

# Chapter 10

## Economic Integration: Customs Unions and Free Trade Areas

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*"Free-traders sometimes in almost the same breath disapprove of preferential reductions of tariffs but approve of customs unions, which involve 100 percent preference."*

Jacob Viner, The Customs Union Issue, 1950.

### I. Chapter Outline

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### II. Chapter Summary and Review

The European Union (EU), the North American Free Trade Agreement (NAFTA), and Mercosur are examples of regional trading agreements. Regional trading agreements can take a number of forms, including **preferential trading arrangements**, **free trade areas**, **customs unions**, **common markets**, and **economics unions**. The important characteristics of each of these regional economic associations are illustrated in Table

## 10.1.

**Table 10.1**  
**Characteristics of Regional Economic Associations**

Type of Association	Lower barriers among members	Free trade Among members	Common trade barriers	Free movement of labor and capital	Harmonization of Fiscal and Monetary Policies
Preferential Trading Arrangements	•				
Free Trade Areas (NAFTA)	•	•			
Customs Union (EU)	•	•	•		
Common Market (EU)	•	•	•	•	
Economic Union (EU, US)	•	•	•	•	•

Similar to the above forms of **economic integration** are duty-free zones or free economic zones in which raw materials and intermediate products can be imported duty free. When the finished products are exported, only the value added in production is generally subject to duties.

The purpose of regional trading agreements is to take advantage of the potential gains from trade between members of the agreement. Although it may appear that lower tariffs and other barriers are consistent with the gains described by the standard trade model, such arrangements may actually reduce national economic welfare.

The analysis of regional trading agreements, traditionally known generically as “customs unions,” is very similar to that of tariffs, but now there are two world prices to be considered—one for future members and one for future non-members. Suppose prior to the formation of a customs union that a nation has a common tariff against all its trading partners. A customs union lowers the tariff for a subset of its trading partners, those that become members of the customs union. *Whether the customs union improves the welfare of a nation depends upon the price of imports from future members relative to the price of imports from future non-members.*

Assume that the price of imports of future members is lower than the price from future non-members. A common tariff prior to the formation of the customs union will mean in this case that the price (plus tariff) of imports from future members will be lower than the price (plus tariff) from future non-members so all imports currently come from future members. The formation of a customs union will eliminate the tariff on imports from members and maintain the tariff on non-members. All imports will still be from future members. In this case the customs union, by lowering the tariff, will benefit the

importing nation because consumers will receive a lower price and will increase the quantity demanded of imports. This analysis is identical to that of the tariff analysis described in Chapter 8. (Chapter 8 analyzed the effects of imposing a tariff, so simply run the analysis in reverse to show that tariff reduction will eliminate the deadweight losses of tariff imposition.) This is an example of a **trade-creating customs union**. The formation of the customs union produces a clear gain to its members.

Now assume a very different situation. Suppose that prior to the customs union, the price of imports (plus tariff) from future non-members is lower than the price of imports (plus tariff) of future members. If the reduction in tariffs due to the formation of the customs union now makes members' prices lower than non-members, then trade will be diverted from lower priced non-members to higher priced (before tariff) members. It is the maintenance of tariffs against non-members that provides the incentive to now import from members. In this case, it is not clear how a customs union affects national welfare. There will be the positive effect of increased consumption in each member nation because the tariff reduction lowers prices, but now imports come from a higher-priced source. If all tariffs were eliminated, the imports would be available from non-members at an even lower price. This is an example of a **trade-diverting customs union**.

The analysis of the welfare effects of a customs union is an example of the **theory of second best**. The theory of the second best states that the elimination of a market distortion (like a tariff) does not necessarily mean an improvement in efficiency if there are other distortions present. If two market distortions are present then the elimination of one does not produce the second-best position, the first being the elimination of both distortions. This is an important statement with many applications. For example, a reduction in monopoly power is usually viewed as beneficial because monopolies produce less than the efficient level of production. If, however, there is pollution, then a reduction in monopoly power will mean increased production, which will mean increased pollution levels. If the costs of the additional pollution outweigh the benefits of less monopoly power, then social welfare is reduced.

