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Introduction: varieties of regional integration

Regionalism, old and new

The revival of regional integration in the 1980s – which Jagdish Bhagwati (1993) labelled the 'Second Regionalism', in contrast to the 'First Regionalism' of the 1960s – raises a number of issues, starting with the question why the first regionalism failed (with the notable exception of the European Economic Community (EEC)), while this time regionalism is likely to endure. The conversion of the United States (US) to regionalism is of major significance in this respect. As the key advocate of multilateralism through the post-war years, its decision to travel the regional integration route seems to have tilted the balance at the margin from multilateralism to regionalism. A second important factor has been the widening and deepening of the European Community/Union (EC/EU). Thus, the fear that European investments would be diverted to Eastern Europe was cited by President Salinas of Mexico as a factor decisively pushing him toward the North American Free Trade Agreement (NAFTA). He felt that a free trade area embracing all of North America would enable Mexico to get the investments needed from the US and Canada, as well as from Japan (Bhagwati 1993; Vega Cànovas 2010). In his comment on Bhagwati's article, Robert Baldwin considered the likelihood of a gradual drift of the North American regional bloc to include a number of other Latin American countries. This enlargement would be driven by pressures from these countries to tap into the US market but another important factor that might drive the expansion of an American-centred bloc, according to Baldwin, 'would be the growing influence of the European Community in trade, macroeconomic and foreign policy matters. US political and economic leaders may adopt the view that it is necessary to expand such a bloc in order to match the increasing political and economic power of the Community' (Bhagwati 1993: 54).

A distinguishing characteristic of the new regionalism is the movement from shallow integration – integration based on the removal of barriers to

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trade at the border and limited coordination of national policies – to deeper integration, concerned with behind-the-border issues such as regulation of services and environmental and labour standards (see chapter 3). This feature of the new regionalism has tempted a number of analysts, including Robert Baldwin, to envisage a 'European' model of the future of regional integration. According to this model 'intensified economic integration implies stronger, more formal institutions that become wider and wider in scope. Institutions become more effective as they become more "state-like"' (Kahler 1995: 19). In reality, far from adopting or adapting the EC/EU model, the new or revived regional groups are seldom supported by significant supranational institutions or elaborate mechanisms for common decision-making. This is true also of regional organizations designed to be more than free trade areas or customs unions. Thus, MERCOSUR (Mercado Comùn del Sur) was established by Brazil, Argentina, Paraguay and Uruguay in 1995 with the objective of establishing a full common market in goods, capital, and people. However, executive power within MERCOSUR is with the national governments rather than with a European-style Commission. The highest decision-making body is the MERCOSUR Council, made up of the foreign and finance ministers of the four countries.

Even more striking (because more successful) is the Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), which, despite its ambitious aims of deeper integration, including full liberalization of trade in services and harmonization of regulatory practices, 'is almost defiantly lacking in formal institutional development' (Kahler 1995: 108). ANZCERTA provides strong support for the thesis, espoused by a number of distinguished economists, that ambitious programmes of trade liberalization, including behind-the-border policies, do not require the support of significant supranational institutions or elaborate mechanisms for common decision-making. Thus the economic agreement between Australia and New Zealand is the clearest example of a model of regional integration that is explicitly alternative to the EU model. After the late 1980s, ANZCERTA entered a very ambitious phase in dealing with behind-the-border barriers to trade and issues of deep integration. By 1990 nearly all barriers to a single market were removed. Harmonization took place in regulatory practices, customs procedures, government purchasing, and technical barriers to trade.

In terms of economic integration, MERCOSUR has been much less successful than either NAFTA or ANZCERTA. According to some analysts this is due, at least in part, to the reluctance of Brazil to use its

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economic and political position as the regional leader to assume active regional leadership (Mattli 1999). As an increasingly influential member of the BRIC (Brazil, Russia, India, China) group of countries, however, Brazil may be willing to play a more active role in the near future. On the other hand, it seems unlikely that it will abandon its staunch opposition to any plan to accept for MERCOSUR anything like an EU-style Commission or supranational courts, not to mention a common currency.

