergence between price and cost is tariffs imposed on imports. As it is obvious that Country A is the least efficient producer while Country C is the most efficient, if Country A was imposing 100% tariffs on imports, then there will be no imports of commodity X and Country A's domestic producers will dominate the market. Now, if A and B decided to form a customs union abolishing tariffs and other barriers to trade between them, while keeping 100% tariffs on imports from C, then A will be importing commodity X from B. This is trade creation. A's resources that were hitherto employed in producing commodity X now will be shifted, i.e. reallocated, to more efficient employment. On the other hand, if, prior to the formation of the customs union A was imposing 30% tariffs on imports of commodity X, then this rate would have been sufficient to block imports from B, but not from C. In this case A was not producing commodity X at home but importing it from C. Now, if A and B form a customs union, abolishing tariffs and other trade restrictions between them, while keeping them against C, then A will import X from B. This is trade diversion. A's imports of commodity X have been diverted from the least cost source C to a higher cost B. Less efficient B resources have been reallocated to produce X, instead of C resources. When customs unions lead to trade creation, then the welfare of the two members have increased, while not adversely affecting the welfare of the rest of the world, in this example, Country C. However, when there is trade diversion, not only the welfare of at least one member, in this example, Country A, but also the welfare of the rest of the world, has declined. This is, in a nutshell, what is meant by trade creation and trade diversion. It depends on the difference in the cost of production between members themselves and with the rest of the world, as well as on the high of the tariff wall before the formation of the union.

Viner's book is remarkable in another sense, for, even by the standards of its day, it was an old fashioned book, if we use this adjective. It employed none of the "techniques" or "tools" that were beginning to dominate economic analysis. It was left to other economists who picked up Viner's concepts and began "refining" them with the end product not much different, but more in conformity with, the form of how economic concepts began to be presented.

As customs unions in practice will involve more than one commodity and in all probability more than two partners, the chances are that there will be trade creation, as well as trade diversion. The conclusion that can be drawn, not only from Viner's analysis, but also from the whole body of literature that was developed later, is that no statement can be made concerning the net welfare effect of customs unions in general terms, but rather that each particular case has to be considered separately. Vinear, in his analysis, seems to suggest, or is thought by some to have suggested(8) that the more similar the economies of the countries forming the customs union, the more likely it is that the net effect will be trade creation. In short, if partners were producing the same, or broadly similar, goods, then the chance for trade creation is much more than if they were producing dissimilar goods. Whether Viner really suggested this explicitly or not, it follows from his analysis. Trade creation happens because there will be resources realloca-tion and that, in turn, can only take place, as we have shown in the above example when one of the partners stopped producing the good in question, and began to import it from its partner. If, on the other hand, they were dissimilar economies, producing dissimilar goods, then there will be no chance of trade creation. As we have shown in the above example, when, before the formation of the customs union, one of the partners was not producing the commodity in question but was importing it from the rest of the world, while the other partner, with a dissimilar economy, was producing it. Thus the formation of a customs union will lead to the diversion of the first partner's imports from the rest of world to its partner. Similar economies producing the same or broadly similar goods are competitive. By implication, dissimilar economies producing dissimilar goods are complementary.

Within two years of the publication of Viner's book the whole issue was thrown into confusion. We can here interpret the controversy in the following manner. Competitive economies producing the same good must mean that they are producing these goods with the ratio of the cost in one country to the cost in the other country equal to, or approaching, one. Complementary economies, by implication, must mean that the cost ratio would be greater or smaller than one. Interpreting Viner's analysis in this way seems contradictory, for how can benefits be greater when specialisation takes place between countries who are producing the good(s) in question with the same or similar cost than when specialisation takes place between countries who are producing the good(s) in question with dissimilar costs. This same interpretation — although put differently — led to H. Makower and G. Morton to conlcude that it is customs unions between complementary economies, rather than between competitive economies, that will lead to trade creation.[9] But really Makower and Morton had in part missed the point. Viner's thesis is that trade creation is possible only if, before the formation of the customs union, the partners were producing the same or broadly similar goods, i.e. there is what was later termed overlap in the partners' production structures. Otherwise how can there be, as we have said above, trade creation through resources reallocation if there was no overlap. Now, given the existence of overlap, the greater the dissimilarities in cost, the greater are the gains from trade creation and vice versa. In a follow-on article, James Meade[10] succeeded in clearing the confusion when he argued that the net gains in welfare are likely to be greater if partners in the customs union were actually competitive, but potentially complementaries. In other words, before the formation of the customs union partners were producing the same or similar goods, with dissimilar costs, but after the formation of the customs union, they will be producing dissimilar goods.

