

THE EVOLUTIONARY LOGIC OF THE THEORETICAL FOUNDATION OF REGIONAL ECONOMIC INTEGRATION

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Abstract. This paper systematically sorts out the three-stage evolution of regional economic integration theories, explores its dual driving force, reveals the paradigm shift and provides theoretical guidance for contemporary deep integration practices.

Keywords: Regional economic integration, theoretical evolution, deep integration, institutional governance.

REGIONAL İQTİSADI İNTEQRASIYANIN NƏZƏRİ ƏSASININ TƏKAMÜL MƏNTİQİ

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Xülasə. Məqalədə regional iqtisadi inteqrasiya nəzəriyyələrinin üç mərhələli təkamülü sistematik şəkildə araşdırılır, onun ikili hərəkətverici qüvvəsi araşdırılır, paradigma dəyişikliyi üzə çıxarılır və müasir dərin inteqrasiya təcrübələri üçün nəzəri istiqamət verilir.

Açar sözlər: Regional iqtisadi inteqrasiya, nəzəri təkamül, dərin inteqrasiya, institusional idarəetmə.

1. Introduction

In the current context of globalization and profound adjustments in the geoeconomic landscape, regional economic integration is undergoing a historic leap from “border tariff reduction” to “post-border regulatory integration”. This practical transformation also presents new demands for theoretical support. The academic community has long explored this topic, forming a complete theoretical system encompassing traditional trade paradigms and contemporary governance paradigms. A review of existing research reveals two typical limitations: one focuses on the vertical in-depth analysis of a single theory, failing to present the overall evolution of the field; the other tends to list different theories in parallel, failing to fully reveal the logic of connection and complementarity between them. This paper argues that the evolution of regional economic integration theory is largely an endogenous response of academic logic to changes in the global division of labor.

First, based on the theories of customs unions, large markets and new trade, the boundaries of markets were broken through and optimized. The logical starting point of this stage was resolving the contradiction between “market size and allocation efficiency” by eliminating explicit barriers to achieve economies of scale. Second, as the division of labor entered the process level, the theories of new trade and global value chains (GVC) emerged, driving profound changes in production organization models. Their core logic shifted from resource allocation between industries to the heterogeneous selection of micro-enterprises and

the transnational nesting of production processes. Finally, facing deep-seated institutional frictions, new institutional economics and new regionalism expanded their perspective to “upgrading institutional and governance models”. Their logical endpoint is to reduce “behind-the-border” transaction costs through institutional supply and to build a multi-dimensional governance system. Through this systematic review, this paper clarifies the evolution of core theories of regional integration, providing a more systematic integration framework for this field and offering theoretical reference for the in-depth advancement of new regional cooperation initiatives such as RCEP and the Belt and Road Initiative.

2. Breakthrough and optimization of market boundaries

In 1950, American economist Jacob Viner, in his book “The Problem of Customs Unions”, systematically defined the “trade creation effect” and “trade diversion effect” of customs unions. Through analyzing these two static effects, Viner first proposed that the impact of customs unions on the economic welfare of member states is uncertain. This view broke with the previous academic consensus that “trade liberalization inevitably increases welfare”, laying the analytical foundation for regional economic integration theory.

The trade creation effect refers to the fact that after the establishment of a customs union, the disappearance of trade barriers within member states leads to the replacement of goods previously produced at high domestic costs with imported goods from other low-cost member states. Resources and factors of production are rationally allocated among member states, expanding the scale of trade, lowering consumer prices and thus improving the economic welfare of member states and the region as a whole.

The trade diversion effect involves third-party countries outside the customs union. It refers to the situation where, after the establishment of a customs union, member countries eliminate tariffs among themselves while retaining a uniform external tariff on non-member countries. This leads member countries to shift their imports from low-cost, high-efficiency countries outside the union (third-party countries) to imports from member countries within the union, where production costs are relatively higher but price-competitive due to tax exemptions. Before Viner [23], few systematically explored the potential negative effects of free trade. This shift, based on artificial tax discrimination rather than production efficiency, leads to a reversal of global resource allocation and results in a loss of fiscal revenue for member countries and a reduction in potential consumer welfare.

