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Theoretical Aspects of Regional Disintegration and Its Consequences for International Competitiveness

Arkadiusz Michał Kowalski

1.1 Introduction

The theory of regional economic integration has developed extensively in recent decades in response to growing integration processes in Europe and elsewhere. The 23 June 2016 referendum in Britain showed, however, that regional integration does not have to be a one-way process as it was once thought to be. While there are well-developed models of regional integration in economic theory, there is little in the way of analytical explanation of the mechanics of disintegration. This is because integration was for many years commonly viewed as a beneficial process, while disintegration was seen as undesirable, which led to a normative bias in research on regional integration. This gap is the main rationale to formulate the aim of this chapter, which is to contribute to developing the theory of regional economic disintegration and gauging

A. M. Kowalski (✉)
Collegium of World Economy,
SGH Warsaw School of Economics, Warsaw, Poland
e-mail: arkadiusz.kowalski@sgh.waw.pl

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its consequences for the international competitiveness of economies in areas such as international trade and the mobility of capital. It must be noted that as the EU–UK negotiations on Brexit started in 2017 and the rules and exact timetable of Britain's exit from the European Union were not yet known, different scenarios were possible, including an option referred to as a "soft Brexit", implying Britain's continued close ties with continental Europe in areas such as trade, investment and migration.

1.2 Regional Integration vs. Regional Disintegration

In recent decades, regional economic integration—defined by Balassa (1961) as "the abolition of discrimination within an area", and by Kahnert et al. (1969) as "the process of removing progressively those discriminations which occur at national borders"—has been a notable trend in the global economy. It involves the establishment of commonly accepted transnational rules on economic activity that lead to greater trade and cooperation between countries. The major examples of economic integration in the global economy, such as the European Union, the Association of Southeast Asian Nations (ASEAN) and the North American Free Trade Agreement (NAFTA), show that a key factor in this process is geographic proximity. In many cases, neighbouring countries become involved in integrative activities because of factors such as relatively short transportation distances, similar consumer tastes and needs, fairly established distribution channels, common history and an awareness of common interests. However, this is not always the case, as similar consumer tastes, for example, cannot be pointed out as a reason for regional integration between the USA and Mexico as part of the North American Free Trade Agreement (NAFTA).

There are two approaches in which we can analyse regional economic integration:

- as a continuing, step-by-step process (dynamic approach) whereby boundaries between national states become less discontinuous, thus leading to the formation of a more comprehensive system (Mennis and Sauvant 1976);
- as a state of affairs (static approach) representing the present level of integration between national economies, which may take on the form first pointed out by Balassa (1961): a free-trade area (FTA), a customs union (CU), a common market (CM), an economic union and complete integration.

In a dynamic perspective, Brexit shows that regional economic integration is not a one-way process and that it may be reversed and turned into regional economic disintegration. Hence, the traditional view of integration as a process where countries deepened cooperation and subsequently switched to modes involving stronger commitment—starting from a FTA, through a customs union, a common market, an economic union, to complete integration—is being challenged. The characteristics of different levels of regional integration, a process that may also turn into disintegration, are presented in Table 1.1.

As the level of economic integration increases so does the complexity of the process involving a set of numerous regulations, enforcement and arbitration mechanisms. However, regional integration does not have to always start with a preferential trade agreement (PTA) or a FTA and end with full integration. For example, the European Union started out as a CU, whereas NAFTA will probably never go beyond the FTA stage. Economic disintegration does not have to be a simple reversal of this process. In general, a devolution of economic integration could occur if the complexity it creates comes at a cost that may undermine the competitiveness and is no longer judged to be acceptable by society.

