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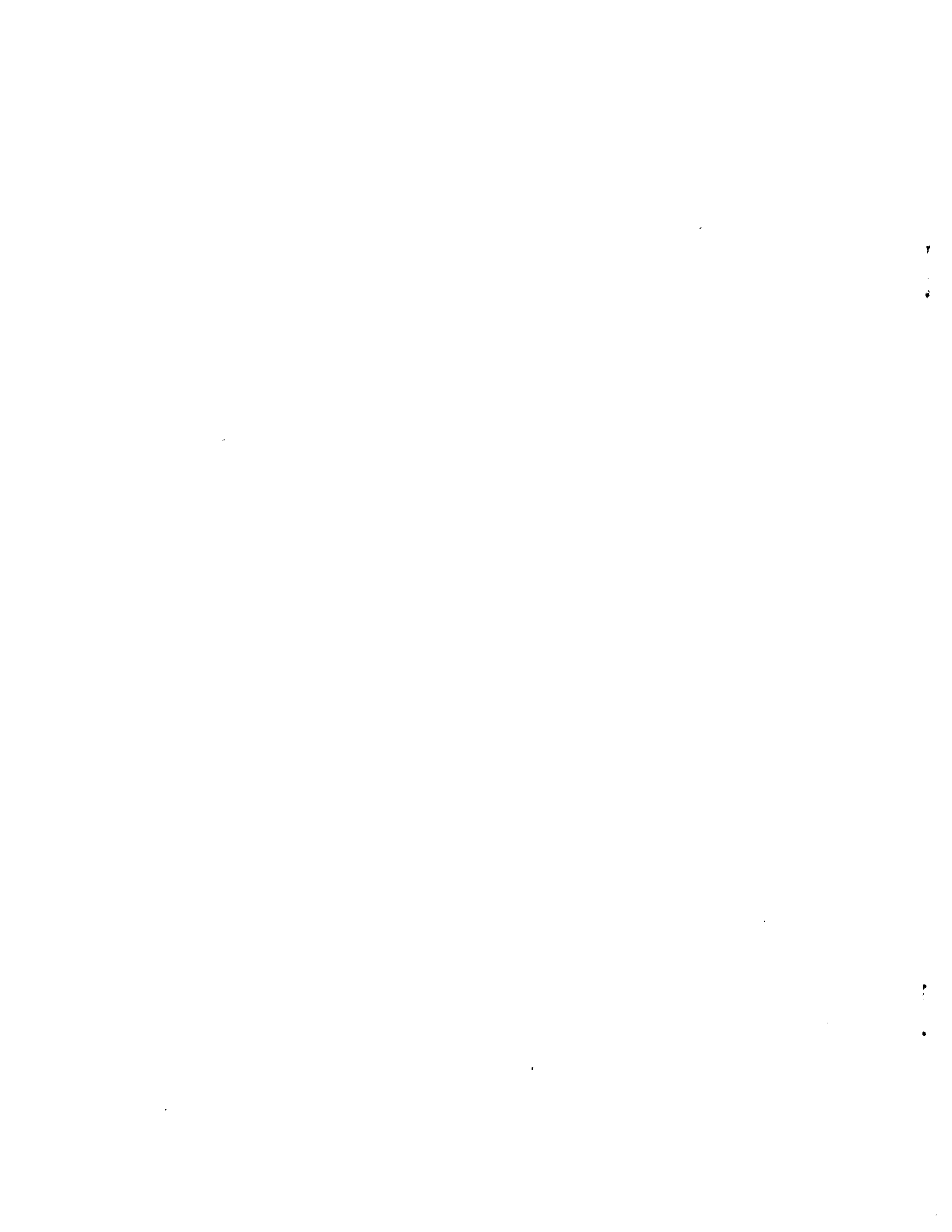
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CUSTOMS UNION - EFFECTS, GAINS (LOSSES)