The customs union can be likened to a balance scale, with the trade creation effect and the trade diversion effect on the other side. Only when the scale tilts towards the trade creation effect will more economic welfare be increased.

To visually illustrate the game between the two effects mentioned above, this study uses a partial equilibrium model, assuming three economies (A , B and C) and a single commodity K , to conduct a welfare analysis (Figure 1). In the figure, D_A and S_A represent the domestic

demand and supply curves for commodity K in member country A , respectively and P_I , P_{II} and P_{III} represent the import price of commodity K (including tariffs), the price in member countries and the world market price, respectively. After A and B establish a customs union, the price of commodity K decreases from P_I to P_{II} . At this point, the trade creation effect is represented by the area of $\Delta abc + \Delta efg$ in the figure. Here, the area of Δabc represents the gains from increased production efficiency (production substitution) and Δefg represents the increase in welfare from expanded consumption. Meanwhile, the trade diversion effect is represented by the area of $\blacksquare adhe$. It represents the fiscal loss that the government of A could have obtained from importing from low-cost countries (non-member country C) after diverting to member country B . In summary, the net welfare change of the customs union depends on the comparison between the area of $\Delta abc + \Delta efg$ and the area of $\blacksquare adhe$. This geometric model rigorously proves Wiener's assertion about the “uncertainty” of integrated welfare: only when $\Delta abc + \Delta efg > \blacksquare adhe$ does it have a positive welfare effect.

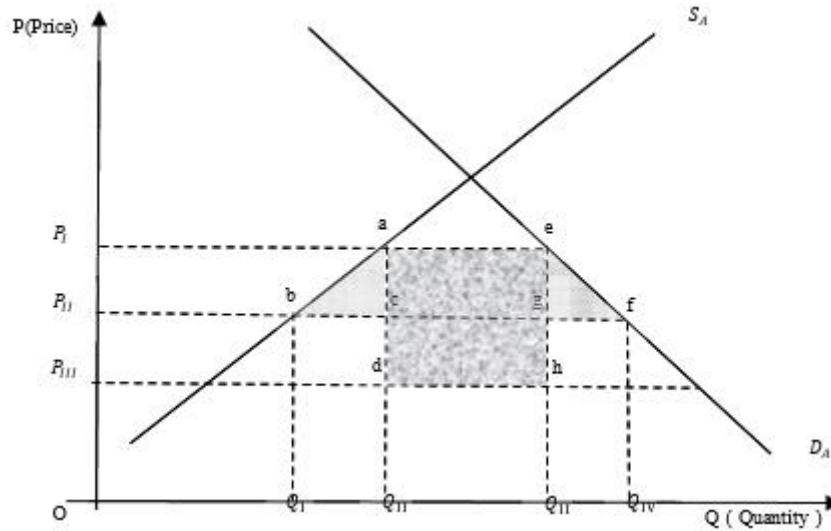


Figure 1. Analysis of the welfare effects of a customs union

The traditional customs union theory [23] primarily focuses on the static welfare redistribution effect after the elimination of trade barriers, but this framework is clearly insufficient in explaining the long-term growth drivers of integration. In the late 1950s, Scitovsky [21] and Deniau [5] jointly proposed the large market theory. Rooted in the classical economic proposition that “the division of labor is limited by the scope of the market” [20], this theory argues that protectionist policies hinder market integration between countries, leading to the fragmentation of large regional markets into smaller units. The market fragmentation caused by protectionism is an institutional barrier to achieving economies of scale. The theory emphasizes that economies of scale, factor mobility and production concentration and specialization should be achieved through market integration. This theory marks a shift in the

perspective of regional integration research from static welfare effects to dynamic growth effects.