The analysis of **trade creation** and **trade diversion** does illustrate the conditions under which a customs union is more likely to be trade creating than trade diverting. Generally, if trade barriers before the formation of a customs union are biased against future members relative to non-members, then a customs union is more likely to create trade. For example, if very high tariffs were maintained against future members relative to future non-members, then any trade coming from future non-members was not due to a comparative advantage but to the structure of tariffs. A customs union will be more likely to produce a pattern of trade consistent with the gains from trade.

Additionally, trade creation is more likely between geographic neighbors rather than between distant neighbors because transportation costs are less likely to be a barrier to trade creation.

Trade creation and trade diversion are concepts produced by a *static* analysis of customs unions—an analysis of the allocation of existing resources. Customs unions also provide other potentially important static gains. First, a relaxation of trade restrictions will lower administrative costs associated with collecting border taxes, policing borders, etc. Next, an economic agreement among a number of countries will increase both economic and political power. Negotiating with the EU is clearly quite different than negotiating with one member of the EU. This increased political power can produce significant gains to customs union members.

Increased economic power can have important terms of trade effects. Each member of a customs union is unlikely have the economic power necessary (monopsony power) to change its terms of trade with the rest of the world through imposing the optimum tariff (see Chapter 8). A customs union, however, is likely to have some economic power and be able to use tariffs to produce a favorable change in its terms of trade.

There are also potential dynamic gains from customs unions. These are identical to the dynamic gains from freer trade in general and include *increased competition, economies of scale, stimulus to investment, and the gains from increased mobility of labor and capital*.

### III. Questions

1. Table 1 is reproduced from Case Study 10-2 in *International Economics*.

**Table 1:** Potential Benefits from a Fully Integrated Internal Market in the EU

	Percent of 1988 EU's GDP
<i>Gains from</i>	
Removal of nontariff trade barriers	0.20
Removal of production barriers	2.20
Economies of scale	1.65
Intensified Competition	<u>1.25</u>
Overall total gains	5.30



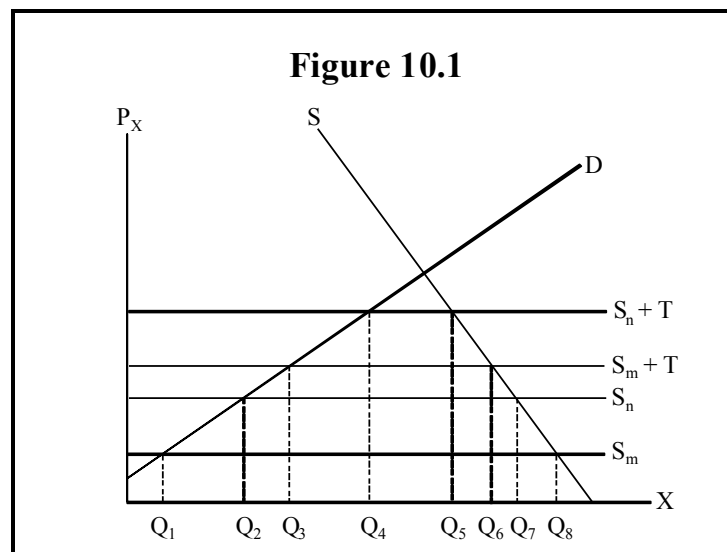
The question is to simply review the relevant parts of Chapter 10 of *International Economics* and describe the each of the sources of gains listed in Table 1.

2. "A free trade area, in which there remains considerable trade between its members and the rest-of-the-world, may find their separate trade policies difficult to maintain. The next logical step for a free trade area is a common market." Explain. (Consider the definition of a free trade area and transshipments.)

3. a) Why does a regional trading agreement between Canada, the United States, and Mexico make more economic sense than one between Burma, Tanzania and the United States?

b) Why do nations often pursue regional trading agreements despite the existence of the World Trading Organization (WTO) that actively promotes free world trade?

