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Free Trade, Economic Integration and Nationhood**

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Abstract

The ability to achieve "national economic targets", including such considerations as the amount of redistribution of product by means of the central government actions, the establishment of national time preference in terms of resource exploitation and other collective decisions, is defined as "nationhood". The effect of increasing degrees of international economic involvement are considered in terms of their costs of "nationhood" renounced : these costs need to be set against the gains from more efficient resource allocation in determining the desired degree of international economic involvement or integration.

I. Introduction

The arguments for free trade and economic integration are set out purely in terms of economic efficiency(better global resource allocation and particularly so in the presence of substantial economies of scale) and pay no heed to any aspects of life which cannot be resolved efficiently by a system of(static) competitive decentralized markets. Free trade eliminates barriers to the exchange of goods(and, potentially, to services) while economic integration eliminates national boundaries as impediments to a broader range of economic activities including international movement of factors of production.[1] In a world in which some concept of "national character or identity" exists(i.e. there is a distinctive set of collective values with respect to economic policies which enter into

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1. Gray(1987, pp. 238-240) distinguishes five possible levels of economic integration. In this note, the concept of integration employed is that of a common market(the elimination of impediments to internal trade and to the mobility of factors of production) except for the lack of a common external tariff with other countries. The concept falls far short of full economic union which involves political union and monetary integration.

the national welfare function), neither free trade nor full integration need be optimal(or even second best). Economic analysts have ridden roughshod over the idea of national character in their search for Pareto's elusive optimum, by assuming that each individual has a given and independently determined set of tastes.[2] This note draws attention to some possible implications of this failure to allow for national character in the establishment of free trade areas for goods, for services and for further movement towards economic integration.

The argument could be made in terms of the process of colonialization by which a colony may be considered to undergo enforced economic union with the metropolitan country, in terms of a free trade agreement between a small or backward country and a large or more developed country or even to the incorporation of quite different ethnic cultures within a(federal) nation state. Kindleberger(1984, Ch.2) effectively considers the problem in terms of the difference between the optimum sizes of a social, political and economic unit. The optimum size increases when the decision criteria change from social to political and from political to economic so that the optimum economic size has enfolded diverse social and political groups within a single entity and social or political independence has been sacrificed in favor of economic efficiency(Social character or political nationhood has been surrendered for prospective gains in per capita income.) The integration is not necessarily bad and one might think that if the economic gains achieved exist well into the future, the economic benefits will almost inevitably outweigh the costs of nationhood renounced. The argument for free trade and economic integration is, presumbly, more likely to exist in some long-run equilibrium than in short-run transitory terms. This assertion would be refuted in the case of colonies in which the benefits from colonization almost inevitably fall disproportionately into the hands of either the metropolitan power itself or expatriate citizens of that power(Gray, 1976, ch. 7). Similar arguments might be made for developing countries entering into a union with an industrialized nation.

The failure of economists to allow for costs of nationhood renounced when considering the benefits to be gained from free international trade and economic integration means that their analyses have little to say about the actual or political decision to undertake the integration process[3] and neglect certain costs which an electorate might

2. Meade(1952, p. 1) was heroic enough to assume identical tastes for all individuals in both(all) countries.

3. The European Community is a very successful case of integration achieved in the aftermath of major economic trauma and launched among nations of roughly equal per capita incomes although there were significant disparities in size in the original six members.

see as quite relevant.[4]

This paper posits that the difficulty of maintaining the national identity, and therefore the "political-economic(socioeconomic) cost" of each stage of international involvement, increases with the progression from autarky to free trade in goods to free trade in goods and services to economic integration : free trade in services is identified separately because some services impair nationhood more severely per dollar of transaction than does trade in goods.[5] In Kindleberger's concepts, increasing international involvement moves the unit towards the economic optimum size and away from the existing political size-presumably implying economic benefits and political(social) costs.

If the process of increased economic involvement with the rest of the world does not generate political costs or these costs can be authoritatively described as being less than the economic gains, then there is no problem. Here again the time dimension is crucial as economic gains can increase as technological innovation provides new efficiencies to undertakings of large size or become greater with the combination of a higher growth rate and the passage of time. Equally, the values of individual nationhood may wane as new generations are born into the more closely integrated world.[6] Thus in authoritative regimes where the governmental decisionmakers also define the national economic values, the lack of attention to national character has no interest. This paper is, then, confined to analysis of democracies.