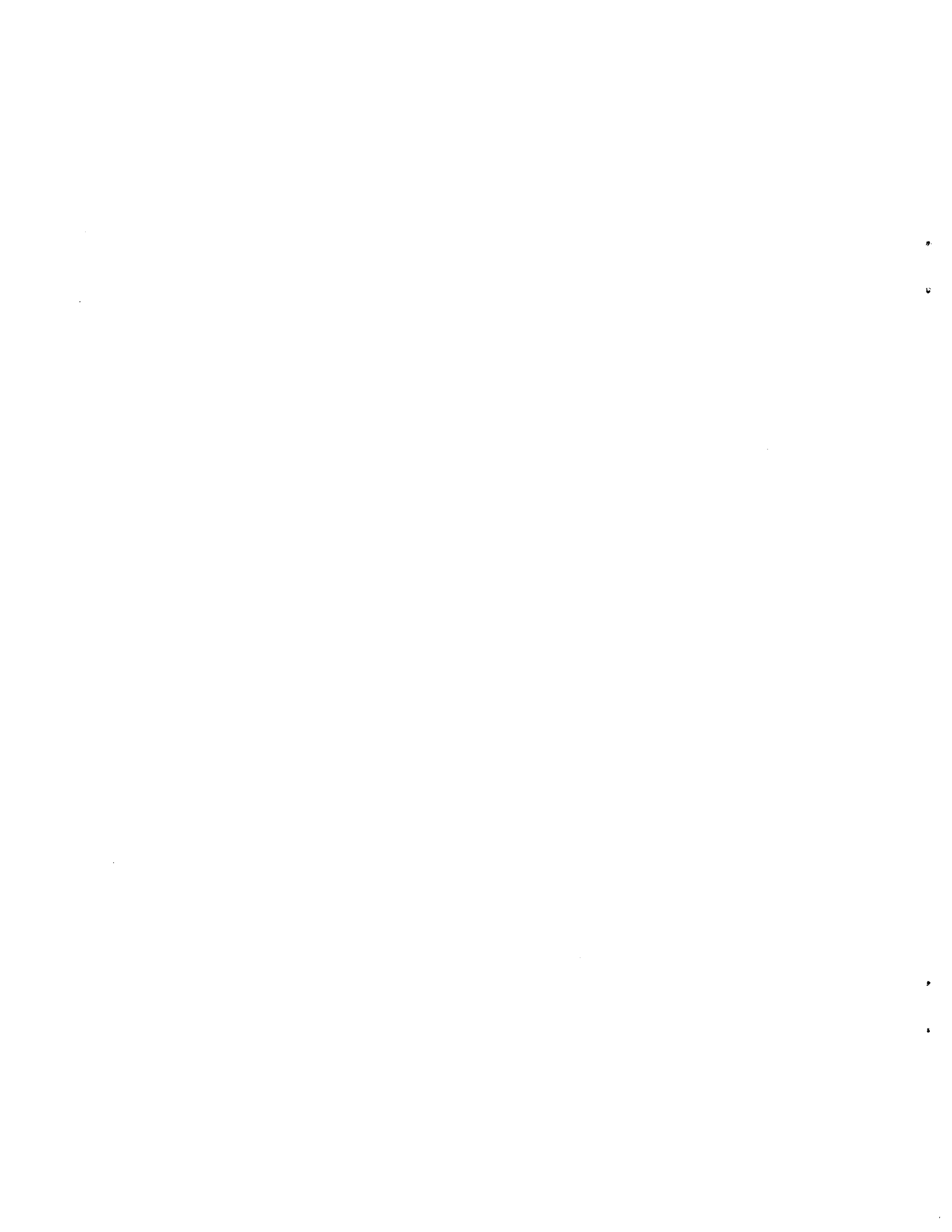
Analytical considerations
for the
ECCM Customs Union Operations

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I. CUSTOMS UNION - EFFECTS, GAINS (LOSSES)

INTRODUCTION

There are in essence two approaches to the theory of customs unions and the analysis varies depending upon the assumption that is made as to the nature of the political process. The first approach assumes government to be "non-economic" and focuses on the economic costs of such activity, which when compared to the non-economic benefit determines whether or not the customs union benefits the community on balance. The second approach assumes that government activity is directed towards maximising the economic welfare of the community and there is a need to develop optimization procedures in support of government objectives.