In sum, despite repeated suggestions to the effect that 'the study of economic integration has been inspired if not dominated by the European example' (Pelkmans 1997: 2), the available empirical evidence points to the fact that the European example has elicited defensive reactions rather than emulative responses. In terms of comparative regionalism, the EU appears be the outlier rather than the model. The emphasis on process rather than concrete results as well as the deep ambiguity about ends discussed in the following chapters go a long way towards explaining the lack of attraction of European-style regional integration.

Process regionalism vs. outcome regionalism

In the article on regionalism and multilateralism mentioned above, Bhagwati considers the question whether regionalism – defined broadly as preferential trade agreements among a subset of countries – will get us closer to the goal of multilateral free trade for all countries than the process of trade negotiation. In this context he introduces a useful distinction between 'process multilateralism' – the process of trade negotiation – and 'outcome multilateralism' – the goal of multilateral free trade (Bhagwati 1993: 24). An analogous distinction can also be useful for comparing different models of regionalism. For example, when political leaders, policymakers, and analysts claim that the EU is the most successful model of regional integration, they may be right in terms of process – level of institutionalization, volume of legislation, territorial expansion, etc. – but not necessarily in terms of outcomes, such as 'closer union among the peoples of Europe', or even full market integration. In terms of performance criteria the superiority of the European model is far from being evident, and in fact it is increasingly disputed by the peoples of the EU themselves – see below. Indeed, there are several indications that even full economic integration – the only generally accepted goal of the process of European integration – may no

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longer be possible in a greatly enlarged and increasingly heterogeneous EU. Generally speaking, a mismatch between process and outcome provides *prima facie* evidence that the particular model of regional integration has been chosen for purposes other than the stated goal(s).

Even before the present crisis of the euro zone the evidence was clear that results produced by European integration remained well below what European leaders had repeatedly promised. Indeed, growth has stagnated, or even regressed, since the launching of the two most important economic projects: the Single Market Programme and Economic and Monetary Union (EMU). After the phase of very rapid catch-up with the US in the immediate post-war period, convergence in the levels of per capita income stopped at the beginning of the 1980s and has remained unchanged since, at around 70 per cent of the US level. A common trade policy, the customs union, a supranational competition policy, extensive harmonization of national laws and regulations, the Single Market project, and finally a centralized monetary policy, apparently made no difference as far as the economic performance of the EC/EU, relative to its major competitors, was concerned. While the American economy was generating employment as well as maintaining working hours, Europe's employment performance was weak and working hours fell consistently. During the 1990s growth of EU gross domestic product (GDP) was disappointing both in absolute terms and by comparison with the US.

The will to improve poor economic performance has driven EU policy over the last thirty years: from the Single Market Programme, meant to be a response to perceived 'Eurosclerosis' in the mid-1980s, to EMU in the 1990s, and the Lisbon Strategy for Growth and Jobs in the following decade. This 'Lisbon Strategy' provides a striking example of what at the national level would be considered a clumsy attempt to deceive the voters and, as such, likely to be punished at the polls, but which seems to involve no political costs at the European level. At the summit held in the Portuguese capital in March 2000 the heads of state and government of the EU (officially known as the European Council) announced extremely ambitious objectives, including the surpassing of the US economy by 2010. In order to achieve these objectives, it was assumed that the Union would grow at an annual average rate of 3 per cent, so as to create 20 million new jobs. Unfortunately, the data kept showing that far from closing the gap and then overtaking the US economy, the EU as a whole continued to lag behind in terms of growth rates, employment, and especially in terms of productivity. The experts knew all along that