Scitovsky focused on academic arguments from the perspective of economies of scale and investment efficiency, while Deniau, combining European integration practices, elaborated on the necessity of stimulating competitive pressure and optimizing industrial structure through a common market. Their research jointly demonstrated that “the breadth of the market directly determines the depth of resource allocation and the speed of technological innovation”. The large market theory provides a dynamic analytical framework for regional economic integration, but its theoretical premise has a significant explanatory blind spot: if a large market is a necessary condition for achieving economies of scale, how can we explain the strong motivation for large economies like the US and China, whose domestic markets already possess enormous scale, to participate in regional integration? This suggests that beyond simple output expansion, integration must contain more complex microeconomic motivations.

In the 1980s, American economist Paul R. Krugman proposed the New Trade Theory. By introducing the framework of monopolistic competition and increasing returns to scale constructed by Dixit and Stiglitz [6], it provided a rigorous microeconomic foundation for the dynamic effects of regional economic integration. Krugman [14] argued that due to the existence of fixed costs, markets exhibit imperfect competition characteristics and firms are strategic participants with a certain degree of pricing power. The theory emphasizes the internal economies of scale brought about by large-scale production, arguing that the driving force of trade lies in expanding market boundaries, enabling firms to spread fixed costs across national borders at a larger output level, thereby reducing unit costs [7]. Furthermore, the New Trade Theory was the first to introduce consumers' “diversification preferences” into its analysis, arguing that the value of integration lies not only in the general price reduction but also in breaking the limitations of a single small-country market that cannot support diversified production, providing benefits from product diversification [10].

To reveal the above microscopic mechanism more intuitively, this paper introduces the PP-ZZ local equilibrium model constructed by Krugman (Figure 2) for analysis.

In the graph, the horizontal axis C_n represents the product's consumption and P/w represents the average cost (including product price and buyers' real wages). The P -line represents the price markup a firm subjectively sets to maximize its current profits under monopolistic competition, given known market demand. The P -line reflects the positive correlation between price and consumption; the larger the consumption C_n , the lower the market demand elasticity and the stronger the firm's pricing power. The Z -line represents the firm's zero-profit line, reflecting the negative correlation between price and consumption; under economies of scale, the larger the consumption C_n , the lower the average cost P/w and the stronger the consumer's actual purchasing power. The P -line intersects with lines Z_1 and Z_2 at

price equilibrium points E_1 and E_2 , respectively, at which point firms have no ability to manipulate price increases and no firms enter or leave the market.

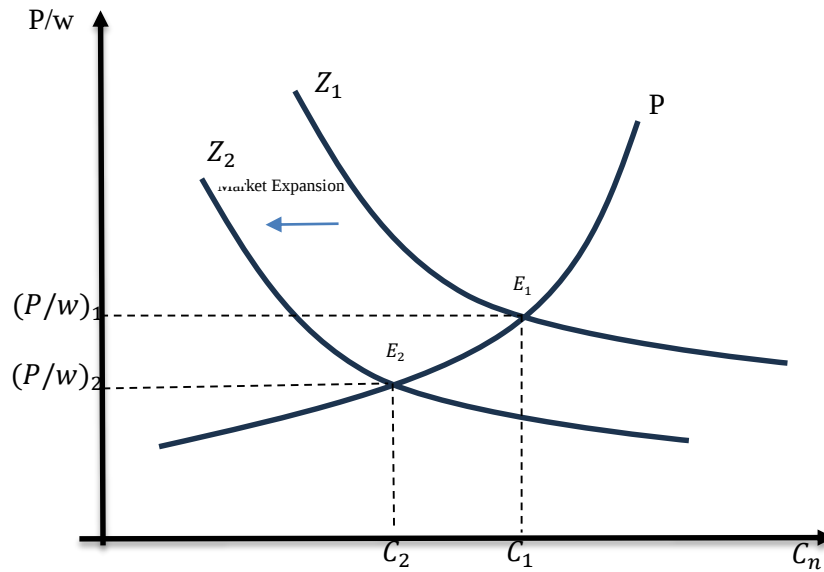


Figure 2. Market size expansion effect under regional integration

As the market expands, as shown in the graph, curve Z_1 shifts to the left to Z_2 . The average cost of the product decreases from $(P/w)_1$ to $(P/w)_2$ and the consumption of the product decreases from C_1 to C_2 . Firms have greater sales space, average costs decrease, firms achieve high-volume, low-margin sales and consumers can purchase a wider variety of goods at lower prices.