Up until this point welfare considerations were in terms of gains in production through more efficient reallocation, i.e. welfare effect of substitution in production. But a customs union does not only affect production, but also consumption. As tariffs are lifted, domestic prices in partner's markets will be affected. In an important contribution R.G. Lipsey[11] argued that the formation of a customs union will result — assuming absence or market imperfection — in import prices being lower than home produced goods. This will lead to substitution in consumption in addition to substitution in production. Consumption of goods imported from partners will go up, while consumption of domestic goods as well as imports from outsiders will go down, other things being equal. R.G. Lipsey's contribution amounted to total welfare criteria, as opposed to the partial criteria that was there until then. Total welfare gains effect of a customs union is the net of the positive welfare effect of trade creation, minus the negative welfare effect of trade diversion, which can be expressed in symbols:

$$TWG = WT_C - WTD$$

Welfare effect of trade creation is made up of two separate parts: welfare effect due to substitution in production and welfare effect due to substitution in consumption. Expressed symbolically:

$$WTC = SP_{TC} + SC_{TC}$$

where SP_{TC} is the positive welfare effect of substitution in production and SC_{TC} is the positive welfare effect of substitution in consumption. In the same way the negative welfare effect of trade diversion is made up of two separate parts. The negative welfare effect of substitution in production in terms of world resources allocation and the negative effect of substitution in consumption. That is:

$$WTD = SP_{TD} + SC_{TD}$$

where SP_{TD} is the negative welfare effect of substitution in production and SP_{TD} is the negative welfare effect of substitution in consumption. We can rewrite the above formula as follows:

$$TWG = \left[(SP_{TC} + SC_{TC}) - (SP_{TD} - SC_{TD})\right]$$

It was only a short step from there for Lipsey to suggest that even when $SP_{TC} - SP_{TD}$ is < 0, $SC_{TC} - SC_{TD}$ will be > 0. Not only that but by a margin that will compensate for $SP_{TC} - SP_{TD}$ being < 0. Hence and according to Lipsey TWG will be > 0.

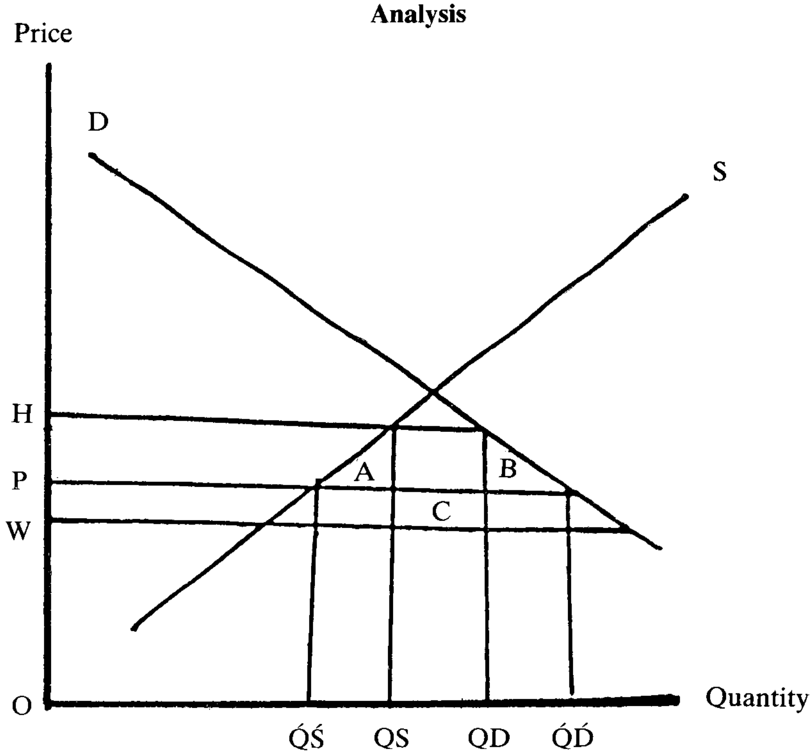
We hope that in another article, when concentrating on the theoretical aspects of the customs union, we will show that Lipsey not only ignored other theoretical possibilities in his assertions of the positive effect of substitution in consumption, but also that these very possibilities have in fact materialised in reality. But that is another issue for just the moment.

