Customs Unions Welfare

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Abstract

In the following paper we look further to analyse the main theories and policies about Customs Unions. We trying also, to examine the effects of Customs Unions in the welfare and the arguments of Viner and Lipsey, who both of them gave its separate definitions on this topic area. Moreover, with our recommendations, we are trying to make a deeper analysis, to agree or to disagree on these significant economical theories. Customs Union is a free trade area with common external tariffs and quotas, but in addition members of each Customs Unions have to adopt common external tariffs and quotas with non-members countries.

Furthermore, Customs Unions means that there is a common market where the member countries acting as a single market with free movement of labour and capital, common taxes and trade laws. Purposes for establishing a customs union normally include increasing economic efficiency and establishing closer political and cultural ties between the member countries. There are many examples of Customs Unions through the world, such as, European Union Custom Union, Central American Common Market (CACM), Andean Community (CAN), Caribbean Community (CARICOM), Economic and Monetary Community of Central Africa (CEMAC), East African Community (EAC), Eurasian Economic Community (EAEC), Arab Customs Union (ACU), etc.

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1. Introduction

"A definition to what is Customs Union and what is the role of them is that, there exist some huge international agreements in which the participating countries-members privileged their partners' exports from all tariffs and adopt a mutual external tariff on goods from the world around of them. Some international agreements such the definitions from the above are the European Economic Community which established in 1958 and is a forward step of the economic and political unification of Europe and perhaps is the larger and most known Customs Union in the world with 27 countries-members until nowadays. The Constitution of the United States also established a Customs Union where the Congress was given the power to regulate commerce with foreign nations and between the several states, were denied the right to lay any duties on imports and exports."

Due to the customs unions combines elements of free trade with elements of protection the analysis of custom unions, has to associated with the conditions for improving the welfare. The argument ,so far, has been concerned with possible gains and losses from the effects of customs union. Viner argues that customs union can postulate, either trade creation, or trade diversion which, raises or lowers the country's welfare accordingly, on the other hand, Lipsey argues that trade diversion can raise welfare. In this paper we focus in the theory of custom unions and also based in the two main parts of the theories, which established by Viner and extended by Lipsey. We shall try to explore whether, or not, a customs union on balance raises, or lowers welfare and finally, the role of the trade creation and trade diversion on welfare improvement.

(http://ec.europa.eu2010; Barnes I., and Barnes P.M., 1999.)

2. The theory of Customs Unions

"Customs Unions represent fundamental issues in world trade, as they create a movement towards free trade areas. However, there are main differences among free trade areas and customs unions. In free trade area, members are free to set their own external tariff. A customs union consists of two or countries, which have no tariff between them and a common tariff against the rest of the world. Furthermore, the idea is to create an area of free trade. So, that once goods enter into it, they are free to get around with no tariffs. Moreover, the Common External Tariff strengthens barriers against external countries, supporting the industries of members and discriminating against non-members. Hence the main similarities among customs unions and free trade areas are that they are both represent discriminating arrangements.

The research focus points out that problem arise in free trade as goods enter through the country with the lowest external tariff and then circulate through members. This may alter the distribution of production, consumption, welfare, income and investment. Thus, the advantage of a customs union with common external tariffs is clear a such as problem that does not arise. Equalisation of rents, wages, profits and interest rates may occur as the convergence process continuous.

Static approaches tend to observe the 'once and for all effects' of a customs union and accommodate two points in time, before and after unionisation. On the other hand Dynamic approaches analyse impacts taken over a period of time." (Lawler K., and Seddighi H., 2001.)

The theory can be developed using an example involving the production costs of commodity as it is shown in the table 1.1, which are follows:

Table 2.1

	Price before the customs union			Price after the customs union		
Country	A	B	C	A	B	C
Cost of Production	200	150	125	200	150	125
100%tariff imposed by A	0	150	125	0	0	125
Price in A	200	300	250	200	150	250

(Lawler K., and Seddighi H., 2001.)

According to the above table, the formation of a customs union the consumers of country A were buying good X at a price of 200, according to the example can now be purchased at a price of 150. Essential theory dictates that if price falls, demand will expand as will supply meet the demand, creating a production effect. Also, the consumer makes a saving of 50 by purchasing imported good X and spends the savings on other goods, this is a consumption effect.
The production and consumption effects demonstration the advantages earned from the union.

