European integration and the economic development of border regions

Conf. univ. dr. habil. Diego VARELA, Universitatea Alexandru Ioan Cuza din Iasi and Universidade da Coruña

Keynote speech at the International Economic Conference "Cross-border cooperation: key ideas and perspectives", Yuriy Fedkovich Chernivtsi National University and Ştefan Cel Mare University Of Suceava, 20-21 May 2016.

Distinguished authorities, professors and students,

First of all, I would like to thank the organizers of this conference, the universities of Chernivtsi and Suceava, for the invitation to deliver this keynote lecture to such a distinguished audience. Chernivtsi and Suceava are not only regions of maximum scientific and political interest for the future of Europe. They also have a profound sentimental value for me. My wife was born in Suceava and, when we got married eight years ago, we came to Chernivtsi to buy her wedding dress.

The topic I have chosen for this lecture, Economic Integration and Economic Development of Border Regions, is one I believe is of the utmost importance not only for our regions, but also to help us understand the process of European Integration and some of the main European Union policies. Understanding this process may also help us understand some internal developments in our own countries, and help us make better informed decisions.

European integration is mostly about the creation of a common market, by eliminating barriers to the free movement of goods, services, capital and workers. It is well known, from the writings of great economists such as Adam Smith, that free international trade can allow countries to specialize in the production of those goods in which they are more efficient, which in turn leads to gains in productivity and higher standards of living. The European Union common market can be seen as a trade liberalization initiative, which in principle would contribute to the achievement of these benefits.

But the effect of EU liberalization on economic development is not so clear-cut, because the kind of liberalization the common market provides is of a special kind: it is discriminatory. European integration means the elimination of barriers with other EU member states, while the barriers with third countries are maintained and, in some cases, increased. It has been argued sometimes that the EU is very open inside its borders but much closed to third countries. The proponents of this argument have even coined the expression of a "Fortress Europe".

Thanks to the contribution of economists such as Jacob Viner, we now know that discriminatory trade agreements such as the EU produce not only positive effects, what is known as "trade creation", but also negative effects that are known as "trade diversion". Trade diversion means that trade is diverted from a more efficient exporter towards a less efficient one by the formation of a free trade agreement or a customs union.

When a country applies the same tariff to all nations, it will always import from the most efficient producer, since the more efficient nation will provide the goods at a lower price. With the establishment of a bilateral or regional free trade agreement, that may not be the case. If the agreement is signed with a less-efficient nation, it may well be that their products become cheaper in the importing market than those from the more-efficient nation, since there are taxes for only one of them. Consequently, after the establishment of the agreement, the importing country would acquire products from a higher-cost producer, instead of the low-cost producer from which it was importing until then. In other words, this would cause a trade diversion.

A simple example will help us understand this phenomenon called trade diversion. Let us imagine that a country called Romania imports chocolate bars from a neighboring country called Ukraine, because it is the most efficient producer. Let us say that in Ukraine a chocolate bar costs 0.90RON plus 20% tariff, i.e. 1.08RON. Let us say that the same chocolate bar produced in Germany costs 1.00RON plus 20% tariff, i.e. 1.20RON. Romania imports the chocolate bars from Ukraine, the most efficient producer.

But let us now imagine that Romania joins the European Union, and tariffs with other member states such as Germany are eliminated, while the ones with third countries such as Ukraine are maintained. As a consequence, now a chocolate bar imported from Germany will cost only 1.00 RON, as compared to 1.08RON for a chocolate bar from Ukraine. Romanian consumers will now rather buy German chocolate bars.

If we look at the welfare effects of this change, we can clearly see that Romanian consumers are now better off, because they can buy chocolate bars from Germany at 1.00 RON that formerly cost them 1.08 RON from Ukraine. They have gained 0.08 RON per bar. But what happens to the revenue from tariffs and import duties? It has been reduced from 0.20 RON to zero now. The overall welfare effect for Romania is negative (-0.12 RON).

The relative size of the trade creation and trade diversion effects will depend of who the most efficient producer was before European integration took place. If the most efficient producer was already inside the EU, the increase in trade will represent pure trade creation. If the most efficient producer was outside the EU, trade diversion will have a greater weight. It is thus important to know who the natural trading partners are before a decision on European Integration is taken.

There have been several empirical studies, some of them financed by the European Commission, to assess the net welfare effect of the single market in terms of trade creation and trade diversion. Almost all of these studies conclude that European Integration has had a net positive effect for EU member states.

But all these studies have in common that they look at the welfare effects of integration in the EU single market from a national perspective. They calculate the difference between the trade creation and trade diversion effects at country level, neglecting any regional differences inside member states.

This makes sense if we have regard to the fact that, in the simple model presented above, all Romanian consumers benefited from lower prices after EU integration, and it was only the government's finance that lost from the reduction in tariff revenue from its imports from Ukraine. As this revenue accrues to the national government, no region should be particularly harmed.

But the previous assumption that the negative effects of trade diversion are spread equally throughout the country is little realistic, and this is why I find that this topic is of special relevance for the participants in this conference. We just have to ask the border guard in the border between Romania and Ukraine, or take a walk in Suceava's bazaar, to realize that the negative effects of trade diversion have affected the Suceava region more than others in Romania.

A simple gravity model of trade can help us understand that the distribution of trade creation and trade diversion effects will not be evenly distributed across regions inside the same country, and that border regions can be the ones that benefit the most (EU internal border regions) or suffer the most (EU external border regions) from European integration.

This has important implications for the economic development of regions like Chernivtsi as a consequence of the process of integration of Ukraine in the European Union. The argument presented so far means that the region of Chernivtsi, as an EU internal border region, is likely to be among the winners from European integration.

Also the region of Suceava is likely to benefit greatly if Ukraine proceeds with its current European integration trend. The negative trade diversion effects that we saw in the last years will be turned around into trade creation gains if the barriers to trade with Ukraine are eliminated.

But the argument developed so far can also help us understand the regional cleavages that the European integration process has produced among Ukrainian regions, which has literally divided the country around this issue. The argument developed here may help us understand some of the sources of this division. Border regions such as Donetsk or Lugansk, if the process of Ukrainian integration continues, risk becoming EU external border regions, with all the risks associated to the new peripheral status.

The European Union has a well-known policy of structural funds to assist regions in economic difficulty, and the North-East region of Romania is well aware of that, but not everyone may agree that this is the optimal solution. In a time of deep economic crisis and national divisions inside the EU, the faith some have in such policies is also limited.

An appropriate neighborhood policy is essential for the future of the EU. European integration is an important process with important potential gains, but it is also important for the EU to have an appropriate neighborhood policy that maximize these gains. Border regions like Bukovina know the importance of this and have a special role to play in this debate.

Thank you very much.