The Integration of Europe: The Study of Economic and Political Integration in International Business

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On January 1, 1993, the 12 member-states of the European Union (EU) implemented the Single European Act (the EU was expanded from 12 to 15 members on January 1, 1996). This act mandated the removal of all frontier controls between EU countries, thereby abolishing delays and reducing the resources required for complying with trade bureaucracy. The act was the logical culmination of the 35-year history of this trading bloc, which has progressively reduced barriers to the free flow of goods, services, and factors of production between its member-states. With the implementation of the Single European Act, the EU became a single market of 340 million consumers.

Introduction

Regional alliances to promote liberalization of international business are an important feature of the postwar international landscape. The past decade in particular has seen a rise in the number and strengthening of trading blocs, as countries seek to integrate their economics more closely in order to open new markets for their firms and lower prices for their consumers.

The most important regional business bloc in the world today is **the European Union (EU)**. The European Union's beginnings stem from the 1952 creation of the European Coal and Steel Community, which has designed to restore those two industries to profitability after World War II. **The European Economic Community (EEC)** was established in 1957 when the **Treaty of Rome** was signed. (Griffin & Pustay: 246)*

Under the treaty, they pledged to create a common market by eliminating internal trade barriers, developing common external trade policies, and improving mobility of labor, capital, and technology within the EEC. A third organization, **the European Atomic Energy Community**, was created in 1958. Officially these three communities formed **the European Communities (EC)**, although the singular form of the noun was often used unofficially. In November 1993, the name of the EC was changed to the EU as a result of the Maastricht Treaty.

The Regional Integration

The study of regional integration usually covers <u>both economical and political aspects</u>. This issue is typically not accepted by many groups within a country, which explains why most attempts to achieve regional economic integration have been contentious and halting.

Theories on Integration

European integration is a unification process of economic and political institutions. This process was initially started from economic cooperation and then shifting into political union. One theory that explain such integration is **neo-functionalism theory**.

* The Treaty of Rome was signed by six countries: Belgium, France, Luxembourg, Germany, Italy, and Netherland

Integration is literally defined as "to unify parts". This definition, however, does not give further explanation to understand concept of integration. **Ernst Haas** confirmed that the ultimate result of integration is political union. It means that decision that has been made is binding countries and shifting their loyalty into supranational body.

Leon Lindberg carefully defined integration which he did not mention specific end of that process. He emphasized on decision making process. His definition is as follows:

> *"(1) The process whereby nations forgo the desire and ability to conduct foreign and key domestic policies independently of each other, seeking instead to make joint decision or to delegate the decision-making process to new central organs; and (2) the whereby political actors in several distinct settings are persuaded to shift their expectations and political activities to a new center."* (Lindberg & Scheingold: 6)

Neo-functionalism is an operational philosophy that is gradually trying to make a peaceful and cooperative one world. No single country wants to disband themself. Therefore, neo-functionalism supports regional and global union gradually. The strategy encourages the development of nonpolitical cooperative organizations. These organizations will function effectively in economic, technical, social, and cultural sectors. These sectors collectively become functional sectors.

Based on neo-functionalism concept forming functional organization is easier than a political institution that possibly threats national sovereignty. Ernst Haas said that politics and welfare is inseparable. This opinion is supported by **Joseph Nye**:

> *Power and welfare cannot be kept radically separated and that true technical self-determination on non-controversial topics will be condemned to triviality. The political game must be played, but played with functionally oriented strategy than a legalistic or constitutional one.* (Nye: 52)

As a result of the process, government will not only emphasizes on power alone, but also stresses on welfare as well. National interest will be fulfilled through political commitment of bigger organization. The most important actor in neo-functionalism theory is interest group that enables government to form regional economic organization. This process is illustrated by Joseph Nye as follows:

> *The process forces or mechanism were in turn to lead to two outcomes: (1) the inconvenience caused by integration of some actors and not others and the political pressure of groups eager to preserve their gains from sector integration would lead national governmental decision-makers to agree to increase the initial grant of power to regional institutions; and (2) group activities and eventually mass loyalties would increasingly flow to the regional center as it came to answer more and more of the interest previously satisfied by the national government. The net effect was to be a continuous and automatic process leading to political unions, provided that the condition outlined above were favorable.* (Nye: 59-60)