The concept of "national character" is sketched out in Section Ⅱ : the questions of how free trade in goods and in services and economic integration affect national character are treated in Section Ⅲ, and the implications of the effect of the(economic) size of countries involved is examined in Section Ⅳ. The argument will be laid out in terms of one country and the rest of the world throughout and in terms of voluntary,

4. The recent Canadian election amounted very largely to a plebiscite on the question of the Free Trade Agreement with the United States. Since the election, the perceived costs in terms of nationhood renounced have resulted in a substantial swing in public opinion in Canada. In 1988, a large-scale polling of Canadians found that 57 percent of the persons polled favored the Canada-U.S. Free Trade Agreement with 32 percent against the Agreement. In 1989, the numbers had shifted to 52 percent opposed against 43 percent in favor. One academic commentator reported : "We do not have a free-enterprise, look-after-yourself--in a word, 'American'--view of ourselves up here." (Reported in Maclean's, January 1, 1990, p. 22).
5. Geld and Sagari(1990) discuss the fact that multinational banking can inspire urgent requests for protective legislation from people who fear foreign domination of this pivotal sector.
6. Scottish nationalism in the United Kingdom, the longstanding separatist movement in Quebec in Canada and the recent burst of nationalistic fervor in the U.S.S.R., all suggest that old national identities are slow to disappear.

democratically-determined decisions to increase the degree of international economic involvement : the argument can potentially refer either to a bilateral or to a global agreement on free trade or integration.

Ⅱ. Nationhood [7]

A nation consists of people who share common customs and history as well as a common currency. They also share economic goals and/or values although, clearly, there are internal divisions and nationhood concerns must be seen separately from the rentseeking activities of internal groups. Democratic nations are entities which define their national goals through the electoral process. The electoral process in a pluralistic society is by no means a perfect mechanism but it is possible for a consensus to be reached so that a nation may elect to power the political party with that program or platform which best represents the values of the electorate's view at the time of the election and on the issues aired during the campaign. The importance of preserving national economic values and, therefore, some degree of national independence will be one of the many variables included in a political election. But a major change in policy or a quantum leap beyond the domain considered in the election could exceed the mandate given to the majority party. National values can vary across national boundaries on a whole range of [political-economic] issues :

the maximum tolerable inequality of income distribution ;[8]

emphasis on employment levels ;

the emphasis to be put on equality of regional prosperity ;

the level of provision of collective expenditures ;

the levels and marginal burdens of taxation among income classes, between corporation and the household sector and between direct and indirest systems of taxation ;

time preference ;

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7. "Nationhood" with a range of values from zero to one(shades of grey) has been chosen over the term "sovereignty" which implies a zero/one(black/white) distinction. The concept is essentially economic and omits many political dimensions.
8. Including the amounts and rules governing payment of transfer payments either directly from government or indirectly in terms of the structure of taxes.

the rate of exhaustion of natural resources ;[9]

expenditures on national defense etc ;

the willingness to submit sectors to regulation.

These collective decisions(nationally-preferred departures from pure laissez-faire) may be referred to as the national "general interest"(Cf. Tinbergen, 1970, Ch. 1) and can differ substantially among nations.[10] The ability to maintain such differences can be referred to as "nationhood". No nation in a world with any economic or political interdependence(i.e. in other than a state of complete autarky) has perfect nationhood so that what must be envisioned is a measure of nationhood on a relative scale(shades of grey). In a world in which all nations have the same political consensus on economic values, nationhood has no importance in terms of the desirable degree of economic integration. Differences between the economic values of the country and those prevailing in the rest of the world must exist before "national character" can constitute an interesting dimension of analysis of commercial policy.