II. Partial Economic Analysis

Trade creation and trade diversion are usually represented in terms of partial equilibrium analysis. Some geometrical representations are straight forward, others are complex.[12] But they all reproduce the same elements. However, comprehension and lucidity are a decreasing function of complexity.

Since we are not concerned here entirely with the complex theoretical issues, it is sufficient for our present purpose to represent the effect of trade creation and trade diversion in the following manner.

Figure 1. Trade Creation and Trade Diversion in Partial Equilibrium Analysis



Source: Charles P. Kindleberger: International Economics Export Edition, 4th Edition, Irwin Series in Economics, Homewood, Illinois, 1908, p. 1984.

D - D represents the country in question demand curve on commodity X. S - S represents the same country supply curve on the same commodity. The least price (for price, read cost) of commodity X is that ruling in the rest of the world which is represented in the above figure by O - W. A potential partner who is less efficient than the rest of the world will have its price represented by O - P. The supply schedules of both the rest of the world and of the potential partner are assumed to be infinitely elastic so as to eliminate adverse terms of trade effect. Now the country concerned is the least efficient, it cannot supply a desirable part of its market from its domestic production at O - W or even at O - P price. Only at O - H does the country concerned suply from its domestic production the larger part of its domestic demand for commodity X.

So to secure price O - H for its domestic industries, it imposes a tariff on the import of commodity X. The rate of the tariff is represented by W - H which covers the differences in price between the most efficient (the rest of the world) and the country concerned. At O - H price, domestic demand is QD while domestic supply is QS. The excess of domestic demand over domestic supply QD - QS is met by imports from the rest of the world rather than from the potential partner. Now if the country concerned formed a customs union with its potential partner, then tariffs will be lifted between the partners while being maintained against the rest of the world. The price of commodity X in the market of the country concerned and its partner will be O - P. The new price being lower than the old one that was ruling in the country concerned prior to the formation of the customs union. The new and lower price will lead to a reduction in the domestic supply of commodity X from oQS to oQ́Ś. While domestic demand will be increased from QD to OQ́D́. The excess of domestic demand over domestic supply in the country concerned has increased from oQD - oQS to oQ́D́ - oQ́Ś. The whole now increased excess oQ́D́ - oQ́Ś is met by imports from its partner. Welfare gains are equal to the sum of triangles A and B. Triangle A represents substitution in production of the partner's more efficient production for less efficient domestic production. Triangle *B* represents substitution in consumption of lower price imports from the partner for higher priced domestic production. Trade creation is represented by triangle A. It is due to the substitution in production which is made up of the quantity oQS - oQ́Ś that is the reduction in the partner's domestic supply multiplied by the difference in price (read cost) between the country concerned and its partner OH - OP. In other words, the resources of the country concerned have been reallocated away from their less efficient employment in the production of commodity X to other more efficient employment. Hence trade creation due to substitution in production is equal to (oQS - oQ́Ś) (OH - OP) . While welfare effect due to the substitution in consumption is made up of an actual increase in consumption by oQ́D́ - oQD multiplied by the reduction in price OH - OP. Hence welfare gains due to substitution in consumption are equal to $\left[(o\acute{Q}\acute{D} - oQD)\ (OH - OP)\right]$ which is represented by triangle B. That is the consumer surplus triangle. Both triangle A and B are trade creation. But we know that if it was not for the external tariffs still maintained against the rest of the world, imports would have been made not from the partner, but from the rest of the world. Hence the imports of the country concerned have been diverted from the rest of the world to the partner. The actual quantity diverted is oQD -oQS. The loss in welfare in terms of world resources is equal to oQD -oQS multiplied by the difference in price (read cost) between the partner and the rest of the world (OP - OW). That is represented by (C) in figure 1. The rectangle C is made up of $\left[(OQD - OQS)\ (OP - OW)\right]$ Total welfare gains (TWG) due to the formation of a customs union will be

$$TWG = \left[(oQS - o\acute{Q}\acute{S})\ (OH - OP)\right] + \left[(o\acute{Q}\acute{D} - oQD)\ (OH - OP)\right] - \left[(oQD - oQS)\ (OP - OW)\right]$$