New trade theory finds that integration not only reduces average costs but also introduces more differentiated product varieties by expanding the market, satisfying consumers' diverse needs and constituting a significant welfare increment. Furthermore, Krugman [14] combined new trade theory with location theory, pioneering new economic geography and explaining the “center-periphery” structure of industries after large market integration. Later, scholars like Melitz [16] proposed firm heterogeneity based on representative firms, forming the micro-level research system of “new new trade theory”.

Overall, the theoretical research at this stage revolved around the core theme of “breaking down market segmentation between countries and optimizing the efficiency of regional resource allocation”. From the dismantling of static welfare through customs unions to the exploration of dynamic scale effects through large-market theory and the expansion of product diversity through new trade theory, scholars gradually integrated previously segmented national markets into unified regional markets, achieving a breakthrough and optimization of market boundaries. However, this stage of research was still mainly focused on industry-level analysis and had not yet delved into the heterogeneity of micro-enterprises and the transnational division of labor in production processes, leaving room for further theoretical development.

3. Profound changes in production organization models

In the early 21st century, American economist Melitz proposed the New New Trade Theory, shifting the perspective of traditional trade theory from inter-industry and intra-industry perspectives to a micro-firm perspective. This breakthrough also propelled the research perspective of regional economic integration theory further down to the micro-firm level. Using firm productivity, size and technological differences as core elements for analyzing trade theory, it abandoned the assumption of firm homogeneity in traditional trade theory and established a heterogeneous firm trade model. The theory posits that firms within an industry differ in production efficiency, size and technological endowment. Firms must pay an unrecoverable sunk cost before entering the market to determine their productivity distribution and only firms with productivity exceeding a certain threshold can achieve profitability and survival [16]. Firms with higher productivity prioritize export trade, while firms with lower productivity and other factors primarily produce and sell in the domestic market. With the development of integration, market competition within the region intensifies, raising the survival threshold of the domestic market and forcing the least productive firms to exit the market, resulting in an increase in overall industry productivity [11]. In his discussion of the relationship between market size, productivity and trade, Melitz points out that overall productivity depends on the combined effect of market size and the degree of market integration brought about by trade. The higher the degree of market integration, the higher the productivity level, but the lower the profit [17].

The New New Trade Theory, through the perspective of heterogeneous firms, successfully reveals the core mechanism of intra-industry resource reallocation under trade openness, clearly depicting the inherent logic of productivity improvement and changes in firm profits during market integration and establishing a basic analytical framework for understanding the export decisions and market selection behavior of micro-firms. However, this theory still treats core variables such as firm productivity differences and sunk export costs as exogenous givens, failing to further explain: what mechanisms drive the transnational allocation of production links? And what factors enable firms to achieve division of labor and cooperation across national borders? These questions mean that the operational logic of deep integration cannot be fully explained solely from the perspective of firm efficiency. This has prompted academia to further expand its research perspective to the level of transnational production division of labor and value chain organization, making global value chain theory the core theoretical support for analyzing changes in production organization models. It provides a key perspective for understanding how regional economic integration moves from “form” to “depth”.

The Global Value Chain (GVC) theory posits that with the transformation of information technology and transportation costs; modern industrial production has become highly fragmented. The complete value chain of a product is broken down into a series of

discrete “value-added links”, which are then optimally allocated globally based on efficiency and comparative advantage. Therefore, the essence of international trade has shifted from traditional “product trade” to a more refined “task trade” [4; 8]. The GVC paradigm breaks away from the traditional theoretical focus on “borderline” tariff barriers, instead turning its attention to the coordination of production networks and the institutional environment “behind the border”.

