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Stages of Economic Integration: From Autarky to Economic Union

As international trade and investment levels continue to rise, the level of economic integration between various groups of nations is also deepening. The most obvious example of this is the European Union, which has evolved from a collection of autarkical nations to become a fully integrated economic unit. Although it is rare that relationships between countries follow so precise a pattern, formal economic integration takes place in stages, beginning with the lowering and removal of barriers to trade and culminating in the creation of an economic union. These stages are summarized below.(1)

FREE TRADE AGREEMENTS

The first level of formal economic integration is the establishment of free trade agreements (FTAs) or preferential trade agreements (PTAs). FTAs eliminate import tariffs as well as import quotas between signatory countries. These agreements can be limited to a few sectors or can encompass all aspects of international trade. FTAs can also include formal mechanisms to resolve trade disputes. The North American Free Trade Agreement (NAFTA) is an example of such an arrangement.

Aside from a commitment to a reciprocal trade liberalization schedule, FTAs place few limitations on member states. Although FTAs may contain provisions in these areas if the signatory countries agree to do so, no further harmonization of regulations, standards or economic policies is required, nor is the free movement of capital and labour a necessary part of a free trade agreement. FTA signatory countries also retain independent trade policy with all countries outside the agreement.

However, in order for an FTA to function properly, member countries must establish rules of origin for all third-party goods entering the free trade area. Goods produced within the free trade area (and subject to the agreement) may cross borders tariff-free, but rules of origin requirements must be met to prove that the good was in fact produced in the exporting country. In the absence of rules of origin, third-party countries seeking trade access to the FTA area will choose the path of least resistance – the country where they face the lowest opposing tariff – in order to gain effective entry to the entire FTA region.

CUSTOMS UNION

A customs union (CU) builds on a free trade area by, in addition to removing internal barriers to trade, also requiring participating nations to harmonize their external trade policy. This includes establishing a common external tariff (CET) and import quotas on products entering the region from third-party countries, as well as possibly establishing common trade remedy policies such as anti-dumping and countervail measures. A customs union may also preclude the use of trade remedy mechanisms within the union. Members of a CU also typically negotiate any multilateral trade initiative (such as at the World Trade Organization) as a single bloc. Countries with an established customs union no longer require rules of origin, since any product entering the CU area would be subject to the same tariff rates and/or import quotas regardless of the point of entry.

The elimination of the need for rules of origin is the chief benefit of a customs union over a free trade area. To maintain rules of origin requires extensive documentation by all FTA member countries as well as enforcement of those rules at borders within the free trade area. This is a costly process and can lead to disputes over interpretation of the rules as well as other delays. A CU would result in significant administrative cost savings and efficiency gains.

In order to gain the benefits of a customs union, member countries would have to surrender some degree of policy freedom – specifically the ability to set independent trade policy. By extension, because of the increased importance of trade and economic measures as foreign policy tools, customs unions place some limitations on independent foreign policy as well.

COMMON MARKET

A common market represents a major step towards significant economic integration. In addition to containing the provisions of a customs union, a common market (CM) removes all barriers to the mobility of people, capital and other resources within the area in question, as well as eliminating non-tariff barriers to trade, such as the regulatory treatment of product standards.

Establishing a common market typically requires significant policy harmonization in a number of areas. Free movement of labour, for example, necessitates agreement on worker qualifications and certifications. A common market is also typically associated – whether by design or consequence – with a broad convergence of fiscal and monetary policies due to the increased economic interdependence within the region and the effect that one member country's policies can have on other member countries. This necessarily places more severe limitations on member countries' ability to pursue independent economic policies.

The principal advantage of establishing a common market is the expected gains in economic efficiency. With unfettered mobility, labour and capital can more easily respond to economic signals within the common market, resulting in a more efficient allocation of resources.

ECONOMIC UNION

The deepest form of economic integration, an economic union adds to a common market the need to harmonize a number of key policy areas. Most notably, economic unions require formally coordinated monetary and fiscal policies as well as labour market, regional development, transportation and industrial policies. Since all countries would essentially share the same economic space, it would be counter-productive to operate divergent policies in those areas.

An economic union frequently includes the use of a common currency and a unified monetary policy. Eliminating exchange rate uncertainty improves the functioning of an economic union by allowing trade to follow economically efficient paths without being unduly affected by exchange rate considerations. The same is true of business location decisions.

Supranational institutions would be required to regulate commerce within the union to ensure uniform application of the rules. These laws would still be administered at the national level, but countries would abdicate individual control in this area.

Basic Elements of the Stages of Economic Integration	
Free Trade Agreement (FTA)	Zero tariffs between member countries and reduced non-tariff barriers
Customs Union (CU)	FTA + common external tariff
Common Market (CM)	CU + free movement of capital and labour, some policy harmonization
Economic Union (EU)	CM + common economic policies and institutions

BLURRING THE LINES

Because countries are free to negotiate economic integration agreements as they see fit, in practice, formal agreements rarely fall neatly into one of the four stages discussed above. This can lead to some confusion of terminology and also confusion as to the state of economic integration in some parts of the world. In the case of Canada, for example, the country is part of a free trade area with the United States and Mexico. However, the North American Free Trade Agreement also includes provisions that partially liberate the flow of labour and capital in the region – an element of a common market. In addition, Canada has in the past pushed to curtail the use of trade remedy measures within North America. While this represents a desire to advance one aspect of North American integration, the next formal step – a customs union – does not appear to be a policy priority at this time.

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(1) This note draws from two principal sources: Rolf Mirus and Nataliya Rylska, *Economic Integration: Free Trade Areas vs. Customs Unions*, Western Centre for Economic Research, 2001; and House of Commons, Standing Committee on Foreign Affairs and International Trade, Third Report, *Partners in North America: Advancing Canada's Relations with the United States and Mexico*, 2nd Session, 37th Parliament, December 2002.