Ernst Haas offered two qualifications on welfare-oriented government:

> *(1) That voluntary group from a regional setting, such as Western Europe, are more likely to achieve integration than an organization with representatives from all over the world; and (2) that experts responsible to no one at the national level may find there recommendation are ignored. Therefore, he suggests that expert manager of functionally specific national bureaucracies joined together to meet a specific need are likely to be the most effective carriers of integration. Haas rephrases the functionalist propotion to read: "International integration is advance most rapidly by a dedication to welfare, through measure elaborated by experts aware of the political implication of their task and representative of homogeneous and symmetrical social aggregates, public or private."* (Dougherty & Pfaltzrfaff: 294)

The main thesis of neo-functionalism is that integration in one sector will lead to integration in other sectors. The creation of supranational bodies to take in charge of functional affairs will encourage political, social, and economic process toward integration. This logic is called *"spillover effect"*. Ernst Haas came up with his definition on spillover as follow:

> *"Spillover as the expansive logic of sector integration, and suggest: if the actor on the basis of their interest-inspired perceptions, desire to adapt integrative lessons learned in one context to a new situation the lessons will be generalized."* (Dougherty & Pfaltzgraff: 294)

This spillover effect has three aspects. (George: 21-18) **First,** *functional spillover* is a mechanism that emerges from technical characteristic which inherently included on its task. The logic is that several industrial economic sectors are mutually dependent so that it is impossible to administer it separately. Reversely, Lindberg emphasized on the nature that expansive logic of the European

Community's tasks. It is hard for the institutions made by European Economic Community not to make centralized policies. Lindberg predicted the spillover effect from *negative integration* (eliminating the discrimination among the member-countries) to positive integration (setting the coordinated policies).

Second, *political spillover* is a mechanism that emerges from plural society of Western Europe. Based on this argument politics comes from inter-group conflict where they fight to gain their welfare. These groups are represented by bureaucratic organizations which enable analysts to concentrate their attention to its leaders that is the elite. The idea is that the elite would experience learning process, so that they developed perceptions that needs fulfillment could be done at supranational level, not at national level. This reorientation encouraged further political integration.

Third, *spillover with engineering*. Although the above conditions indicate an automated steps of integration process, some scholars like Haas and Lindberg emphasized on the creation of supranational institutions, especially the European Commission. (Lindberg & Scheingold: 8) Such institutions are designed to form common interest as a driver toward integration process. Thus, the birth of integration was engineered through creation of supranational bodies.

The European Commission is composed of 20 people selected for five-year terms. The smaller EU countries each nominate one citizen to serve on the Commission; the larger countries selected two. However, once these individuals are in office, their loyalty is to the EU itself, not to their home countries. The Commission's primary mandate is to be "the guardian of the treaties". (Griffin & Pustay: 254)

Haas explained spillover with engineering in the creation of **the European Coal and Steel Community (ECSC)**. Haas found that European politicians had interest in coal and steel but few of them supported the ECSC. By establishment the ECSC a vertical sector-oriented approach – also called **functional approach** – had been opted for. In line with this approach, Monnet – this time as President of the Committee of Action for the United State of Europe – presented a proposal to work out sectoral integration in greater detail, his initial idea being to lay down supranational regulations on atomic energy. (Vanthoor: 142) After the ECSC showed the success the support were coming along. This evidence encouraged the creation of cooperation in others fields. Such process enhanced the degree of cooperation which, in turn, would result in political union.