From the perspective of global value chains, the deepening mechanisms of regional integration exhibit new characteristics. Baldwin's [2] “Second Great Dismantling” theory profoundly reveals how the geographical separation of production links fosters “de facto integration”, that is, tightly locking national economies together through transnational production networks rather than single trade agreements. This deep integration based on the interdependence of production links places higher demands on member countries' infrastructure connectivity, logistics efficiency and regulatory coordination. The operation of GVCs is highly sensitive to the efficiency and stability of the institutional environment; any asymmetric regulations or high transaction costs will hinder the optimal allocation and smooth operation of the production network. Deep integration driven by global value chains can no longer be achieved solely through market openness and the division of labor; it must further rely on institutional coordination, the alignment of governance rules and the systematic reduction of transaction costs. It is against this backdrop that institutional and governance issues have become the core topics of regional integration theory and related research has officially entered a new stage of institutional constraints, governance models and integration upgrades.

4. Institutional constraints, governance models and intergrated upgrades

The demand for deep integration has led academia to focus more on the underlying factors determining firm trade costs and the depth of specialization - the institutional environment. New institutional economics provides a micro-governance perspective for analyzing institutional changes in regional economic integration.

Coase [3] first proposed transaction cost theory in “The Nature of the Firm”. His core argument is that markets are not frictionless; economic agents inevitably incur non-productive costs such as searching, negotiating, contract signing and execution when exchanging goods and services through markets. Williamson [24] further developed this theory, introducing concepts such as bounded rationality, opportunism and asset specificity, arguing that the emergence of economic organizations is essentially to minimize transaction costs through specific governance structures.

Applying transaction cost theory to the analysis of regional economic integration reveals that integration is an institutional arrangement aimed at reducing friction in cross-border transactions, thereby lowering total transaction costs within the region and enabling continuous improvement in the degree of production specialization. Due to the incompleteness of contracts and the fragmentation of institutions in a transnational environment, firms often inhibit their

trade and investment activities when faced with high cross-border search costs and potential “hold-up” risks. Regional integration, by establishing frameworks for collective action and multilateral reputation collateral mechanisms, provides a relatively stable institutional environment for transnational economic exchange, thereby achieving an “institutional substitution” for fragmented markets and significantly reducing the monitoring and dispute resolution costs required to ensure transnational cooperation [25].

Building upon transaction cost analysis, North [18] derived the theory of institutional supply and demand in regional integration from his discourse on institutional change. This theory posits that the deepening of integration is a dynamic process of continuous matching between institutional supply and demand. As economic ties among member states strengthen (e.g., the expansion of trade and investment driven by the Belt and Road Initiative), micro-entities will generate institutional demands for lower transaction frictions, more efficient dispute resolution and more unified market rules. Conversely, policy coordination, legal alignment and the construction of multilateral mechanisms led by sovereign states or regional organizations constitute “institutional supply”. The success and deepening of regional integration depend on whether institutional supply can effectively match the endogenous demands of economic development [19]; if supply lags or is mismatched, it will lead to “institutional bottlenecks”, thereby hindering the further release of integration benefits.

Regarding the evolutionary path of integration models, Tinbergen [22] proposed the classic distinction between negative and positive integration. Negative integration focuses on “eliminating barriers”, that is, removing artificial obstacles that hinder trade flows (such as tariffs and quotas), mainly addressing “hard costs” at the border; while positive integration focuses on “establishing rules”, that is, establishing a common governance framework behind the border through the coordination and unification of laws, technical standards and administrative procedures among member states). This theoretical framework provides an important perspective for explaining the impact of the Belt and Road Initiative on deepening regional economic integration: in the early stages of the initiative, physical transaction costs were reduced through infrastructure connectivity (negative integration), while subsequent “policy communication” and “standard alignment” marked a deeper step towards positive integration. This paradigm shift from reducing “border” friction to eliminating “behind-the-border” regulatory asymmetry not only reduces the market switching costs for enterprises but also provides the necessary institutional premium for the deep embedding of global value chains (GVCs) in the regions along the Belt and Road [1].