We have tried to simplify the issue as far as possible. But we are no wiser. The questions have still not been answered. Do customs unions per se increase welfare? In terms of the above equation will TWG be $> O$ or $= O$ or $< O$. No theoretical analysis, however sophisticated, was able to give an answer. Economic theory was then to fall back on less rigorous and less watertight reasoning in an attempt to answer the above question. General statements were advanced to the effect that the larger the number of partners, the lower the post union tariffs, the more competitive and the greater cost dissimilarities, the more likely a customs union will have a positive TWG. Of course Triangle A will be bigger the flatter the supply curve S is, i.e. the more elastic the home supply. Equally, triangle B will be bigger the flatter the demand curve D is, i.e. the more elastic the home demand.

III. The March Towards Integration - Facts and Fancies

While this was going on, integration and unity enthusiasts were busy making proposals. Of the several proposals for European economic integration that were made in the immediate post War period, a proposal for free trade in coal, iron and steel was adopted. In 1951 the Benelux countries, France, W. Germany and Italy signed the Paris Treaty establishing the European Coal and Steel Community (ECSC). Britain refused to join as a full member. However later on it became an associate member,[18] sending observers to Luxemburg, undoubtedly to keep a watchful eye on what is going on. It is surprising that no economist at the time asked the question, why coal, iron and steel, why not potatoes, bread or butter, or for that matter, why not sausages, cheese or wine? To be sure there was a proposal along such lines — the so-called Green Plan — but it was rejected in favour of ECSC.[8] There were at least two compelling reasons at the time for a European community in agricultural products. The first was that in the immediate post-war era Western Europe was suffering from general food shortages. Destruction and dislocation caused by the war meant that Europe was producing, as well as importing, less food than it required. The second was that a major partner, W. Germany, had lost to E. Germany, Poland and the Soviet Union, the very agricultural producing areas that were the main source of its agricultural needs. A third reason was to be provided later. As the ECSC evolved into a fully-fledged European Economic Community (EEC), European agriculture and its problems became an all embracing issue that persists until today.

The reason(s) why ECSC was adopted and not an agricultural products community is to be found in the following reasoning. To have a viable European integration as a first step towards full European unity, Germany must be rehabilitated. This necessitated the reconstruction of Germany. For Germany to be able to reconstruct its shattered economy, it had to be allowed to rebuild its heavy industry, that is iron, steel and coal. But that opened up the possibility, however remote, that Germany might utilise its reconstructed heavy industry for armament purposes. Given the anxieties that such a possibility might entail to other European Countries, ECSC was designed to involve not only free trade in coal, iron and steel, but, more importantly, the establishment of a trans-national European high authority to overseas the industries concerned. One of the most important powers that the authority enjoyed was the imposition of production quotas on members. In effect, the authority could, and probably did, make sure that Germany produced coal, iron and steel enough for peaceful purposes only. Germany had already experienced such a restriction through the dismantling and outright destruction of its heavy industrial plants on the order of the Allied Control Conucil that ruled W. Germany since May 1945. W. Germany's heavy industrial capacity was severely curtailed.[13]

It should be clear by now why a free trade in agricultural products was not adopted. It was for the simple reason that no country can make war with sausages and potatoes.

The rush in the direction of implementing proposals for European economic integration and the inability of international trade theory to give definite and unambiguous answers as to the gains expected motivated economists to try to measure the gains in welfare that were likely to materialise. The first such attempt was made as early as 1952 by P.J. Verdoorn. But it was written in Dutch and was not translated. However it was commented on by Tibor Scitovsky.(14) Verdoorn took 1952 as his base year and assumed a customs union between ECSC members plus the UK and Scandinavia. He estimated that trade between the countries of this proposed customs union would increase by 17%. Then he weighted this increase with the respective tariffs. He concluded that the welfare effect of a prospective customs union amounted to 0.05% of the sum of GNP of the countries to be studied. Tibor Scitovsky thought that even if Verdoorn underestimated the possible welfare gains, increasing the above estimate four or five times, the possible gains are still insignificant. Another study by Bela Balassa and Associates in 1957(8) of a North Atlantic customs union (including Japan) concluded that gains would be insginificant. It estimated possible gains for the UK to be equaivalent to less than 1% of the UK's GDP. These gains called static gains in the sense that they can be had from existing production possibilities, but after substitution in production and of course, later on, in consumption.