Consideration of a political nature played an important role in the ECSC Treaty. Here was the essence of what has since become known as 'The Community Method': namely, progress toward political unity by integrating one economic sector at a time. The type of institutional structure in the ECSC Treaty represented a major element in the gradualist approach to political unity. (Vanthoor; 140)

Decisions that are made by organizations at international level can be more integrative. The decisions will spillover to other function, involve more people, and of course, more complicated. So there will be expansive logic from one sector to other sector. This process is the way nations to enhance their common interest. (Dougherty & Pfaltzgraff: 295)

Haas and **Schmitter** formed three variables that influence integration process up to political union. First, variable backgrounds which consists of size of units, rate of transactions, elite complementary, and pluralism. Second, conditions during economic integration such as the authority of new bodies and governmental ends. Third, other conditions like decision making style, the level of transaction, and governments' ability to face the crisis. (Haas & Schmitter: 707)

According to Haas and Schmitter economic union has chance to spillover into political union. Haas concentrated his research on region which has such criterion that is West Europe. This opinion is supported by Joseph Nye:

> *"......... and when foreign policies were locked tightly in the vise were assumed to be economic incrementalist and thus responsive to the economic logic of integration. It was thought that the technocrat-politician would be able to bypass the electoral or support politicians and directly forge links to an ever stronger regional organization until engrenage would have proceeded so far that it would be too late for anyone to change the partner."* (Nye: 60)

Ernst Haas said that integration process needs shared political commitment.

> *This is precisely the condition that, in a pluralistic setting, cannot be expected to occur very often. Otherwise, integration can go forward gradually and haltingly if both leaders and major elites share an incremental commitment to modest aims and pragmatic steps. The difficulty arise when the consensus between statesmen and major non-governmental elites is more elusive and temporary incremental commitment to economic aims among the leaders will not lead to smooth integration if the major elites are commited to dramatic political steps. More commonly, a political commitment to integration by the statesmen will rest on very shaky ground if the interest of the major elites are economic. They*

rest on an even weaker basis if the statesman's commitment is to national grandeur and the elite's to economic gradualism, as in the case of contemporary France. (Dougherty & Pfaltzgraff: 297)

Neo-functionalism based its thought on pragmatism and technocratic decision making. (Nye: 60) Integration process will be success if national stability and trust toward the government are exist. Such situation needs political leader who is able to encourage integration process.

Forms of Economic Integration

Several forms of economic integration are possible in theory. The characteristic of most importance to international businesses is the extent of economic integration among a bloc's members, because this affects exporting and investment opportunities available to firms from member and nonmember countries. From least integrated to most integrated, they are a free trade area, a custom union, a common market, an economic union, and a full political union. (Hill: 223-225)

Free trade area. A free trade area encourages trade among its members by eliminating trade barriers among them. In the theoretically ideal free trade area, no discriminatory tariffs, quotas, subsidies, or administrative impediments are allowed to distort trade between member-countries. Each country, however, is allowed to determine its own trade policies with regard to nonmembers.

Customs union. The customs union is one step further along the road to full economic and political integration. A customs union eliminates trade barriers between member-countries and adopts a common external trade policy. Establishment of a common external trade policy necessitates significant administrative machinery to oversee trade creations with nonmembers. Most countries that enter into a customs union desire even greater economic integration down the road.

Common market. The theoretically ideal common market has no barriers to trade between member-countries and a common external trade policy. Unlike in a customs union, in a common market factors of production also are allowed to more freely between member-countries. Thus labor and capital are free to move, as there are no restriction on immigration, emigration, or cross-border flows of capital between member-countries.

Economic union. An economic union involves the free flow of products and factors of production between member-countries and the adoption of a common external trade policy. A full economic union also requires a common currency, harmonization of the member-countries tax rates, and a common monetary and fiscal policy. Such high degree of integration demand a coordinating bureaucracy and that member-countries sacrifice significant amounts of their national sovereignties to that bureaucracy.

Political union. The move toward economic union raises the issue of how to make a coordinating bureaucracy accountable to the citizens of member-nations. The answer is through political union.

The Creation of the European Union

Going beyond the initial concept of the European Community as a common market, many European argued for the creation of an economic union with common military and foreign policies. Heeding this call, the European Community's Council of Ministers met in the Dutch city of the Maastricht in December 1991 to discuss the European Community's economic and political future. The result was the **Treaty on European Union** and informally as the **Maastricht Treaty**.

The Maastricht Treaty rests on the three "pillars" designed to further Europeís economic and political integration:

1. A new agreement to create a common foreign and defense policy among members
2. A new agreement to cooperate on police, judicial, and public safety matters
3. The old familiar Economic Community, with new provisions to create an economic and monetary union among member states.