3. Effects of a Customs Union

"The impending benefits and losses by a union's theory are separated in two main areas, on initial static benefits and dynamic benefits over time. The static benefits are simple to analyse but on the other hand the dynamic effects are more difficult for analysis and needed deeper examination to understand better the meaning of them which are involved in to monopolies, economies of scale, terms of trade and increased relative efficiencies. If the above factors combine it is presumed that the dynamic benefits may be real. After that, if the countries choose the option to specialise, then they could focus on the production of assured products, capable the possibility of better production techniques and technological advancement.
Additionally, we can see now what are exactly the effects of a customs union for the static and dynamic effects as well as.
The static effects by join a customs union is that each country-member shall find that its trade patterns change. To be more specific two main changes could be happen, trade creation and trade diversion.
A general definition for the following phenomenon which will analyse better by the theories of Viner farther is that trade creation is where customs union leads to greater specialisation according to comparative advantage and thus a shift in production from higher cost to lower costs sources. "
(Carlin W. and Soskice D., 2005; Pornfret R., 2003)

The other main change that could be happen is trade diversion, where consumption shifts from a lower cost producer outside the customs union to a higher cost producer within the union.

The dynamic effects depended from the supply and demand curves that are unaffected by the changes in trading patterns. If a country joins a customs union the curves are likely to shift. A membership affects demand and supply, sometimes makes curious advantages and on the other hand makes some disadvantages.

"So, according to the above there are the dynamic advantages, such as:

- Increased competition between member countries may stimulate efficiency, encourage investment and reduce monopoly power.
- External economies of scale. Increased trade may lead to improvements in the infrastructure of the members of the customs union. This could bring larger long-term benefits from trade among members and external trade too, by making imports and exports cheaper.
- Integration may encourage a more rapid spread of technology.
- The members gain better terms of trade by the bargaining of the whole customs union with the rest of the world.

There are also some dynamic disadvantages on this situation which are:

- Diseconomies of scale. That happens if the union leads to development of large companies, they may become bureaucratic and inefficient.
- If integration encourages greater co-operation among firms in member countries, it may also encourage greater oligopolistic collusion that will keep prices higher to the consumer. That would be might also encourage mergers and take-overs, which could increase monopoly power.
- The costs of administering the customs union may be high. These costs may increase over the time if a member country have deficient controls over the union's expenditure. This shall encourage members to press for higher expenditure when it benefits them specifically, because the members will meet the costs collective. "

(Dunn R.M., and Mutti J.M., 2000; Cowen T., 2000)

4. Viner's Conundrum

Jacob Viner (1950), an American economist who made many contributions to trade theory and identified two ways in which a customs union could influence trade patterns and resource grant, undertook the first rightness analysis of customs unions.

"Viner named the first phenomenon trade creation and the second, trade diversion. When trade creation is dominant, a union raises the welfare of its members collectively and raises world welfare, too. One member of the union may suffer a welfare loss, but the gain to the other will exceed loss. Outside countries must suffer welfare losses, but the gain to the union will exceed them.

Viner did not show how to weigh trade creation against trade diversion. Furthermore, the distinction between them tends to break down when drop assumptions implicit in this reason, that all goods are produced under constant returns to scale." (Kenen P.B., 1989)

As it is shown from the above Viner does not agree that customs unions help to be welfare.

In order to understand better when and how trade diversion takes place there is the following example involving one good and three countries:

Country C is the lowest cost producer and country A is the least efficient producer. If the tariff of 100% was imposed, the domestic market for the good is cheaper in comparison. An assumed union among countries A and B, maintaining the 100% tariff against C. country A stops production of the good and imports all supply from B. the union's formation has enhanced international trade, a trade-creating effect. There is a gain in welfare as the good is purchased for 35 rather than 50.

Determining, only the 50% of tariff on A's imports it is showing then that the production of the good in country C is cheaper than domestic production, so A imports from country C. When the union is formed, the tariff is imposed against country C but not against country B. Now products of B is cheaper than C's, so A imports from B.