It should be also remembered that reaching a formal agreement does not necessarily ensure real integration between member states, as exemplified by regional integration arrangements in Africa. On the one hand, identifying the process of economic integration with

Table 1.1 Different levels of regional integration and disintegration processes

Integration process	Type (level)	Principal features	Disintegration process
	Preferential trade agreement (PTA)	Tariffs between the members of the agreement are reduced (or eliminated) only for some goods or services, sometimes unilaterally	
	Free-trade area (FTA)	No internal tariffs and import quotas Each member determines its independent trade policies with all countries outside the agreement	
	Customs Union (CU)	No internal tariffs and import quotas Harmonisation of external trade policy: Establishing a common external tariff (CET) and import quotas on goods entering the region from third-party countries	
	Common market (CM)	As for customs union above Free movement of factors of production such as labour, capital, and other resources within the region	
	Economic Union	As for common market above Coordinated monetary and fiscal policies as well as labour market, regional development, transportation and industrial policies	
	Political Union	Common home and judicial policies and a common foreign and security policy	

Based on Hill (2016)

membership in the group is debatable; on the other, it is controversial to put an equality sign between disintegration and exit from an integration grouping. For example, Poland's integration with the

European Union occurred many years before the country's formal accession. Meanwhile, a situation in which a member state ignores a judgement of the Court of Justice of the European Union is a mild form of disintegration. An example of gradual decomposition to the point of full institutional disintegration was the break-up of the Council for Mutual Economic Assistance (CMEA) in 1991, as analysed by Marszałek (1993). In fact, there were many cases of regional disintegration processes in the past, even in ancient times. For example, Goldsworthy (2009) analyses the process of the disintegration of the Roman Empire, finding plenty of analogies to the current EU situation.

Different scenarios are possible for the UK's exit from the European Union, and there are opinions that the final outcome will be the so-called soft Brexit, which could involve keeping strong linkages with the EU, e.g. through some form of membership in the FTA, customs union or even European single market, to guarantee free movement of goods, capital, services and labour. This means that regional economic disintegration does not have to necessarily mean that the leaving country will be totally out of the integration levels listed in Table 1.1. However, the question is which of these levels of relations between the European Union and the UK will be established after Brexit. Possible Brexit scenarios may be classified on the basis of findings by Barrett et al. (2015), as presented in Table 1.2.

One potential solution is that Britain will stay inside the European Economic Area (EEA), which provides the free movement of persons, goods, services and capital, and whose members also include non-EU countries representing the European Free Trade Association (EFTA). However, according to some studies, remaining a member of the common market or customs union will be not possible after Brexit, for example, because such an arrangement would not respect the result of the 2016 referendum. As the final decisions have yet to be made, the theoretical analysis of the consequences of regional disintegration for the movement of goods and capital will be developed further on in this chapter.

Table 1.2 Different scenarios for regional disintegration in the Brexit case

Alternative scenarios	Selected characteristics
Membership of the European Economic Area (EEA) and the European Free Trade Area (EFTA) (Norway's model of relationship with the EU)	• Access to the EU Internal Market for goods, but no full access to the internal market for financial services • Freedom to set own external trade policy, and own VAT regime • Freedom from participation in the Schengen free-movement zone • The need to abide by the EU law in relation to the EU Internal Market, and to contribute to the EU budget
Bilateral agreements with the EU and membership of EFTA (Switzerland's model of relationship with the EU)	• No obligation to apply and/or contribute to Common Agricultural Policy (CAP), Common Fisheries Policy (CFP), and structural funds • Freedom to conclude trade agreements with third countries • No obligation to transpose EU Internal Market legislation automatically into UK law • UK goods exported to the EU would have to comply with all relevant EU standards
Membership of a Customs Union with the EU (Turkey's model of relationship with the EU)	• Partial freedom to set own external trade policy • Access to the EU Internal Market for goods without the need to comply with EU Rules of Origin for non-EU countries • No contribution to the EU budget • The right to regulate its own financial sector • Common external tariff on imports from outside the UK/EU customs union • EU product standards for goods • EU common commercial policy
Bilateral Free-Trade Agreement with the EU	• Freedom to set own external trade policy and VAT regime, and to conclude FTAs with third countries • No obligation to contribute to the EU budget • UK goods exported to the EU would have to comply with all relevant EU standards

(continued)

Table 1.2 (continued)

Alternative scenarios	Selected characteristics
No preferential trade agreement with the EU	• National competence over trade policy and border control • Removal of the requirement to contribute to the EU budget and of all EU legislative rights • Most favoured nation tariffs will be applied in line with membership of the World Trade Organisation