When the world economic system is tranquil(i.e. not in serious disruption because of shocks within the global economy), there is an economic cost to nationhood in the sense that greater independence or nationhood will reduce the gains potentially available from being a member of a freely-trading or an integrated global economy, i.e. greater nationhood involves a reduction in potential gains from international exchange and specialization.[11] When the world economy is turbulent or disrupted, the benefits of non-involvement can be tremendous in the sense that it becomes possible for a nation to isolate itself, albeit less than completely, from foreign disruptions as well as enjoying the distinctiveness of its own "general interest".[12] Finally, any consideration of integration plans must countenance the possibility that integration could overwhelm some effective

9. It is important to recognize clean air and water as natural resources so that environmental concerns are included with the rate of exhaustion of natural resources. Free factor movement can be taken to imply "national treatment" but both foreign and domestic corporations can, in principle, be dragooned by tax measures.

10. It is possible to think of the collective character of national tastes as an externality. These considerations are not explicit in most models of commercial policy presumably on the grounds that any "costs" of integration can be offset by domestic measures. This position does not allow for the limitations of governmental effectiveness.

11. It is assumed that the global gains from greater interdependence will always be shaed between the two parties so that the individual nation always has some benefit from greater international involvement.

12. Always assuming the disruption has its roots in foreign markets or in foreign countries. Foreign involvement permits a reduction in the amount of adjustment needed when the disturbance has a domestic origin.

political constraints, e.g. that high levels of employment be feasible for all regions of the country. Such a condition would preclude creating an arrangement that permitted free mobility of labor between a large labor-surplus country and a small country.

The argument for free trade assumes that electorates in protectionist nations fail to recognize the potential gains from trade or that potential losers from free trade manage to prevent an increase in economic efficiency in order to maintain their own privileged positions. In other words, free trade is seen as a means of maximizing economic gains from involvement in the global economy and protectionism is assessed purely in terms of the costs and benefits deriving from more efficient resource allocation. The argument for free trade is set in static(or tranquil dynamic) equilibrium with no externalities so that, in the absence of some possible positive optimum tariff which would increase the share of world output) the national benefits of protectionism are negligible.[13]

Nationhood, then, represents the degree of achievement of a national general interest function which will enable the nation to perform as well as it can according to its own collective set of values. It has a positive economic cost(assuming disruptions originate abroad) since it requires potential gains from international involvement to be sacrificed in the pursuit of nationhood. These gains may be conceived either in terms of income foregone on a permanent basis or may simply involve a reduction in the social costs of adapting to externally-generated instability. In extreme, pure nationhood(sovereignty) requires economic isolation. The greater the turbulence arising from foreign disruptions or shocks, the greater are the benefits from a high level of nationhood or non-involvement in the world economy.[14] If the global economy shows signs of or is experiencing severe instability, there is a serious possibility that, by reducing involvement in the global economy to a minimum, a country's domestic economy can avoid the con-

13. There are, of course, distributive gains from protectionism for some. The failure of the free trade model to include exhaustible resources also poses problems of long-run benefits against more immediate benefits from exhausting the natural resources for the benefit of the existing generation. A more sophisticated assessment of commercial policy(Bhagwati, 1989) argues only that free trade is better if the assumed conditions are met, and that intervention may have value if they are not met. On the other hand, where the assumptions are not met because of a domestic problem, the matter is better solved by eradicating the domestic problem than by imposing protectionist measures.

14. Vulnerability to economic sanctions or trade warfare is directly related to a lack of nationhood (Gray and Licklider, 1985).

sequences of that global instability.[15]

Free trade is not the ultimate degree of economic involvement in the global economy : it is surpassed by complete economic integration which allows for the free movement of factors of production across national boundaries and, inevitably, the integration of national values with the global general interest function--largely influenced by the economic policies of the largest nations.[16]

It is not possible to separate free trade and economic integration completely from financial integration in which financial claims are freely mobile across national boundaries. The potential of financial integration for disruption(even in a world of little movement of physical factors) is substantial, if only because of the speed with which financial claims can be shifted from on financial jurisdiction to another through the foreign exchange market.[17]

Ⅲ. Free Trade, Economic Integration and Nationhood

In abstract analysis, it is possible to distinguish between free trade involving the absence of barriers to the exchange of goods(and services) and full integration. Free trade would exclude the freedom of movement of factors of production implied by economic integration and would, therefore, provide greater freedom for national decisions on tax structure and incidence as well as on environmental and other regulations that would impact on factor movements and income distribution.[18] Integration, by allowing full freedom of movement to factors of production including capital and therefore of inward

