

*Routledge Library Editions*

---

# ECONOMIC THEORY AND WESTERN EUROPEAN INTEGRATION



---

ECONOMICS

*Routledge Library Editions*

---

ECONOMIC THEORY AND  
WESTERN EUROPEAN  
INTEGRATION



---

ECONOMICS

INTERNATIONAL ECONOMICS  
In 11 Volumes

I	Applied Economics	<i>Brown</i>
II	Introduction to the World Economy	<i>Brown</i>
III	Economic Analysis and the Multinational Enterprise	<i>Dunning</i>
IV	Economic Survey	<i>Lewis</i>
V	International Monetary Economics	<i>Machlup</i>
VI	Problems of Economic Union	<i>Meade</i>
VII	An International Economic System	<i>Polak</i>
VIII	Britain in the World Economy	<i>Robertson</i>
IX	Economic Theory and Western European Integration	<i>Scitovsky</i>
X	International Monetary Co-Operation	<i>Tew</i>
XI	An Outline of International Price Theories	<i>Wu</i>

# ECONOMIC THEORY AND WESTERN EUROPEAN INTEGRATION

TIBOR SCITOVSKY

 **Routledge**  
Taylor & Francis Group  
LONDON AND NEW YORK

First published in 1958

Reprinted in 2003 by  
Routledge  
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

Transferred to Digital Print 2007

*Routledge is an imprint of the Taylor & Francis Group*

© 1958 Routledge  
1962 Routledge, introduction

All rights reserved. No part of this book may be reprinted or reproduced or utilized in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

The publishers have made every effort to contact authors/copyright holders of the works reprinted in *Routledge Library Editions – Economics*. This has not been possible in every case, however, and we would welcome correspondence from those individuals/companies we have been unable to trace.

These reprints are taken from original copies of each book. In many cases the condition of these originals is not perfect. The publisher has gone to great lengths to ensure the quality of these reprints, but wishes to point out that certain characteristics of the original copies will, of necessity, be apparent in reprints thereof.

*British Library Cataloguing in Publication Data*  
A CIP catalogue record for this book  
is available from the British Library

Economic Theory and Western European Integration  
ISBN 0-415-31364-3  
ISBN 0-415-31355-4

Miniset: International Economics

Series: Routledge Library Editions – Economics

Printed and bound by CPI Antony Rowe, Eastbourne

# Economic Theory and Western European Integration

BY

TIBOR SCITOVSKY

*Professor of Economics  
University of California, Berkeley*

 **Routledge**  
Taylor & Francis Group  
LONDON AND NEW YORK

FIRST PUBLISHED IN 1958  
REPRINTED WITH NEW INTRODUCTION 1962  
THIRD IMPRESSION 1967

*This book is copyright under the Berne Convention. Apart from any fair dealing for the purpose of private study, research, criticism or review, as permitted under the Copyright Act, 1956, no portion may be reproduced by any process without written permission. Enquiry should be made to the publisher.*

© Routledge 1958

Introduction © Routledge 1962

*Routledge*  
*2 Park Square, Milton Park, Abingdon,*  
*Oxon, OX14 4RN*

It is hardly possible to overrate the value, in the present low state of human improvement, of placing human beings in contact with persons dissimilar to themselves, and with modes of thought and action unlike those with which they are familiar. . . . Such communication has always been, and is peculiarly in the present age, one of the primary sources of progress.

John Stuart Mill in *Principles of Political Economy*



*This Page intentionally left blank*

## Introduction to the Second Printing

This book was written at a time when Western European integration was little more than a hope and an idea—or rather a number of different ideas, competing, complementary, some even contradictory. Today, the European Economic Community has realized many of these ideas and fulfilled some of the hopes. In four and a half years, the E.E.C. has achieved a degree of integration that, even according to its more optimistic timetable, it was only supposed to accomplish in six years; and its success, to judge by the reaction of public opinion, has surpassed not only the cautious optimism voiced in this book but perhaps the high hopes of its most ardent advocates as well. Public opinion in the member countries credits the Community for much of their prosperity. Outside the Community, the universal belief in its success is evidenced by applications for membership by Britain and other countries, by the movement for the United States and other Western countries to join the E.E.C. in a wider Atlantic Community, by the ground the Common Market idea is gaining in West Africa and Latin America, and perhaps even by the very hostility the E.E.C. has engendered in some quarters. I shall be pleased if events prove excessive the caution with which I tried to appraise the chances and benefits of economic union. It is evident that I greatly underestimated the expansion of intra-E.E.C. trade and the benefits to be derived from it; although I was probably right in expecting the most from an increase in competition. By all accounts, the most promising development so far has been the rebirth of competition even in areas where it has long been dead.