Based on Barrett et al. (2015, pp. 1, 70–71)

1.3 Explaining Regional Disintegration with the Concept of Neo-functionalism

The so-called neo-functionalist approach to conceptualising regional disintegration was proposed by Schmitter and Lefkofridi (2016). Originally, neo-functionalism was developed by, e.g. Haas (1964) and Schmitter (1970) as an important theory of European integration, assuming higher efficiency (functionality) of regional integration in relation to actions taken by individual countries. According to the neo-functionalist approach, regional integration is a relatively steady process, involving two parallel elements: market integration and the delegation of policy-making competence to an organisation above the national level. At the core of neo-functionalism is the concept of spill overs, which refers to situations when a certain sector is placed under the authority of a central institution (such as the European Commission) and when pressures are created to extend the authority of this institution into neighbouring areas of policy, such as taxation, wages or currency exchange rates (Tranholm-Mikkelsen 1991). The theory was optimistic about regional integration, and even crises were perceived as catalysts for positive change as they led to stronger regulatory expansion. This assumption was challenged during the global financial crisis that started in 2008. It showed that European integration was not functional because EU institutions were unable to effectively deal with this crisis (Grosse 2016).

One of the proponents of neo-functionalism, E. Haas (1968, p. 16), defined regional integration as “the process whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new centre, whose institutions possess or demand jurisdiction over the pre-existing national states”. From that perspective, disintegration does not have to be the same as a reversed process of integration, as authority may not be transferred back to national states but can be shifted instead to regional authorities. Thus, disintegration is not necessarily a choice between states and a central institution, as regions may emerge as important actors.

Regional disintegration was conceptualised in the neo-functionalist approach by Schmitter and Lefkofridi (2016), who state that:

- if the benefits of integration are not evenly distributed across member states and its societies, the risks of disintegration increase;
- as neo-functionalism assigns a key role to experts, those in supranational institutions and national parliaments, disintegrative forces can come about if there is heterogeneity in preferences between member states and regional institutions;
- disintegrative pressures emerge if the process of regional integration is not gradual and requires “a radically different mode of decision-making or conflict resolution” and if member states fail to implement EU decisions;
- regional integration unavoidably generates conflict among member states. If the conflict is too big to be effectively handled by a central institution, it will mobilise an increasingly wider public expressing a greater diversity of opinions.

1.4 New Intergovernmentalism and the Implications for Regional Integration and Disintegration Processes

As neo-functionalists stressed the relevance of Community bodies in the process of regional integration, the “new intergovernmentalism” is an alternative theory that highlights the continuing importance of nation states (Hoffmann 1995, pp. 71–106). Being sceptical about the "community method" as the main modus operandi of the European Union, the theory postulates an active role for member states in advancing stronger cooperation in areas in which they have competence. Hence, in areas where there was no EU competence, integration can be advanced only by the member states.

The new intergovernmentalism was used as a theoretical explanation of the process of regional disintegration by Bickerton et al. (2015), who formulated the hypothesis that the European Union is in a "state of disequilibrium" as there are constant tensions between member states. However, even from this perspective, this concept is not used for predicting a potential break-up of the European Union, but it rather explains a particular feature of European integration since Maastricht. On the other hand, according to Fabbrini and Puetter (2016, p. 488), "if consensus is threatened or impossible constitutional or redistributive adjustments are either inevitable in order to mitigate tensions and asymmetries between the Union's member states or, if these options are not available, there is a risk of disintegration". Hence, the new intergovernmentalism does not assume automatic regional disintegration, but has clear disintegrative elements, and may be used to explain how the disintegration process occurs.