This is a trade diverting effect, as country, as country A, pay a price 35 for the product rather than 25 it was paying before under free trade. The increase in price means a loss of welfare from forming a customs union. This is also a static loss and is hurting consumers in country A. (See, Table 4.1)

Table 4.1

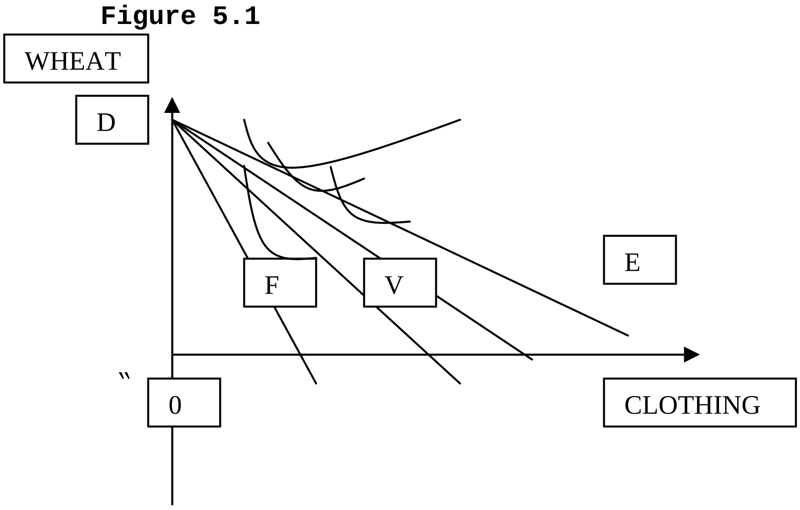
Country	A	B	C
Price (=unit costs)	50	35	25
Price in A include 100% tariff		70	50
Price in A include 50% tariff		52.5	37.5

(Lawler K., and Seddighi H., 2001)

5. Lipsey Theory/Examples

On the other hand Lipsey (1957) disputed with Viner's arguments and determined the situation by his own view. Production and consumption were his effects and stated that. Lipsey used for his example a three-country model with all the countries consuming two products, wheat and clothing.

