Chapter 5

HISTORY OF ECONOMIC INTEGRATION THEORY AND APPLICATIONS

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1. INTRODUCTION

The word of "economics" comes from ancient Greek philosopher Xenephon who lived between years 430-354 BC. Xenephon had a work and its title was *Oikonomikos*, which means "Household Management" in Greek language. Xenophon saw that in a small town the same workman may have to make chairs, doors, ploughs, and tables, but he cannot be skilled in all these activities. However, in large cities because demand is so large that men can specialize in each of these tasks and become more efficient. The thing he saw was so important, but he took this only for division of labour He does not connect division of labor to the market mechanism size of the market. Of course, since Xenephon scientists realized that if market is bigger than it will increase division of labor and it will also reduce costs by scale economics. Scale economics effect is greater when a firm sells its products to a greater market. The greater the size of the market the greater will be mass production and effect of scale economies will be also greater. As a result, this effectiveness and effect of bigger demand and sales will increase profits while it will reduce costs by scale economies making production more effective.

If you are a firm only facing with a small city demand these effects will be small however instead of selling goods in local area if this firm sells its good to whole country these effects mentioned above become greater. And if this firm sells its products two other countries or to the whole world it will face a much greater market and so a greater demand. Therefore, these effects will be greater in international companies. This will have also positive effect for country's export and also to its citizens. They will find a work so they will not be unemployed, and they will consume cheaper products since effectiveness of scale economies drops costs. On the other hand, countries budgets will be in a better position.

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After mercantilism's protectionisms with classical economy economists and businessman mostly in favor of free international trade. They wanted to decrease customs barriers so they can sell more goods and increase trade so the profit. These ideas on removing or reducing customs or other barriers that prevents international trade become more favorite and desirable after the second World War.

We see that countries reduced customs or removed between multilateral agreements and more over we see that they go beyond this by forming economic integration and also political integrations like the one in European Union.

In this article we tried to give types of these integrations and their history and applications. We first explained integration types and later we explained application history and the history of integration theory.

2. TYPES OF ECONOMIC INTEGRATION

Economic integrations are usually divided according to their degree. While some academicians add this preferential trade agreements to this separation, perhaps they separate the phase after economic integration as a full economic integration. These can be listed according to their degrees as follow, preferential trade agreements, free trade zones, customs unions, common market, economic unions, full economic integration.

2.1. Preferred Trade Agreements

In preferential trade agreements, which are the least comprehensive economic cooperation, member countries reduce the tariffs either mutually or unilaterally on certain goods, (Seyidoğlu, 2001).

2.2. Free Trade Area

It is an integration process in which customs tariffs, quantity restrictions and all other restrictions that prevent trade between member countries are removed. Each member country is free to impose restrictions on countries outside the union and each member country freely determines its own foreign trade policy (Güran, 1999). EFTA (European Free Trade Association) can be given as an example of this type of union (Ertürk, 1991).

2.3. Customs Unions

In the customs unions, which are a further step of free trade area, beside the liberalization of trade between member countries, common customs tariff is applied to countries outside the union (Güran, 1999). It is the most common union stage in practice today. In the USA, the North-South union, the Zollverein, which consists of the union of German states, the Italian Union and the Benelux Union are the first successful customs union practices in history (Ertürk, 1991).

Free-traders and protectionists are in conflict, but a customs union may be seen as an agreement between this two class. Free traders are happy because of removing barriers inside the union, on the other hand protectionists are happy to continuing barriers against imports out the union (Machlup 1986).

2.4. Common Market

In addition to the applications in the customs union, in this stage production factors such as labor and capital are free to move among member countries (Güran, 1999). European Economic Community can be given as an example to this in the past (Ertürk, 1991).

2.5. Economic Union

In addition to the common market features, it is an advanced stage in which economic and social policies are harmonized and combined by the member countries. Policies are determined by a decision-making body which includes representatives of the member states. It includes the monetary union between the member countries in which exchange rates are fixed and monetary and fiscal policies are harmonized (Güran, 1999). The best example for this stage is The European Union's determining EURO as to be the common currency in 1999 and starting its actual usage on January 1, 2002 which were decided in Maastricht criteria in 1991.