It must also be said, however, that the E.E.C. has been favoured by exceptionally good luck and does not quite deserve all the credit it receives. The causal relation between the formation of the Common Market and its prosperity may be more nearly the other way around. The high prosperity and fast rate of growth of most member countries started long before the E.E.C. was established and probably explain the ease and smoothness with which the gradual elimination of trade restrictions could be carried out and even accelerated. A period of expansion is an ideal time in which to institute economic reform, since market expansion absorbs the strains and stresses of transition. The fortunate timing of the introduction of the E.E.C.

#### INTRODUCTION TO THE SECOND PRINTING

will have permanent benefits; may the remainder of the journey towards complete integration have equally fair weather.

Another circumstance that has favoured the E.E.C. is the balance-of-payments deficit of the United States. I have argued at length in Part II of this book that more and freer trade among a group of countries requires better machinery for dealing with balance-of-payments difficulties than exists at present; and I advocated an integrated capital market and close coordination of employment and investment policies, preferably in a supra-national authority, as part of this machinery. The E.E.C. has established no such machinery and has experienced no balance-of-payments problems. Indeed, the member countries boast favourable balances of payments and their combined gold and foreign-exchange reserves have reached an all-time high, whatever the standard by which such records are measured. This, too, however, seems just a fortunate circumstance, created by the United States' willingness to tolerate—or inability to remedy—her large and protracted payments deficit. One country's loss of reserves is another's gain; and the formation of the E.E.C. probably had something but not very much to do with the fact that the Six have been the principal gainers. It is fair enough that the Union of the Six should begin with a honeymoon; let us hope that having tasted the honey, the newly-weds will be all the more willing to make the adjustments, compromises and sacrifices of sovereignty that Union also entails. For the honeymoon will end, machinery for dealing with intra-E.E.C. payments will then be required, and creating such machinery will raise the problems discussed in Part II. One of these, the problem of a coordinated or common employment and stabilization policy, is all the greater because the leading nations of the E.E.C. have had the least experience with and shown the greatest distrust of such policies even on a national basis.

This problem, however, is only one of many yet to be faced. The establishment of the E.E.C. has given great impetus to the process of integration, its easy progress so far has added more; but the issues to be analyzed and problems to be solved are still there, perhaps more pressing today than they were before. That is why I hope that this book can still be of use.

*Berkeley, California. July 1962*

TIBOR SCITOVSKY

## Preface

The union of Western Europe is a bold and grandiose idea, which has captured the imagination of many, and whose popular appeal has generated emotions that may go far towards overcoming the obstacles in its way. For the gains seem great, simple, and obvious, the obstacles many, complex, and highly technical; and the contrast between the grandiose simplicity of the former and the involved technicality of the latter is an important political asset of the integrationists. It is almost with a guilty conscience therefore that I have undertaken the pedantic task of analysing the advantages and discussing them on the same technical level with the difficulties. And yet, the task seems worth undertaking, even to one who shares the enthusiasm for an United Europe. For one thing, there is no danger that the simple vision of the enthusiasts should be displaced by my complex picture, which is technical, addressed to the economist, and couched in his language. For another, I feel that a better understanding by both sides of the nature of the gains and of the conditions necessary to obtain them would lead ultimately to a better version of an integrated Europe.

The belief in the advantages of economic union is based partly on the classical argument for free trade, partly on the example of such large economic units as Zollverein Germany, the United States, and the Soviet Union, all of which have had an impressive economic development. As to the latter, it has rightly been pointed out that from the fast progress of economies integrated at an early stage of their development one can hardly draw conclusions to the effects of the integration of countries already highly industrialized. As to the former, the classical argument consists of a number of shrewd but general observations, of which those suitable for formal analysis have been further developed and rendered more rigorous by neo-classical and modern theory, the rest have been neglected and all but forgotten. Today therefore we have two versions of the

## PREFACE

free-trade argument: the original statements of the classical economists, which, by the standards of modern economics, often sound like a set of vague generalizations; and their modern restatements, which are elegant, rigorous and formal but tell only part and, I suspect, the less important part of the story.