1.5 The Concept of International Competitiveness

When analysing the consequences of regional economic disintegration for international competitiveness, it is necessary to introduce the concept of economic competitiveness. Although it is one of the most widely used terms in modern economics, there is a significant lack of consensus on what it really means. Ketels (2015) calls for a shared definition of the term in order to make it a useful category for policy dialogue, proposing the adoption of the Aiginger and Vogel (2015) definition of competitiveness as the "ability of a country (region, location) to deliver the beyond-GDP goals for its citizens". This definition reflects the comprehensive nature of the concept of competitiveness, which encompasses different dimensions, in terms of both different types of economic performance and the geographical perspective. With respect to beyond-GDP objectives underlined in the definition, competitiveness refers to not only income levels, but also other perspectives, including social, ecological and institutional. Under the methodology used by the Warsaw School of Economics' World Economy Research Institute in its annual competitiveness reports (e.g. Weresa and Kowalski 2018), competitiveness is understood as an economy's ability to achieve:

1. a sustainable increase in the standard of living (income competitiveness),
2. an improvement in a country's position in the global marketplace (trade competitiveness),
3. enhanced investment attractiveness, mostly for foreign capital (investment competitiveness).

In general, the concept of competitive ability is distinguished from that of competitive position in research reports. Competitive ability is also called factorial competitiveness, as it is assessed on the basis of a number of factors that describe the size, structure and use of productive resources, the socio-economic system, the government's economic policy and the international economic environment. All these factors determine the ability to compete in foreign markets and to achieve a certain competitive position. Meanwhile, the competitive position indicates the level of economic development achieved by a country and reflected in the level of income, as well as the efficiency with which factors of production are used, and the country's position in foreign trade (Kowalski 2013, p. 77). Meanwhile and Gorynia (1998, p. 35) proposes a division into an *ex post* competitive position, i.e. the current competitive position, which is the result of the implemented competitive strategy, and an *ex ante* competitive position, understood as a future (prospective) competitive position, which is determined by the relative ability of the company (compared to the abilities of its competitors) to compete in the future, and thus representing its competitive potential.

Economic competitiveness and its determinants can be analysed at different levels. With respect to the level of aggregation or geographical dimension, competitiveness can be analysed at different system dimensions:

1. microeconomic competitiveness (single company level),
2. mesoeconomic competitiveness (regional or sectoral perspective),
3. macroeconomic competitiveness (country level),
4. megaeconomic competitiveness (group-of-countries perspective),
5. metaeconomic competitiveness (competition between different models of capitalism).

It should be noted that all the above-mentioned levels are strongly interconnected, as it is the successes of single companies that determine the prosperity of local regions, which subsequently contribute to the development of particular countries forming bigger groups of national economies sharing similar characteristics (Kowalski 2018).

1.6 The Impact of Regional Disintegration on Production and International Trade

Regional disintegration means that some effects of the customs union are eliminated. One of the most important is the trade creation effect, which occurs when domestic production of a good in a member country is replaced by imports of the same good from another member country within the customs union because of lower production costs. From this perspective, Brexit would reverse this process, meaning that some goods would be produced in the UK instead of being imported from continental Europe. However, this would not benefit customers because of higher prices for such products. In the same way, exports of British products to the European Union would be diminished because of the disintegration process.

Another economic consequence of regional disintegration is connected with the trade diversion effect, which occurs when imports from a non-member country are replaced by imports from a member state because of the application of common customs tariffs to non-member countries. In this scenario, part of Britain's exports to different EU countries may be replaced by trade between member states.

Regional disintegration may lead to some dynamic effects. Based on the results of a systematic investigation of the dynamic effects of economic integration that was first carried out by Balassa (1961), it is possible to identify the following effects of regional disintegration:

- adverse effects on economies of scale: as globalisation and regional integration have brought with them a fragmentation of production and vertical specialisation, leading to economies of scale, the regional disintegration process will diminish the disintegration of production, at least to some extent, limiting the economies of scale experienced by an economy leaving the union;
- adverse effects on competition: leaving the customs union diminishes the market in comparison with free trade and reduces the level of competition, with negative consequences for efficiency;
- adverse effects on capital formation and investment: leaving the customs union may diminish outside investment. This would have negative effects on international competitiveness as investment is usually attracted to the most productive and competitive sectors;
- adverse effects on the terms of trade in the economy leaving the union; the terms of trade may deteriorate as the country will have less bargaining power;
- negative impact on technological progress and innovation, as undertaking joint research and development (R&D) or international cooperation for the sake of technology transfer are becoming the key drivers of the innovativeness of economies, especially in the context of internationalisation processes involving innovation (so-called techno-globalism).