2.6. Full Economic Integration

At this stage, national economic independence is largely abolished, and the harmony of economic, social, and financial policies are determined by a supranational authority (Güran, 1999).

3. HISTORY OF ECONOMIC INTEGRATION APPLICATIONS

The idea of economic unification first started to be thought with the industrial revolution. The first economic union initiative at the international level emerged in 1819 with a reasonable treaty involving the integration of some small parts of the Schwarzburg-Sondershausen principality surrounded by Prussian borders into the Prussian economy. As a result of similar agreements with other states that follows this small beginning, the Prussian Customs Union, which was the first important international common market, was established in 1831. Around the same time, with a similar development that took place in the south of Germany, the Bavarian Customs Union was formed. When these two decided to unite their economies in 1833, the German Zollverein was founded in 1834, which would set an example for all subsequent economic mergers. This union, which demonstrated the success of an economic union without giving up political independence, pioneered the establishment of many other customs unions (Kohr, 1960). After this union include all German states, it became a real political integration with the declaration of the German Empire by Bismark in 1871 (Güran, 1999). San Marino joined Italy in 1862 and Monaco to France in 1865. Both still continues together. After the Zollverein, the two most important customs unions of the 19th century are the Austrian Customs Union and the South African Customs unions (Kohr, 1960). In addition, the US Constitution of 1789 prohibited the states from having different customs regulations and different currencies and the USA completed its economic integration towards the end of the 18th century (Güran, 1999).

In the years following the First World War, smaller scale customs unions were formed. The unions established for economic purposes, between Luxembourg and Belgium in 1921 and between Liechtenstein and Switzerland in 1923 continued without losing their power. On the other hand, political unions established for peace purposes have collapsed or lost their importance with the newly developed political developments (Kohr, 1960).

After the second World War, since political, cultural, military, etc. relations has rapidly increased and moreover economic relations, which are closely connected with these relations, have developed very sharply so that as a result, the interdependence between the countries has increased rapidly and it has become impossible for the countries to pursue self-sufficient economic policies. Developing countries need to import intermediate and investment goods, capital and technology from developed countries and they need to find foreign markets for their exports. On the other hand, developed countries depend on other countries to import raw materials, finding new markets for their goods and satisfying their labour force demand. As a result of rapid international developments, international economic organizations have developed. These international organizations contributed to increase trade and to increase economic relations between countries. As a result of these, from the end of the 1950s, after the efforts of north-north, south-south unifications, in the 1980s, north-south unions began (Güran,1999).

To increase and to liberalize international trade after the second World War countries followed some solutions. It basically differs int two. The first is The Customs Tariffs and The General Agreement on Trade (GATT), the second is regional economic Mergers. The aim of GATT is to remove customs tariffs and other trade restrictions while the second aims to increase trade by forming economic unions.

As a result of these developments, treaties made with Brazil under the leadership of Argentina a customs union was established first time in Latin America in 1941. Other treaties followed these in Latin America. Free markets were established in Africa in 1959, one between Chad, Congo, Gabon, and the Central African Republic, and the other between Mauritania, Senegal, French Sudan, Volta, Nigeria, Ivory Coast and Dahomey (Kohr, 1960).

However, the most important developments after the second World War took place in Europe. Belgium and Luxembourg, which had already been united in 1921, united with the Netherlands on January 1, 1948, with the treaties made in 1944 and 1947, and formed the Benelux Customs Union, which created the first major common market in the 20th century (Kohr, 1960).

In addition to these, in 1947, countries that join the Marshall Plan, established the European Customs Union Working Group, which is headquartered in Brussels. Beyond being an information centre by collecting data and publishing annual reports, the main purpose of the group is to encourage other regional customs unions, especially in Scandinavian countries, Western Europe and the Balkans, as in the Benelux example. The first success of the Group is the declaration that investigates the possibility of building a similar customs union that was signed between Italy and France in 1947 which predicts to start a customs union in 1950. Although both failed, they helped to remove the obstacles to the Rome treaty, which is the crown of economic union efforts, that is signed by Italy, France, Federal Germany and the Benelux Countries on 25 March 1957 (Kohr, 1960).

4. HISTORY OF ECONOMIC INTEGRATION THEORY

The theory of economic integration did not become a separate topic in economic theory until Viner's pioneering work "The Customs Union Issue" published in 1950 (Tovias, A.).