Meanwhile, the theory of new regionalism provides a macro-analytic framework for understanding how contemporary regional economic integration transcends a purely economic sphere and evolves into a complex governance process involving multiple dimensions and stakeholders. The rise of contemporary regionalization is not driven solely by single economic interests (as in the “old regionalism” of the mid-20th century), but rather by the combined

effects of globalization challenges, geostrategic competition, national development strategies and the interactions of non-state actors [12]. Therefore, integration is viewed as an open, dynamic and gradual process of institutional building and deepening cooperation, far more complex than single-dimensional economic cooperation.

Drawing on the “spillover effect” of neofunctionalism, new regionalism argues that successful cooperation in one area is not an isolated event, but rather generates “pressure” and “motivation”, “forcing” member states to engage in deeper policy communication and institutional alignment in other related areas (such as trade facilitation, financial integration, cultural exchanges and even security). This “multi-driven, multi-dimensional” cooperation model not only explains why initiatives like the Belt and Road Initiative have expanded from economic issues to broader areas of cooperation, but also points to its inherent “challenges and risks”. This openness may lead to loose governance structures, limited depth of cooperation and heterogeneity of interests and asymmetry in power structures among nations [13]. Therefore, new regionalism provides a “panoramic” perspective for analyzing contemporary complex regional cooperation, suggesting that when assessing the effectiveness of integration, we must simultaneously focus on its functional deepening and governance complexity.

Conclusion. This article systematically reviews the evolutionary logic of the theoretical foundation of regional economic integration. By dividing theoretical development into three major stages - “the breakthrough and optimization of market boundaries”, “profound changes in production organization models” and “institutional constraints, governance models and integration upgrades” - it integrates seven core theories: customs unions, large markets, new trade, new-new trade, global value chains, new institutional economics and new regionalism. It comprehensively presents the paradigm shift in this field from static to dynamic, from macro to micro and from single-dimensional economic efficiency to multi-dimensional governance.

Research reveals that the evolution of regional economic integration theory is essentially a continuous expansion of the depth and boundaries of integration research: early theories focused on eliminating explicit trade barriers “at the border”, starting from static trade welfare distribution and gradually expanding to dynamic economies of scale and product diversity benefits, answering the fundamental question of “how market integration improves resource allocation efficiency”. Subsequently, the research perspective shifted to micro-enterprises and production processes, revealing the micro-mechanisms of resource reallocation within industries through a heterogeneous firm framework. Further, relying on global value chain theory, it analyzed the endogenous driving force of “task trade” on deep integration under production fragmentation, shifting the research focus from final product trade to the coordination of transnational production networks. Finally, the theoretical evolution turned to the institutional and governance dimensions “behind the border”, explaining the core role of institutional coordination in reducing cross-border friction from the perspective of transaction costs and institutional supply and demand. Through a new regionalism framework, it integrated

the cooperation logic of economic, political and social dimensions, responding to the complex governance needs of contemporary deep integration.

This evolutionary logic provides an important theoretical reference for current regional cooperation practices: new types of regional cooperation, represented by the Belt and Road Initiative and the Regional Comprehensive Economic Partnership (RCEP), follow this path of development from “passive integration” to “active integration” and from simple trade liberalization to multi-dimensional institutional integration. Their core lies in releasing the integration dividends brought about by deep embedding in global value chains through the matching of institutional supply. This also illustrates that the core of contemporary regional cooperation is no longer simply tariff reduction, but rather building a stable institutional environment for transnational production networks and factor flows through rule alignment and governance synergy.

Faced with new challenges such as the rise of the digital economy, the restructuring of global value chains and geopolitical conflicts, the theory of regional economic integration still has room for further development. Future research can further focus on how new issues such as digital trade rules and cross-border data flows supplement integration theory, as well as the adaptive adjustments of regional governance models under geopolitical competition, thereby providing more explanatory theoretical support for regional cooperation in the new era.

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