In the following essays I have tried to apply some of the general principles of economic theory to the particular problems of the economic union of Western Europe. The result is a great variety of arguments, some of which will be familiar, others, while not original, may be new in this context and perhaps new also as applications of well-known principles. The free trader's stock argument, the beneficial reallocation of production between countries resulting from the freeing of trade, turns out to be of little significance in the case of Western Europe; and the main results of integration are shown to be various consequences of the increase in competition which the common market is almost certain to bring about. This conclusion is not new, as I discovered when, after having reached it, I re-read John Stuart Mill's chapter on International Trade. He stresses there the importance of the indirect and non-economic effects of commerce as against its direct effect; and his enumeration of the indirect effects could be the theme on which these essays are the variations. Indeed, much of the following is a detailed discussion of the implications of competition in Mill's wide sense of the term. This seemed inevitable, because the effects (if any) of economic union would come about mostly as a result of the increased pressure that increased competition brings to bear upon the economic behaviour of Governments, entrepreneurs, workers, and others. I have tried to indicate the nature and direction of these pressures; to judge their effectiveness would have required appraising the malleability of human behaviour as determined by tradition, ingrained habits, and set prejudices; and for this I do not feel qualified.

Economic union and an increase in competition have both good and bad effects; and if the discussion of the good effects takes up more space here, the reason is not that they predominate but that the discussion dealing with the bad effects is

## PREFACE

centred not on their analysis but on the conditions and actions necessary to prevent or offset them. Thus, the fact that European integration would render national employment policies more difficult is merely mentioned and the discussion centred on the need for and nature of a coordinated all-European employment policy to displace national policies. In short, I have tried to seek out the good effects of European union and the conditions necessary to obviate the bad ones. Some of these conditions have turned out to be very drastic and far reaching, unlikely to be realized in the foreseeable future; but they are stated here in their ideal form. This gives a theoretical tone to much of what follows; but in our rapidly changing times this seemed preferable to working out compromise solutions acceptable to the political temper of the time of writing. Similar considerations have kept me from revising and bringing up to date, except in minor detail, some of the earlier essays.

Most of my thinking and writing on this subject was done in 1953-54, while on sabbatical leave from Stanford University and holding a grant of the U.S. Office of Naval Research. I had originally hoped to collect statistical data; and if I had to settle for collecting mainly impressions and opinions, it was not for lack of help and cooperation from all those I have approached. I am very grateful to my many friends and acquaintances, in the ECE, the OEEC, the ECSC, and in the civil service and productivity centres of France, Holland, and Western Germany, for their help and advice. I also want to thank many of my colleagues and students at Stanford for useful discussions and suggestions; I have benefited especially from Mr Paul Streeten's and Professor William Capron's comments.

The main part of my work on this subject, as well as the most comprehensive one, is the first essay, which was privately circulated as an Office of Naval Research Technical Report. It is printed here with a few changes. All the others are offshoots of the first and deal with more specific aspects of the problem. The second paper, reprinted with minor changes from *Kyklos*, deals with the closely related problems of a common currency, a common capital market, and the all-European coordination

#### PREFACE

of stabilization policies and public investments, all of them shown in the first essay to be necessary conditions for obviating some of the bad and assuring some of the good effects of economic union. The third essay, reprinted from the *American Economic Review*, deals with a particular way in which competition may affect the nature of investment—a subject singled out for detailed analysis not so much for its importance to European union as for its interest for the theory of competition. The fourth essay, also published in *Economia Internazionale*, deals with the problem of integration by sectors. I am grateful to the editors of the above journals and the Office of Naval Research for allowing me to print these papers in this book.

*Christmas, 1957*  
*Stanford, California*

# Contents

<i>Introduction to the Second Printing</i>	page 7
<i>Preface</i>	9
I. THE PROBABLE EFFECTS OF ECONOMIC INTEGRATION IN WESTERN EUROPE	15
A. Economic Organization and Relations within the Union	17
1. <i>The Effect of Union on Employment</i>	17
2. <i>The Effect of Union on Productivity</i>	19
(a) The Effect of Union on Methods of Production	
(b) The Effect of Union on the Allocation of Output	
(c) The Effect of Union on Investment	
3. <i>The Distribution of Gains among Member Countries</i>	48
B. Economic Relations with the Outside World	52
4. <i>The Orthodox Argument</i>	52
5. <i>An Illustration</i>	64
6. <i>The Effect of Increased Productivity on the Terms of             Trade</i>	70
II. THE THEORY OF THE BALANCE OF PAYMENTS AND THE PROBLEM OF A COMMON EUROPEAN CURRENCY	79
A. The Theory of the Balance of Payments	80
1. <i>The Classical Theory</i>	80
2. <i>The Income Theory</i>	82
3. <i>Migration</i>	85
4. <i>The Role of the Capital Market</i>	85
5. <i>The Role of Employment Policy</i>	92
B. The Problems of Currency Union	95
6. <i>The Problem of an all-European Capital Market</i>	95
7. <i>The Problem of an Integrated Employment Policy</i>	97
8. <i>The Adequacy of Reserves</i>	99
C. A Note on the Concept of Adequate External Reserves	101