Additionally, the Maastricht Treaty granted citizens the right to live, work, vote, and run for election anywhere within the European Community and strengthened the powers of the European Community's legislative body, the European Parliament, in budgetary, trade, cultural, and health matters. The treaty also created a new cohesion fund, a means of funneling economic development aid to countries whose per capita GDP is less than 90 percent of the European Community average. In recognition of the increasing integration of Europe, the treaty also changed the name of the Europe Community to the European Union.

Without a doubt, the most important and most controversial aspect of the Maastricht Treaty is the creation of **the economic and monetary union (EMU)**. The ultimate goal of the EMU is to create a single currency for the EU, thereby eliminating exchange-rate risks and the costs of converting currencies for intra-EU trade. European financial services firms hope that the planned single currency will be as important in international commerce as the U.S. dollar or the yen. Ultimately, the EU will establish a single European central bank in charge of monetary policy for the entire union.

Creation of the EMU is proceeding the three step:

1. Full membership in **the exchange-rate mechanism (ERM)** of the European Monetary System by all European Union members.
2. The creation of **the European Monetary Institute (EMI)** which is charged with overseeing members' monetary policies to ensure that they promote the eventual creation of a single currency. Upon successful completion of this step, the EMI will be transformed into the European Central Bank.
3. Complete economic and monetary union, which is to occur no earlier than January 1, 1997, and no later than January 1, 1999. At this time **the European currency unit (ECU)** will be transformed from a basket of individual moneys to a single medium of exchange based on fixed exchange rate. By the year 2000, Europeans may be able to pay for their purchases with ECU-dominated banknotes and coins. (Europe: 16a)

However, in order to participate in the EMU, members must meet certain convergence criteria, which include the following:

1. A country's inflation rate must be no more than 1.5 percentage pints higher than that of the EU country with the lowest inflation rate.
2. A country's long-term interest rates must be no more than 2 percentage points higher than that of the EU country with the lowest long-term interest rates.
3. A country must not have devalued its currency in the two years prior to joining the EMU.
4. A country's government budget deficit must be no more than 3 percent of its GDP.
5. A country's outstanding government debt must be no more than 60 percent of its GDP.

Effectively, this conditions require convergence of the monetary and fiscal policies of the participating countries. This is a necessary condition for the long-term survival of any fixed rate-exchange system. Only those European Union members that meet this criteria will be allowed to join European Monetary Union.

Creating a single European Union currency will not be easy. Its development implies members will lose the ability to control their own domestic money supplies and economic destinies. National governments facing recessions will be deprived of one tool for reviving their economies and will become more vulnerable to losing elections because of short-term pocketbook issues. (Griffin & Pustay: 251-151)

The Economic Case for Integration

The economic case for regional integration is relatively straightfroward. Theories of international trade predict that unrestricted free trade will allow countries to specialize in the production of goods and services that they can produce most efficiently. The result is greater world production then would be possible with trade restrictions. Given the central role of knowledge in stimulating economic growth, opening a country to foreign direct investment also is likely to stimulate economic growth. In sum, economic theories suggest free trade and investment is a positive-sum game, in which all participating countries stand to gain.

Given this, the theoretical ideal is total absence of barriers to the free flow of goods, services, and factors of production among nations. Because many governments have accepted part or all of the case for intervention, unrestricted free trade regime, success has been less than total. In a world of many nations and many political ideologies, it is very difficult to get all countries to agree to a common set of rules.

Against this background, regional economic integration can be seen as an attempt to achieve additional gains from the flow of trade and investment between countries beyond those attainable under international agreements such as GATT and the WTO. Undoubtedly, it is easier to establish a free trade and investment regime among a limited number of adjacent countries than among the world community. Problems of coordination and policy harmonization are largely a function of the number countries that seek agreement. The greater the number of countries involved, the greater the number of different perspectives that must be reconciled, and the harder it will be to reach agreement. Thus attempts at regional economic integration are motivated by a desire to exploit the gains from free trade and investment.