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the goal announced in Lisbon was in fact unfeasible since it would have required an annual growth rate of productivity of about 4 per cent. Instead, in recent years productivity in Europe has been growing at about 0.5 to 1 per cent, while in the US productivity growth has been about 2 per cent per annum. The disappointing results finally convinced EU leaders that it was wiser to drop the target date of 2010, which they quietly did at the 2005 Spring European Council. By then businesses and economists were pronouncing the Lisbon economic reform process comatose, if not quite dead, while the three largest economies of the euro zone – France, Germany, and Italy – made little attempt to fulfil their Lisbon promises. No leader was punished by the voters because of the empty promises made in the Portuguese capital. On the contrary, press releases following the Spring 2007 meeting of the European Council reported that the Council 'acknowledged the success of the Lisbon Strategy for Growth and Jobs, reflected in higher growth and falling unemployment figures'. As it turned out, what the Council celebrated was only a cyclical upswing, not structural growth, as was shown by the data released by the European Statistical Office in August 2007: the Union was still dragging behind the US on practically all indicators.

The Lisbon Strategy – the complete failure of which was eventually admitted by Commission President Barroso, who used the failure as an excuse to announce a new 'Europe 2020' project – was an attempt to coordinate, in a flexible, non-binding way, the economic policies of the member states. But policy coordination is precisely what has *not* happened. Since the launching of the Lisbon Strategy in 2000, the governments of the major continental economies have each attempted to solve their structural problems in a different way, leading to large differences in key economic indicators. The reluctance of the member states to coordinate their policy actions has been demonstrated again in the first stages of the sovereign-debt crisis of the euro zone (see chapters 1 and 2).

Size, scope, and transaction costs

As noted above, a significantly lower level of institutionalization is a key feature distinguishing the regional organizations established in the 1980s and 1990s from the EU. Two other important differences from the European model are: the much smaller membership of the new organizations compared to the twenty-eight member states of the EU (now including Croatia), with many more to come in the near future; and also

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a more limited and more precisely defined scope of competences. The largest of the three regional groups already mentioned, MERCOSUR, has four members, possibly five in the near future; NAFTA, three members; and ANZCERTA includes only two countries. In the early 1990s it was expected that the free trade agreement between Canada, the US, and Mexico, would expand to include most countries of Latin America. However, plans for a Free Trade Area of the Americas did not materialize. Today, the US is apparently no longer interested in extending regional integration beyond North America, preferring instead to sign bilateral free trade agreements with other countries of Latin America. It is now generally acknowledged that the cost of integration on NAFTA terms is probably too high for many Latin American countries – an expression of economic and political realism largely absent in the EU. At the same time, the regional leader in South America, Brazil, does not seem to be interested in giving up its position of dominance within MERCOSUR for membership in a regional organization dominated by the US.

The size of regional organizations matters for at least two reasons. First, a small organization economizes on bargaining, influence, and other transaction costs: see chapter 4. Second, the small size facilitates the development of a system of reputations based on mutual trust, and such a system, in turn, facilitates the enforcement of agreements among the members of the organization. Because the contract – in the general meaning of voluntary agreement – is the basic unit of analysis in transaction-cost economics, economists of this school have given a good deal of attention to problems of contract enforcement. They point out that in situations in which detailed contracts cannot be written, making legal enforcement difficult, enforcement may still be possible if the parties themselves have enough information to evaluate each other's past behaviour, which information is a basic requirement of any system of reputations. Even if it is possible to write detailed contracts, a good reputation can often allow the decision-maker to avoid that expense as well as the use of costly and error-prone legal contract enforcement mechanisms. One of the ways that people enhance the effectiveness of a system of reputations is by narrowing the range of people with whom they do business. Also, frequent transactions allow trust to flourish. If these conditions are not satisfied, however, then recourse to legal contract enforcement mechanisms may be unavoidable. The legal system, however, has many disadvantages for contract enforcement. Because it is a general system, it relies on general rules that may be poorly tailored for

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the particular context where the dispute arises. Also, legal procedures tend to be cumbersome, time-consuming, and expensive, while legal rules based on historical precedents may be unresponsive to changing technologies and other changing realities. The relevance of these observations to the case of the EU will be demonstrated in chapters 3 and 4 in the present book.