The development of the economic integration theory will be explained by dividing into two as before Viner and after Viner.

4.1. Economic Integration Theory Before Viner

One of the first suggestions about integration theory was made by Adam Smith. He argued that the countries entering the customs union will benefit from putting customs to other countries. Taussing stated that the share of countries in trade will determine the benefits and costs of mutual tariff reductions. Also, Taussing mentioned that, because the share of the USA's was very small, the preferences given by the USA to Hawaiian sugar in 1876 affected American sugar prices very little, but the income of the Hawaiian producers increased. Another author, Torrens, stated that the effect of preferences depends on the optimum tariff in the presence and absence of reaction of other countries. He opposed, stating that the multilateral tariff negotiations would adversely affect the terms of trade. Torrens opposed free trade and stated that free trade is the ultimate goal and will create politic dependency, on the other hand independent countries will benefit from trade by applying an optimum tariff if there is no retaliation. Torrents' statement is important since stating that a country will maximize its welfare by acting as a discriminatory monopolist (Ertürk, 1991).

4.2. Economic Integration Theory After Viner

Economic integration theory developed after Viner's work, which he did in 1950. From this time until 1965, the economic integration theory has gone through two stages. In the first period, the effect of the customs union on production was examined, in the second period, consumption and trade flows were examined (Tovias, A.)

4.2.1. Developments in the Theory of Economic Integration from Viner to year 1965

Viner focused on whether the customs union would cause a freer trade or greater production. Viner has introduced two basic concepts as "trade creator" and "trade diversion". He showed that there can be no general assumption for customs union bias by using the Ricardian model of production, which focuses on the effect of changes in the centre of production on welfare. According to this, union naturally produces two opposite outcomes whose net results dependent on specific events. The first is the "trade creation effect", which is the result of the removal of the barriers that protect domestic producers from the producers of other member countries, and the second is the "trade diversion effect" arising from the protection provided to member country producers from tariffs created against third countries. According to Viner, the customs union increases prosperity by shifting consumers' demand for a good from a high-cost domestic producer to a low-cost member-country producer, and reduces welfare by shifting trade from a low-cost non-union country to a high-cost in-union country (Krauss, 1972) .

Viner stated in his study that a perfect customs union should meet the following three criteria: 1-) Total abolition of tariffs between member countries, 2-) Application of a common tariff against imports to be made from countries outside the Union, 3-) Sharing customs duty revenues between countries according to an agreed formula (Viner, 1950).

The assumptions in the Viner analysis are these. There are fixed rates in consumption and fixed costs in production. Since these assumptions do not reflect the real world, they have been the target of criticism and the acceptability of Viner's results are very limited (Krauss, 1972). In later analysis, it was concluded that by stretching the assumptions of Viner, there would not be a decrease in welfare because of diverted trade caused by the customs union (Ertürk, 1991).

After Viner, in his studies in 1953 and 1955 J.E. Meade, softened the assumption of fixed costs in production and removed the assumption of fixed rates in consumption from the analysis and included customs union's "production effects" into analysis. He explained consumption effects under the partial equilibrium approach (Güran, 1999). He used Cardinalist welfare assumptions, losses and gains in comparison and added consumption into analysis (Ertürk, 1991).

Second best theory was developed by Lipsey and Lancester. According to this theory, the first-best case is free world trade, where all countries in the world remove their customs. The second-best case is the customs unions where customs are removed among member countries, and only applied to non-member countries. It is controversial if the case of customs unions or the case of an equal customs against all countries is better for welfare. The result may differ depending on the circumstances.

Mainly Economic integration examined by two stages. The first stages include traditional theories that explain the possible benefits of integration and are usually known as static analysis. These are based on book "The Customs Union Issue" written by Jakob Viner. Static analysis cannot totally explain the impact of integration on welfare, thus dynamic effects analysis was introduced by Bella Balassa in 1962 and followed by Cooper and Massell in 1965. Dynamic effects have a larger impact on economic integration than static ones. Some of these effects can be stated as increase in investment expenditure, sustainable increase of demand, improvement of the production management and technology, creation of economic growth, increase of production efficiency (Marinov, 2014).