1.7 The Impact of Regional Disintegration on the Mobility of Capital: Foreign Direct Investment

Regional economic disintegration, which increases regional trade barriers and investment restrictions, negatively impacts different forms of firm internationalisation processes, including foreign direct investment (FDI) flows. FDI, one of the possible channels of international economic involvement, represents a large part of the increasing and all-encompassing trends towards globalisation. Basically, it is a part of multinational companies' attempts to overcome obstructions to foreign trade, licensing, joint ventures, management contracts and so on, so the reason for its growth at the global level is the imperfections in the world economy and protective trade policies pursued by different countries. According to the definition by the International Monetary Fund (2009, p. 100), foreign direct investment "is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy".

The inflow of foreign direct investment results in many benefits for the host economy, so different countries compete trying to offer better conditions and incentives to attract multinational companies. For example, multinational companies can bring new technology and provide technical assistance, which is especially valuable for developing countries. Foreign direct investment generates jobs for both skilled and unskilled labour and contributes to GDP growth. These benefits may be reduced by regional disintegration, which diminishes the capital inflow to the economy leaving the integration grouping. One of the main reasons is smaller market size because of regional disintegration. This may motivate foreign companies to move their investment from a country leaving an integrated economic area (i.e. the UK in the case of Brexit) to other countries within this area. According to different studies, the size of the host market is an important determinant of attractiveness to FDI (Globerman and Shapiro 2003). This especially applies to market-seeking investors, whose motivation is focused on gaining access to particular markets through local production and distribution, rather than by exporting from the home country or from a third country. Entering a new market provides a company with a chance to achieve economies of scale and to be more competitive. Market-seeking investment is attracted by factors including host country market size, per capita income and market growth.

Regional disintegration may provide national economies with additional location-specific advantages that serve to attract FDI. One of the tools that may be applied when analysing this problem is the diamond model of competitive advantage proposed by M. E. Porter (1980). The model distinguishes between different location-specific advantages:

1. factor conditions,
2. demand conditions,
3. related and supporting industries,
4. industry structure and rivalry.

Regional economic integration may influence changes in location-specific competitive advantages. For example, new market boundaries can reduce the rivalry among competitors (which is the fourth component of Porter's diamond model). A smaller market will also have a negative effect on the buying power, while the bargaining power of buyers will decrease due to smaller supply (so the second component of Porter's diamond model is affected). It should be noted, however, that theoretically, the loss of an economy leaving the union depends on the size and strength of this economy. Based on the J. Dunning (1997) observation that Regional Integration Agreements may modify firm-specific advantages—which, in turn, have an impact on incentives for companies to undertake FDI—regional disintegration may weaken the geographical concentration of specific industrial activities. This is because businesses in the country leaving the union have less of an incentive to concentrate their production in the market with higher production costs, as the economies of scale are diminished. This finding is of particular relevance to industries that exhibit significant agglomeration economies, meaning benefits that companies obtain when locating near each other (Blomström et al. 1998, p. 5).

1.8 Conclusions

The Brexit referendum has changed the perspectives of European integration, which was previously perceived as a constant process of deepening cooperation among countries. Although there are some theoretical concepts that form the background for analysing regional disintegration, such as "new intergovernmentalism" and neo-functionalism, economic theory has failed to provide a deeper analytical explanation of the mechanics of this process. In the case of Britain's exit from the European Union, it must be noted that negotiations on the rules and exact timetable of the process started in 2017 and different scenarios are possible, including different variants of a so-called soft Brexit, which would imply Britain continuing to enjoy some form of a common market or customs union with continental Europe. If, on the other hand, a "hard Brexit" scenario were to pan out, removing the customs union between the UK and the EU would eliminate the trade creation and trade diversion effects. It would also lead to adverse dynamic effects on economies of scale, competition, capital formation and investment as well as terms of trade, technological progress and innovation. Disintegration processes, by increasing regional trade barriers and investment restrictions, would negatively impact different forms of firm internationalisation, including FDI flows to the UK. This would reduce many of the benefits for the British economy in areas such as job creation and technology transfer.

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