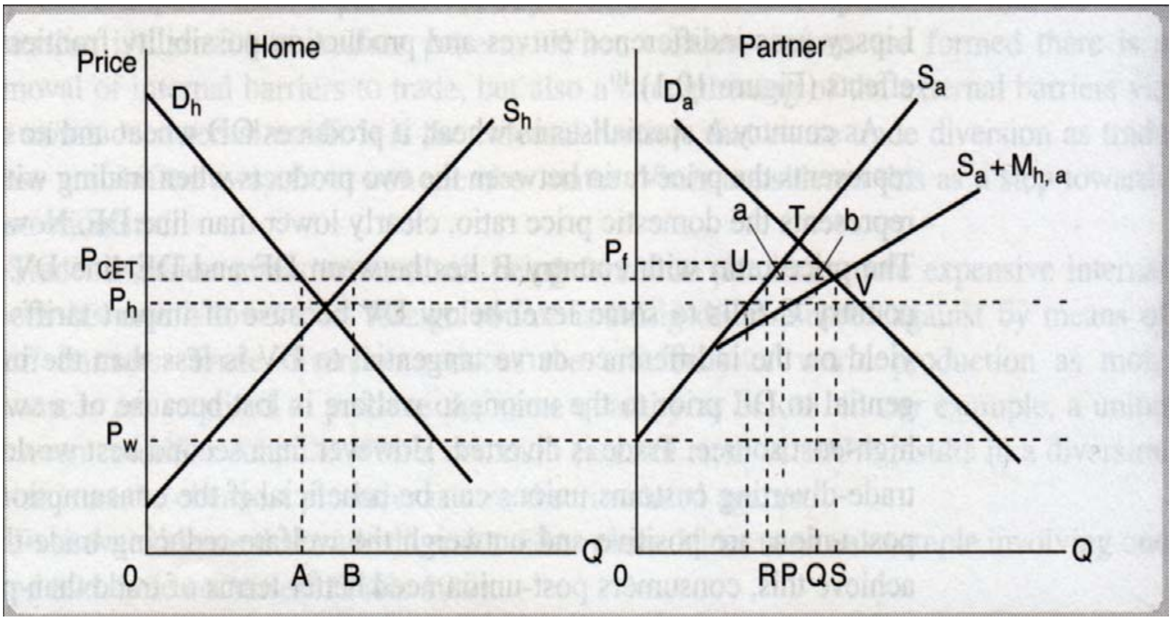
Figure 5.1



Country A specialises in wheat, it produces OD wheat and no clothing. The line Den represents the price ratio between the two products when trading with country C. Line DF represents the domestic price ratio, more clearly than line DE. So, now the union is formed. The price ratio with country B lies among DE and DF, line DV. The price ratio with country C falls to some level below DV because of import tariffs. Clearly, the welfare yield on the indifference curve tangential to DV is less than the indifference curve tangential to DE prior to the union, so welfare is lost because of switch from a low to a high cost source. Trade is diverted." (See, Figure 5.1), (Lawler K., and Seddighi H., 2001, "International Economics", Prentice Hall., page 139)

"In the first case, pre-union tariffs meant that there was no trade. The prices at home and abroad were Ph and Pf respectively. After the union is formed, a common external tariff is imposed, and for this analysis assumes that it is the average of pre-union tariff rates. Pcet denotes this on figure 5.2 the price causes demand abroad to rise to OS whilst supply abroad contracts to OR. In the home country, demand falls to OA whilst supply abroad contracts to OR. IN the home country, demand falls to OA whilst supply expands to OB. Obviously, the extra supply at home is exported to meet the extra demand abroad. From one point of view, there is trade again. Consumer surplus has risen by PcetVTPf, whilst producer surplus has lowered by PcetUTPf. The net value is a gain of TUV. In the home country prices rise by PhECPcet. Clearly, the producer surplus falls by PhEGPcet whilst producer surplus rises by PhECPcet. Clearly, the producer surplus gain outweighs the consumer surplus loss, and delivers a welfare gain.

Figure 5.2
(Lawler K., and Seddighi H., 2001)



A second case is where only the home country has a prohibitive tariff whilst the foreign country has lower tariff rates allowing trade with the rest of the world. The initial price abroad, including the tariff, was Pf. This allows PQ imports from the rest of the world with OP production domestically. The revenue collected would be PQPwPf. The customs union results in a universal tariff of Pcet. Demand abroad rises to OS and domestic production falls to OR. Triangle (a) represents saved costs from reducing the scale of inefficient production and triangle (b) represents the gain in customer surplus. Together, these represent all gains. However, the union has shifted the imports of the foreign country from a low – cost producer (the rest of the world) to a high – cost producer (the home country). There is a thus a trade-diverting effect. Unit cost rise by PwPcet, and this multiplied by PQ exhibits the total trade diversion abroad. Collectively, trade diversion outweighs trade creation so there is an overall trade – diverting effect, but this could go in reverse, either in (a) general equilibrium change, or (b) if b > a in the diagram.)(See, Figure 5.2) (Lawler K., and Seddighi H., 2001.)

6. Conclusions/Recommendations

Concluding and according to the views, examples and theories of Viner and Lipsey who the first of them, Viner define that trade diversion is not helpful for the customs unions to be beneficial, supporting this optimal view by serious examples and theories. The second of them Lipsey, advocate at the first case that trade diversion is very important for the gains of customs unions and in the second case in raw, that the trade diversion does not occur to be beneficial for customs unions. As we can easily presume, the trade diversion is a very significant and determinant factor for customs unions, if they are beneficial or not. So, it depends in any case of the customs unions from the level of influence and the role that has, in any case the term of trade diversion which is the key factor, in the relation with other, if the customs union be beneficial.

Finally, the welfare effects on the world as a whole depend on the production and consumption effects. A customs union is more likely to raise the welfare when the production effects are trades creating rather than trade diverting, when goods from low-cost sources replace goods from high-cost sources. From the above, we are more likely to agree with arguments and thoughts of Lipsey, after the determination that the trade diversion is significant factor ,which influence customs unions to be beneficial and gain more economic advantages through, the free trade among the member countries by increasing competition, reducing monopoly power and maximise the profits and the benefits of customs union in addition with rest of the world.

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