Despite this the momentum to European economic integration went ahead. During the decade of the 1950s it dawned on France that it had little hope of regaining its former status as a world power. Its statesmen, particularly Charles de Gaulle, felt that although France, in theory, was an equal member of the western alliance, it was less equal than the US.* Equally evident was the fact that the western alliance had become increasingly dominated by the Anglo Saxon club of nations, i.e. USA, UK and Canada. France began to look around for like-minded new allies on the European mainland. They were easily found; members of ECSC, none of whom belonged to the Anglo Saxon club of nations. In essence, the establishment of the European Economic Community (EEC) was an extension of the ECSC to other sectors of the economies concerned. The treaty establishing the EEC was signed in Rome in March 1957. It envisaged: (1) a gradual reduction of tariffs between members; (2) the erection of common external tariffs (CET) against non-members; (3) the proceeds of the CETs are to be distributed among members according to a certain formula. The above three elements of the Treaty of Rome constitute the necessary elements of a customs union. However, the Treaty of Rome envisaged more than that. It stipulated free movement of labour and capital across national boundaries. Hence it was a treaty for a common market. Even that was an under-estimate of the scope of the Treaty, for there were provision for the harmonisation of economic policies. So economic unity was envisaged from the start. On second thoughts, more than that was envisaged. During the same signing ceremony another Treaty was signed - a Treaty on nuclear cooperation! France was then, and is now, the only nuclear power. This should have been a hint to the other members as to who was going to be the dominant member. There was not much pretence to the pure economic objectives of the Treaty of Rome. The first President of the EEC Commission declared in 1961. "we are not in business at all - we are in politics".[15]

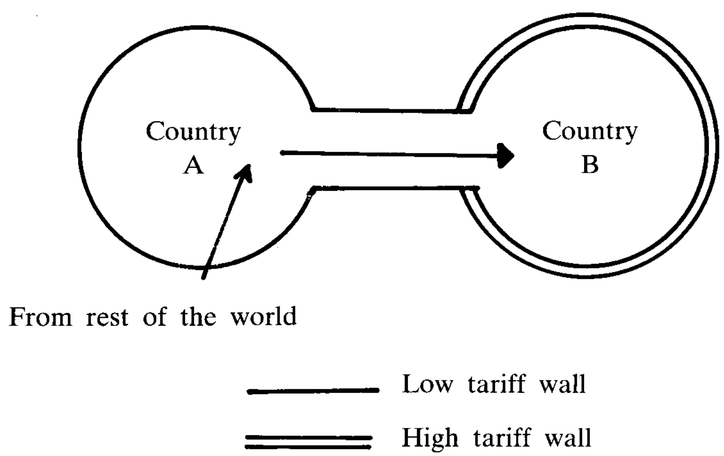
*In 1965, after several years of disenchantment, France left the western military alliance, NATO.

IV. UK and European Economic Integration:

For several years Britain displayed an uncertain attitude towards the EEC. Initially it refused to join. This was undoubtedly a relief to France. Britain, in contrast to France, was slower in realising its diminished status as a world power. Moreover, being an island off the European mainland, it could hardly pretend to be the dominant power in Europe. So, relying on its special relationship with the US, it carried on the pretence of being a world power, albeit in the shadow of the US. This was the third time in which Britian rejected a serious proposal for European unity. Besides rejecting membership of ECSC and the EEC, it had also rejected a proposal for a European Defence Community in 1954. A key factor behind all this was Britain's desire not to distance itself from its further afield, yet closer, relatives, the US, Canada, Australia, New Zealand and South Africa. This factor was also behind the proposal made by the then famous British economist, James E. Meade, for an Atlantic Confederation.