15. This statement needs qualification to the extent that it would require adept and intelligent economic policy on the part of the authorities of a nation be it never so slightly involved in the turbulent global economy. Moreover, it is unlikely that a nation can change its degree of international economic involvement if it forsees forthcoming turbulence and to attempt to withdraw from the international economy after the onset of depression will inflict even greater social costs.
16. That is, if the outside world is run on purely laissez-faire principles, full integration into that world would effectively oblige a country to conform to the dictates of laissez-faire.
17. Here again, there is a trade-off between the real gains that derive from perfectly integrated financial systems(Bryant, 1987, Ch. 6), and the costs of potential instability international financial markets. Unfortunately few economic models which focus on allocative efficiency allow for the possibility of gains from a reduction of instability(Gray and Gray, 1981, pp. 55-61).
18. If the ability of national high-technology firms and industries to compete internationally is determined by the ability of those firms to reinvest revenues in R&D in the broadest use of the term, then a nation has no alternative but to allow its corporate profits tax rate and base conform to the international norm and, in this way, the freedom of tax structure is restricted even with free trade.

and outware direct and financial investment as well as the mobility of labor, implies a lower level of nationhood than free trade. Provided that trade is balanced, free trade will influence rates of return on different factors of production if factor markets are competitive : the extant degree of income inequality may be affected in this way. But limiting international involvement to free trade in goods will allow a nation to align trade flows and production patterns with other national values so that, for example, it will be possible for a nation to favor tighter environmental controls and to eliminate an ostensible comparative advantage in the production of some product(s) with high environmental costs. Such measures would require a reduction in the nation's net barter terms of trade but would allow the nation to impose its collective will on the returns to certain resources--in this example, clean air and water. Any unwillingness to expose the national economy to domination by international trade can be achieved by some sacrifice of the terms of trade(i.e. a deterioration in the real rate of exchange).

To push beyond free trade to freedom of factor movements in both directions is to recognize the ability of factors to seek their perceived highest rate of return in either country. The country with the most favorable tax structure for highly sought-after factors will gain the greater share of those factors : to prevent such a loss, a country may find itself forced to reduce still further its level of concern for, say, the equality of income distribution and must meet the factor-market conditions prevailing elsewhere. Thus, "national general interest" becomes submerged in the "global general interest".

International trade in certain services is to be distinguished from trade in goods by the fact that these services require a "related foreign presence" if they are to serve customers in a foreign market(Gray, 1989). Such services, especially the knowledge-intensive services which benefit greatly from new developments in data handling and communications, will require freedom to invest abroad if they are to be provided by a foreign source(Sauvant, 1986, pp. 31-5). The existence of trade in these services also requires that foreign corporate subsidiaries be given the same freedom of scope and action as indigenous firms(so-called "national treatment").[19] Thus, free trade in these services blurs the distinction between free trade in goods which can, in principle, be thought of as being conducted without foreign direct investment, and economic integration with freedom of movement for factors of production,

19. The inability to separat freedom of trade from freedom to invest presents serious problems for multilateral trade negotiations under the GATT which has steadfastly declined to be involved in problems stemming from foreign direct investment.

Some aspects of economic life are more closely allied to national identity than others. One of the basic features of national economic identity is the national currency and financial system. Similarly, the right to privacy of citizens is important. Both of these are endangered by free thrade(and investment) in knowledge-intensive services such as data-processing and financial activities. This is likely to have a greater social costs for a developing country when freer trade in services can be expected to allow domination of the national financial system by foreign firms using their better technology and better access to sophisticated capital markets than can local firms. By the same token, it is not unreasonable for home governments to insist that foreign financial subsidiaries in the country be structured so as to be certain to be able to meet their local obligations irrespective of the level of income of the host country(Hindley, 1982). Moreover, as with all direct investment, there is the awareness that, unless circumvented, foreign subsidiaries will be better able to ignore the host-country's political goals(national character) than indigenous firms can or would want to.[20] In the financial sector, this is potentially crucial.