Regional economic integration need not lead to centralized, law-based institutions that tend to expand the scope of their own competences. As already noted, most of the new regional organizations have deliberately minimized recourse to legal and bureaucratic institutions. According to the 1988 Canada–United States Free Trade Agreement (CUSTA), for example, prospective trade conflicts were to be treated by consultations and a variety of dispute-settlement mechanisms. The other institutional provisions similarly minimize the use of legal means, favouring instead recourse to mediation and arbitration, supported by the appropriate kind of expertise and, if necessary, by the threat of retaliation. Many of the novel features of the Canada–US Agreement were retained in the design of NAFTA, which was ratified in 1993. In particular, NAFTA's dispute-settlement mechanisms closely resemble those of CUSTA in most respects, while moving beyond them in others. While in the EU disputes over trade and investment must be resolved by the European courts applying European law – a system that mimics the legal centralism prevailing at the national level – the dispute-resolution mechanisms established by NAFTA represent a new experiment in international governance, see chapter 9. Legal centralism maintains that disputes require access to a forum external to the original social setting of the dispute, and that remedies will be provided according to rules designed by experts who operate under the auspices of the state. In reality, most disputes between market actors, including many disputes that could be brought to a court, are resolved by more flexible means, as will be seen in chapter 3. In many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute. Because of the serious limitations with which court ordering is beset, the costs of contract implementation can be quite significant. The NAFTA arrangements for dispute resolution depend much less on legal centralism and court ordering than the corresponding arrangements in the EU, and for this reason they are likely to be more cost-effective, as well as more transparent, than the more traditional, state-like mechanisms adopted by the Union.

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A widely used label to characterize the European model of regional integration is 'integration through law'. The label is appropriate because it suggests that European law has been used not only as a substitute for democratic politics, but also to compensate by legal means the lack of mutual trust among a growing number of member states. A good example is the Stability Pact, which was meant to force members of the euro zone to respect the Maastricht parameters, see chapter 1. By now even pro-integration experts agree that there were no valid economic reasons to impose a common currency on a group of structurally very different national economies. Consequently, the old Stability Pact was not so much geared towards coordinating as towards disciplining the fiscal policies of the members of the euro zone. According to some analysts, this is precisely the reason why it failed. This emphasis on punitive mechanisms of contract enforcement shows the absence of mutual trust in a group of countries that is supposed to move toward 'ever closer union'. The architects of regional organizations such as the CUSTA, NAFTA, and ANZCERTA were apparently more aware than European leaders of the risks of forcing integration beyond the limits voters are prepared to accept. One of the standard arguments used in the 1990s to justify the introduction of a common European currency was that exchange-rate instability would disrupt trade in the common market. However, a monetary union between Canada and the US has never been seriously considered even though the trading relationship between these two countries is the largest bilateral trading relationship in the world – with about two-thirds of Canada's imports coming from the US, and three-quarters of its exports going to the US; about one-fifth of US imports coming from Canada and one-quarter of US exports going to Canada. The fact that Canadian and US traders, like traders in Australia and New Zealand, continue to operate, apparently with success, using their own currencies shows that the empirical evidence that currency swings dampen trade is far from being convincing. The two Pacific countries, like the countries of North America, provide ample evidence that a single market does not require a single currency.

Integration for its own sake?

The arguments and evidence presented in the preceding sections strongly suggest that the EU, far from being a source of inspiration for the designers of new regional organizations, was actually rejected by them as a useful model. On the other hand, scholars who insist on the

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sui generis nature of the Union implicitly deny the possibility of any meaningful comparison with other regional blocs. They do not tell us, however, what makes the EU essentially different from other schemes of regional integration. One such distinctive feature would be a commitment to full economic *and* political integration. However, nowadays there are very few advocates of fully-fledged political union – the old vision of the United States of Europe. Even political and intellectual leaders who claim that the present general crisis of European integration can only be solved by the magic formula 'more Europe' acknowledge the impossibility of a federal solution, see chapter 7. The political content of the magic formula remains, however, wholly indeterminate. The only clear objective is the continuing expansion of EU powers: process regionalism.