However, to keep a foot-hold on the European mainland, to enable it to continue playing its classical balancing role, Britain in its turn began looking for partners. What it eventually succeeded in finding were six small countries that did not, for one reason or another, join the EEC. These were Austria, Denmark, Norway, Portugal, Sweden and Switzerland. They signed in Stockholm during January 1960 the Stockholm Convention that established the European Free Trade Area (EFTA). Later on Finland joined as an associate member. The Seven, as the members of EFTA came to be known (as opposed to the six members of the EEC) were either geographically remote from each other, neutral, or would be neutral if they were allowed to choose. Britain's partners in EFTA were never in the main stream of European politics, but were really peripheries. Two years before the signing of the Stockholm Convention, Harry Johnson estimated that benefits to the UK were likely to be around 1% of its GNP.[17] EFTA was a looser economic arrangement than the EEC. Tariffs between members were to be abolished gradually. But each member was to keep its existing external tariffs against non-members. The arrangement, as it stood, might suggest an attempt at simplyfying matters, but in reality it introduced serious problems. The first was, since each member would keep its existing tariffs against non-members and given that existing tariffs differed, then a non-member could use this as a loophole in penetrating the high tariff wall of a member(s) in the following manner. Exports are initially made to a member(s) with a low tariffs wall. Once there they are then redirected towards a member(s) with a high tariffs wall. Hence circumventing high tariffs wall by exploiting the inter-area free arrangement. In other words, avoiding higher walls by jumping over lower ones. This is depicted in Figure 2.

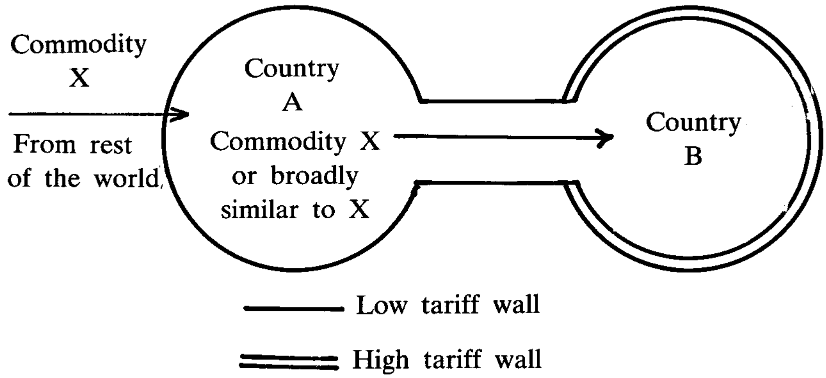
Figure 2: Direct Trade Deflection



To avoid such a posibility, termed trade deflection, EFTA regulations stipulated that inter-area trade should carry a certificate of origin. But no certificate of origin could eliminate the second possibility that is called "indirect trade deflection". A member's exports will benefit from the elimination of inter-area tariffs, so its resources are reallocated towards export industries. However, this same member may have another idea about where its imports should come from. If the member has no external tariffs against the imports in question, then imports will come from the cheapest source of supply which could be outside area sources; or if the external tariffs of the member in question are sufficiently low that they do not cover the whole difference in the cost of production between area sources and the rest of the world. Otherwise the member may lower its external tariffs so as to be able to tap the cheapest sources of supply. This can be illustrated in the following Figure.

Figure 3: Indirect Trade Deflection to a Free Trade Area

From rest of the world



As the winds of change began to blow away the British empire, Britain finally realised that EFTA was no substitute for the EEC, pleading its special trading relationship with the dominions and commonwealth countries. Twice in the middle and late sixties it applied to join the EEC. But this time it was France's turn to say no. By then it had become abundantly clear that the size of immediate economic gains were at least insignificant, if not negative. In 1961 the then British Prime Minister admitted that his government was applying for EEC membership without making the studies of the likely impact on British industry.[15] In May 1967 when Britain was negotiating its entry into the EEC, the then Prime Minister declared that "the political argument is stronger". He went on to state that the aim of his government was "the creation of a strong Europe that could exert far more influence on world affairs than at any time in our generation". At the same time the leader of the Opposition and a future Prime Minister who was to sign for Britian's membership of the EEC declared that the main objective in the negotiation is political. I believe it was in 1961.[18]

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So much for that. The point is that statesmen across Europe have been more or less frank about the reason(s) for integrating their economies. However, some economists, having discovered that the static gains are insignificant, to say the least, found themselves unable to support integration, primarily on political grounds. So they advanced a new set of possible gaints which they called dynamic gains. These are the positive effect of economies of scale, improvements in the terms of trade, the positive effect of increased competition, changes positively affecting the quantity and quality of factors input due to increased capital inflows and changes in the rate of technological changes.[19] But these dynamic gains have not been postulated by economists in their usual theorizing manner. Economists have not discovered these so-called dynamic changes through formal analysis, but were rather speculation that had no immediate evidence to support them. In a forthcoming study we will show that they were just that — speculations. We must now return to our story.