The Political Case for Integration

The political case for regional integration has also loomed large in most attempts to establish free trade areas, customs unions, and the like. By linking neighboring economies and making them increasingly dependent on each other, incentives are created for political cooperation between the neighboring states. In turn the potential for violent conflict between the states is reduced. By grouping their economies together, the countries can enhance their political weight in the world.

These considerations certainly underlay the establishment of the European Community in 1957. Europe had suffered two devastating wars in the first half of the century, both arising out of the unbridled ambitions of nation-states. Those who have sought an United Europe have always had at the forefront of their minds the desire to prevent another outbreak of war in Europe, to make it unthinkable.

Implications for Business

Currently the most significant developments in regional economic integration are occurring in Europe and North America. Although some Latin American trade blocs may have greater economic significance in the future, as ultimately may Asia Pacific Economic Cooperation (APEC), at present the events in Europe and North America have far more profound and immediate implications for business practice. Similar conclusion could be drawn with regard to the creation of a single market anywhere in the world.

Opportunities

The creation of single market offers significant opportunities as markets those were protected from foreign competition are opened. For example, in Europe before 1992 the large French and Italian markets were among the most protected. These markets are now much more to foreign competition in the form of both exports and direct investment. Nonetheless, the specter of "Fortress Europe" suggests that to fully exploit such opportunities, it will pay non-European Union firms to set up EU subsidiaries. Many major U.S. firms have long had subsidiaries in Europe. Those that do not would be well advised to consider establishing them now, lest they run the risk of being shut out of the EU by nontariff barriers. Non-EU firms rapidly increased their direct investment in the EU in anticipation of the creation of a single market. (The Economist: 17)

Additional opportunities arise from the inherent lower costs of doing business in a single market – as opposed to 15 national markets in the case of the EU or 3 national markets in the case of NAFTA (North American Free Trade Area). Free movement of goods across borders, harmonized product standards, and simplified tax regimes make it possible for firms based in the EU and the NAFTA countries to realize potentially enormous cost economies by centralizing production in those EU and NAFTA locations where the mix of factor costs and skills is optimal. At the extreme, rather than producing a product in each of the 115 EU countries or the 3 NAFTA countries, a firm may be able to serve the whole EU or North American market from a single location. This location must be chosen carefully with an eye on local factor costs and skills.

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Threats

Just as the emergence of single markets in the EU and North America creates opportunities for business, so it also presents a number of threats. For one thing, the business environment within both groups will become more competitive. The lowering of barriers to trade and investment between countries is likely to lead to increased price competition throughout the EU and North America. To survive in the tougher single-market environment, firms must take advantage of the opportunities offered by the creation of a single market to rationalize their production and reduce their costs. Otherwise they will be severely disadvantage.

A further threat to non-EU and/or non-North American firms arise from the likely long-term improvement in the competitive position of many European and North American firms. This is particularly relevant in the EU, where many firms are currently limited by high cost structure in their ability to compete globally with North American and Asian firms. The creation of a single market and the resulting increased competition in the EU can be expected to result in serious attempts by many EU firms to reduce their cost structure by rationalizing production. This could transform many EU companies into efficient global competitors. The message for non-EU business is that they need to prepare for the emergence of more capable European competitors by reducing their own cost structures.

A final threat to non-EU and/or non-North American firms inherent in the creation of a single market has already been alluded to. This is the threat of being shut out of the single market by the creation of "Fortress Europe" or "Fortress North America". Although the free trade philosophy underpinning the EU theoretically argues against the creation of any "fortress" in Europe, there are signs that the EU may arise barriers to imports and investment in certain areas. Non-EU firms might be well advised, therefore, to set up their own EU operations as quickly as possible. This could also occur in the NAFTA countries, but it seems less likely.

Conclusion

Nowhere has the movement toward regional economic integration been more successful than in Europe. A number of levels of economic integration are possible in theory. In order of increasing integration, they include a free trade area, a custom union, a common market, an economic union, and full political union. Integration is not easily achieved or sustained. Although integration brings benefits to the majority, it is never without costs for minority. Concern over national sovereignty often slow or stop integration attempts. Regional integration will not increase economic welfare if the trade creation effects in the free trade area are outweighed by the trade diversion effects.

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