The competences of the EU have grown so much since establishment of the EEC by the 1957 Treaty of Rome that according to some specialists of European law the Union's 'policy-making powers now [touch] almost every imaginable public policy objective' (Curtin *et al.* 2013: 1). More than twenty years ago a distinguished legal scholar and member of the EU's Court of First Instance (renamed General Court by the Lisbon Treaty) could claim that 'there is no nucleus of sovereignty that the Member States can invoke, as such, against the Community' (Lenaerts 1990). Indeed, in the euphoria created by the Single European Act and the very successful marketing of the 'Europe 1992' programme it became tempting to imagine that there were no effective barriers to the continuous, if incremental, expansion of European competences.

According to EU leaders, this continuous expansion of supranational powers has produced a steady flow of benefits for the citizens: 'European integration has delivered 50 years of economic prosperity, stability and peace. It has helped to raise standards of living, built an internal market and strengthened the Union's voice in the world.' These opening lines of the Commission's White Paper on *European Governance*, published in 2001 (Commission 2001), were repeated almost verbatim by Chancellor Angela Merkel, as rotating president of the European Council, on the occasion of the fiftieth anniversary celebrations of the signing of the Treaty of Rome. The flow of benefits generated by the steady expansion of the legislative and policymaking powers of the EU should have produced a steadily growing popular support for European integration. Unfortunately, this is not at all the case. Over the years popular attitudes towards integration have changed from a 'permissive consensus' – when a large majority of citizens in all the member states were either not interested in European integration or took

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the supranational institutions for granted as an accepted part of the political landscape – to outright hostility. Recent opinion surveys have measured the extent of the hostility.

According to the extensive survey conducted by the Washington, DC-based Pew Research Center in 2012, Germany is the only member of the EU in which most people (59 per cent) think their country has been helped by European integration. The most negative were the Greeks, with 70 per cent saying that European integration has hurt them, followed by the French with 63 per cent. The survey, entitled *European Unity on the Rocks, Greeks and Germans at Polar Opposites*, was conducted in eight EU countries – Britain, France, Germany, Italy, Spain, Greece, Poland, and the Czech Republic – and the US, and queried 9,108 people between 17 March and 16 April 2012. According to the report, what started out in 2009 as a sovereign-debt crisis has now triggered a full-blown crisis of public confidence: in the economy, in the benefits of European economic integration, in membership in the EU, in the euro, and in the free-market system. In particular, Europeans largely oppose further fiscal austerity to deal with the crisis; are divided on bailing out indebted nations; and oppose Brussels' impending oversight of national budgets. Across the eight EU member states surveyed, a median of only 34 per cent think that European economic integration has strengthened their country's economy. Indeed, majorities or near majorities in most nations now believe that the economic integration of Europe has actually weakened their economies. This is the opinion in Greece (70 per cent), France (63 per cent), Britain (61 per cent), Italy (61 per cent), the Czech Republic (59 per cent) and Spain (50 per cent). Only in Germany do most people (59 per cent) say that their country has been well served by European integration. Among the five members of the euro zone surveyed, a median of only 37 per cent believes having the euro as their common currency has been a good thing. This includes just 30 per cent of the Italians and 31 per cent of the French. A median of about four-in-ten Europeans (39 per cent) surveyed think favourably of the European Central Bank (ECB), the institution at the centre of the debate over how to deal with the euro crisis. That includes just 15 per cent of the Greeks, 25 per cent of the Spanish, and only 40 per cent of the Germans. At the same time, the three non-euro zone countries surveyed are quite happy they have kept their own currencies, including nearly three-quarters of the British (73 per cent). The conclusion of the Pew Report is that the European project is a major casualty of the on-going European sovereign-debt crisis (Pew Global Attitudes Project 2012).

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