4.2.2. Developments in the Theory of Economic Integration after 1965

After 1965 integration theory developed in four different ways (Tovias, A.)

1- Effects of integrations on trade
2- Effects of scale economies and imperfect competition
3- Other integration types and customs unions
4- Non-tariff barriers and their effects

4.2.2.1. Effects of integrations on trade

Mundell in 1964 and Vanek in 1965 partly explained Trade effects but Kemp 1969, Negishi 1969 and Caves 1974 explained much more. Pearce made a conclusion from these scientist's work in 1970 and suggested that for small countries customs unions can be a bit advisable since they cannot individually affect the terms of trade. These countries can do the things that they cannot do alone by joining a customs union. Vanek, Kemp, Negishi, Caves focused how member countries gain from union between each other and against non-members. From this main conclusion was that the country gain from the integration, but partners having large trade numbers with the rest of the world would not be the same and they would lose (Tovias, A.).

4.2.2.2. Effects of scale economies and imperfect competition

As known mass production in companies decreases average costs per unit this is one of the expected outcomes from economic unions. Corden 1972 analysed and showed two supplementary effect as negative and positive effects. Negative effect is that when union established if there is a country left outside the union and before union all countries were importing goods from this country since it sells the cheapest price, now it is replaced with the country in the union which is less effective. So, this trade diversion is the negative effect. The scale economies idea has been merged with intra-industry trade, which is firstly developed by Grubel and Lloyd 1975. This theory is opposite to Hecksher-Ohlin type of theories (Tovias, A.).

Balassa, states that selecting a benchmark for evaluating changes in trade flows during 1959-70 period shows the superiority of trade creation in the European Common Market (Balassa, 1974)

4.2.2.3. Other integration types and customs unions

Other scientists thinking differently than Viner, stated that integrations could be extended to free trade areas. For example, Shibata (1967) showed that there is a shifting effect, an indirect form of trade deflection in the case of free trade areas. If member countries are geographically closer, shifting effects are more likely and this maybe the reason why there are not many free trade areas among neighbours. This is because high tariff countries are naturally hostile to trade deflection and shifting effects. Economists agree that customs unions are not better then partial preferential trade arrangements, which is opposite of GATT idea. Besides, in these trade arrangements customs revenue does not drop in the same percentage as in customs unions or free trade areas moreover it may increase. Ideas on common markets is not much developed but Wooton worked on this. Wooton (1988) examines a customs union's countries may gain from moving to a common market. He proved that all depends on the level chosen for the Common External Tariff (Tovias, A.).

4.2.2.4. Non-tariff barriers and their effects

About integration ideas trade creation and diversion effects are important. When tariffs are for protection countries against each other, trade diversion is undesirable for member countries. Pelkmans and Winters 1988 showed that when barriers which are removed it does not generate revenue instead it increases cost. The elimination of different Non-tariff barriers has been studied by authors in the mid-1980s to complete its internal market (Tovias, A.).

5. CONCLUSION

Most of the studies searched the effect of Economic unions trade diversion or creation effects are important. The union made between USA and Mexico had an negative effect on USA non skilled labour but it has much more positive effect in skilled workers since export of USA increased and created more skilled worker jobs than the ones lost in non-skilled workers sector. The European Union passed all these steps and quite successful. But on the other hand, we see that China with its mass production and very cheap labour when combined with technology we see that all world production started to move this country and also to India. After the Second World war developed western countries wanted other non-developed or developing countries to reduce or remove their customs barriers so that they could sell their advanced technological products to them. After the demolishing of Berlin wall and finishing the communist economies we saw that China adopted itself to this market mechanism. And the prey became the hunter. Chinas development feared western countries especially USA President Trump realised that all production is moving to china and Chinese products not only the ones produced in china by western countries but also China's own brands and goods started to dominate all western countries. President Trump started customs war against China. And since 1950's we see the popularisation of free international trade by USA and European countries but now we see that their increasing customs and other barriers against China and maybe this will also include India. USA under the management of President Trump started this trade wars. If this continues and European Union also joins USA world will face another economic situation. So should we turn back to the situations before 1950's? In a integrated world with internet and social media and buying goods from internet from any country on the world will push all countries maybe to remove all barriers and maybe it will push further to use one currency in all world.

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