4. Fig. 10.1 shows an importing country before the formation of a customs union. The curves  $S$  and  $D$  are, respectively, domestic supply and demand.  $S_n$  represents the supply from future non-members,  $S_m$  represents the supply from future members, and  $T$  is the tariff. Assume that after the formation of the customs union,  $T$  is maintained against non-members and eliminated for members. Where necessary, use letters from Fig. 10.1 to answer the following questions.



a) What is the level of domestic production, domestic consumption, and imports prior to

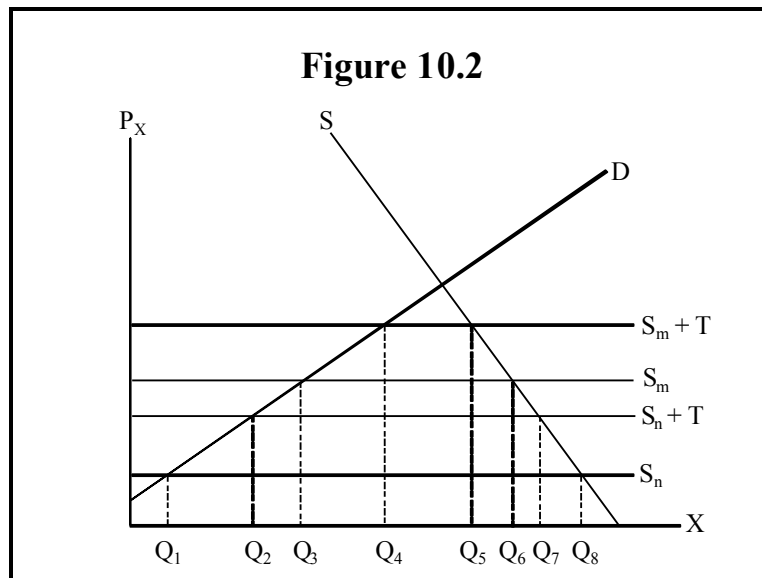
the formation of the customs union? From which nation will these imports be purchased?

b) What is the level of domestic production, domestic consumption, and imports after the formation of the customs union? From which nation will these imports be purchased?

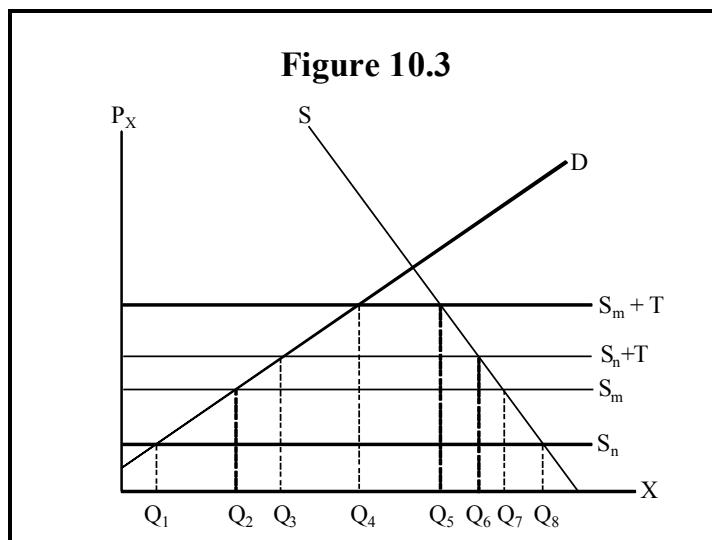
c) Will the customs union be trade diverting or trade creating? Explain.

d) Will there necessarily be gains from the formation of such a customs union?

**5.** Answer the same questions posed in Question 4, but use Fig. 10.2 for the source of your answers.



6. Answer the same questions posed in Question 4, but use Fig. 10.3 for the source of your answers.



7. Other than the standard trade diversion argument, what other aspect of a customs union could lead to a misallocation of resources and less world trade? Consider the power of groups of nations versus individual nations to affect the terms of trade.