As De Gaulle departed from the scene in France, Britain was admitted to the EEC in 1972, along with another member of EFTA, Denmark, as well as the Irish Republic. Later on Greece, Spain and Portugal were admitted. So while the EEC survived, as well as expanded, EFTA, a British creation, faded from the stage. As British became a member of the EEC the cost of membership, i.e. net welfare loss, including terms of trade adverse effect, was estimated to range from £1,144 million to £453 million (1969 prices).[19] This was by no means the end of the story. Britain's membership of the EEC has been a continuous saga of squabbles. Britain never liked the EEC common agricultural policy, for it meant that in order to achieve as close as possible to European self-sufficiency in food, costly European food producers would have to be subsidised. This meant that Britain would have to forgo its cheap food imported from outside Europe, particularly from North America and Australia .

At present the target date for a "single" as opposed to a "common" European market is to be achieved by 1992. Here again Britain is the dissenter. Britain alone in the EEC has rejected the proposed European Monetary Union. The reasons are made to appear technical and serious, but the real reason may be much simpler. Accepting a single European currency is tantamount to the abandonment of a traditional symbol of sovereignty. It is difficult, however, to see how a single market can be achieved without a single currency. However, it should be noted that disagreement among EEC partners is not only confined to serious issues such as the single European currency. Frequent and routine squables usually break out on other less glamours issues, such as British apples versus French ones, and Italian tomatoes versus other ones. At one time the issue that became a typical example of overindulgence in trivia was the milk content of European icecream.

Even with a single European currency can one say that a single market will have been achieved at least? Can there be a single market when buyers and sellers do not comprehend a common language? Can there be a single market when labour mobility is the exception, rather than the rule? Can there be a single market when culturally determined consumption patterns can be as varied as that between Greece and Denmark or between Ireland and Portugal?

Despite that, the EEC has been a success story and is likelyto expand to include other West European countries at present outside or East European countries on the point of defection from the eastern block. However, its success was in terms of binding members' economies together by tireless efforts made by EEC bureaucrats in Brussels. Intra EEC exports in 1987 accounted for 58.9% of total EEC exports. This means that nearly 60% of EEC trade is within the EEC, while 40% is with the rest of the world. Still, how much economic gains, statis and dynamic, each member derived from membership is still uncertain. The hoped for emergence of Europe as a power independent of both super powers is still just a hope. The US is still very much the leader of the Western Alliance which includes members of the EEC. There has been hardly a tendency for the EEC to assert itself in internattional politics. Members realise that for the foreseeable future, their ultimate security depends on the US, so they are not likely to stray far from the US drawn lines. Far from that the US saw, and still sees, a closer economic and political cooperation among Western European States, as a necessary condition for a viable western alliance.

V. Conclusion

This paper has dealt with the issue of European economic integration as it stood mainly during the 1950s and early 1960s. The rationale for European economic integration during the 1950s and early 1960s rested on two separate plains. The first is political/strategical. The second is economic. Taking this within the conditions that were relevant then, three hypotheses have been tested in this paper.

The first hypothesis is that political/strategical factors were the dominant factors. This hypothesis has been validated for this paper has shown that with respect to the three European integration schemes that have been implemented, ECSC, EEC (the Six), EFTA and, finally, the enlarged EEC were politically motivated. This is still as true now as it was then. The democratisation of Grece, Spain and Portugal was a necessary pre-condition for their admission. We may speculate here that the democratisation of East European States will open the door for them into the EEC.

The second hypothesis is that economic theory then provided no guide-lines for policy makers. This hypothesis was also validated. The whole economic debate was more or less overshadowed with confusion. In the beinning economists mistakenly considered the customs union as a step towards free trade with the same kind of benefits that the latter entails. Later they corrected their stand, but their new position was indecisive. Economic theory passed no clear verdict. Instead the issue was to be settled through ex ante or feasibility studies of proposed customs unions. Despite that leading economists were among the most enthusiastic for European economic integration. The third hypothesis is that results of ex ante applied economic studies or feasibility studies that were undertaken prior to the formation or at the early stages of the EEC and EFTA were ignored, not just by politicians who carried on with their schemes for European economic integration just the same, but also by economists who, upon discovering how negligible werethe size of the static gains, proposed a new set of gains which they named "dynamic" gains. But these later gains were really unproven assertions. In fact, on one occasion, the application for membership of the UK into the EEC in the early 1960s was made without any feasibility study being undertaken.

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