The cost in terms of nationhood foregone could increase sharply once nations integrate beyond the level of free movement of goods. There can be no assurance that the economic benefits will be worth the cost in nationhood renounced.[21]

Ⅳ. The Effect of National Size

For any given disparity between the national character of the nations and the composite national character of the rest of the world, the economic size of the nation opening itself up to free trade or economic integration will have an influence upon the diminution of nationhood that accompanies the liberalization of global economic activity. If full integration were to be achieved through political union and a common general in terest function were to evolve, all nations would potentially lose a substantial amount of

20. A simple graph would show the costs of integration increasing with international involvement with upward shifts of the curve as first services and then complete freedom of factor mobility are introduced.
21. The problem is particularly severe when a small nation relies heavily on exports of tourism services so that the home culture is swamped by the numbers of tourists who inevitably impose some of their home values and as the culture is commercialized for easy consumption by the visitors.

their national characters to the new composite identity.[22] Presumably, the new national identity would be some political compromise, approaching a weighted average of the individual values of the previously separate nations. In practice the exact outcome would be impossible to formulate because the chemistry of any association is likely to take over and dominate a simple process of "proportionate representation". The smaller the nation as a part of the final group, the less would its national characteristics and preferences be expected to be identifiable in the final amalgam. Given the existence of economies of size, the final distribution of features might be expected to tend to over-represent the values of large nations and the interests of their indigenous corporations.

In terms of economic power, the larger nation or group of nations would be expected to have a decisive influence if only because of the funds which they control. This might be particularly damaging to periphery nations with large supplies of natural resources needed by the metropolitan, larger countries.[23] Similarly, the more economically involved a nation would be with its partners(the higher the rations of international trade and foreign direct investment to gross domestic product), the more a movement towards free trade or economic integration might be expected to reduce nationhood. This does not imply that nationhood is in danger of being reduced to zero because some areas of economic activity are still peculiarly national and because, at least in the early years of integration, some sense of loyalty to or preference for the home country might be expected to affect individual decisionmaking.

The outcome of notably freer trade or greater economic integration will probably take a long time to evolve as the process of integration works itself out to some new situation of approximate balance. Even with the best brains in the world, it would be impossible to forsee either the magnitude of the economic benefits or the final extent of the loss of nationhood involved in any proposed agreement.[24] The size effect suggests that smaller nations would have a steeper "cost curve" in terms of nationhood sacrificed

22. Recall that nationhood is only lost if the amalgam of global values differs from the individual nation's own "national character". The loss of identity is a phenomenon that contains both economic and non-economic components. Such costs of loss of nationhood might generate antipathy to greater international involvement, i.e. the submergence of Ruritania into a monolithic Balkan state might well cause distress among the citizens of Ruritania. This problem lies at the root of concerns of ethnic minorities but is undoubtedly accentuated by perceived economic inequality between groups and discrimination.

23. This problem is one of the essential features of colonial exploitation but also plays a role in the history of Canadian-U.S. relations.

24. There are very severe measurement problems of anything as intangible and multi-dimensional as "nationhood" so that empiricism is probably impractical.

per unit of economic integration than would larger nations.

V. Conclusion

It is argued that there exist two discontinuities in the schedule denoting costs of nationhood renounced in terms of the degree of economic involvement. The first discontinuity comes when free trade in goods has been achieved. Free trade in [knowledge-intensive] services, to the extent that it penetrates closer to the heart of the national character, may involve a higher level of loss of nationhood. Finally, full integration(as the term is used here and involving perfect freedom of movement of factors of production) imposes a still higher cost of international economic involvement. It is difficult, if not impossible, accurately to estimate at what level of integration the costs come to exceed the benefits--not least because of the difficulties of estimating and measuring the costs and benefits over the long-term. However, the longlasting opposition to economic unification of colonies and culturally distinct components of larger(federal) nations suggest that economic integration is not costless even over the longer term and that the costs of loss of nationhood can exceed what are arguably substantial gains from economic integration. Of course, where gains are not seen as being "reasonably equally divided" among participants(as in colonialism), economic gains acknowledged by the group which receives the smaller share, may appear very small indeed.

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