Traditionally the former was taken as the point of departure, and the analyses concentrated on trying to identify the gains and the losses attributable to customs union, separating those which enhance from those which lower the total of social welfare.^{1/} But more recently the theoretical orientation has been away from those welfare effects of customs unions, to the more fundamental question of why they are formed in the first instance. Such change reflects both a theoretical and an institutional imperative. The former being the failure of traditional trade theory to explain why policies other than free trade or modified free trade are followed by governments; the latter due to the recent interest of developing countries in economic integration as a means of accelerating their rate of economic progress.

For small developing countries entering customs unions, the economic considerations as a rule are regarded as attractive; and to the extent that there is an economic case for such specially close economic ties between the countries, the case is likely to be stronger where it rests on specific economic criteria. But in practice the essence of the relationship goes beyond purely economic considerations to embrace other aspects of policy. As a consequence customs union analysis has more recently come to be based on acceptance of the idea

^{1/} This was based on the implicit assumption that "real income" is identifiable on social welfare function lines with the utility derived by individuals from their personal consumption of goods and services.

that it is a deliberate use of tariff policy by two or more countries to achieve objectives not attainable through individual action. And related to this is the further idea that the customs union approach is attractive to countries that individually are unable to affect their terms of trade, although they are able to trade at the foreign rate of product transformation.

Such considerations focus tariff policy in customs unions as essentially protective mechanisms, which, by the elimination of tariffs within the union along with the maintenance of tariffs against countries outside the union, enable the partners in the union to develop as sources of supply, thereby replacing some imports from countries outside the union.

TRADE EFFECTS

Because of the central place of tariffs in customs union arrangements and the effects that tariffs have on trade, the theoretical analyses of the operations of customs unions invariably stress the trade aspects. The general approach is in terms of separating these effects as to whether they are "trade creating" or "trade diverting". In the first category are put the accretions to trade among the partners, and in the second the extent to which the union has resulted in substituting supplies from inside the union for imports from outside the union. In practice the net trade result is a combination of these two effects. According to the traditional view, if the trade creation is the greater element there is an addition to social welfare; and if the trade diversion is the greater there is a reduction in social welfare.^{2/}

The question has been considered, whether trade diversion always results in lowering of welfare, and it is now accepted that this is not necessarily so. The line of argument may be summarised as follows: when a customs union is formed some dutiable goods formerly imported from outside sources will be replaced by the same goods imported from a partner country, duty free but at a higher real cost. The shift to a higher-cost source of supply tends to lower the country's real income, and consequently consumer welfare; but the tariff reduction also works as removal of a constraint on consumption and may raise welfare. If the second effect is favourable, and outweighs the first effect, there is a net rise in welfare.

^{2/} It may be noted that this approach leads virtually automatically to the conclusion that welfare is maximised under free trade conditions.

Conceptually at least there can be new trade creation without trade diversion. Such a case would apply to commodities which one of the members will now newly import from a partner (but which it did not formerly import at all) because the price of the protected domestic product is now lower than the price at any foreign source plus the duty. Equally it is in theory possible for a customs union to have no new trade-creating effect and only trade-diverting effect, as in the case where the common tariff shuts off foreign sources of supply, and inside the union existing industries acquire a new set of customers in partner countries without undergoing any significant change (as would be expected to happen if the industries were to meet new competition originating from partner countries).

As a consequence of the large attention paid to these trade effects, there is strong support for the view that the primary purpose of a customs union, and its major consequence, is to shift sources of supply. What is more, the shift can be either to lower-cost or to higher-cost sources depending on the circumstances. Where intra-union supplies are substituted for lower-cost foreign imports, the shift is to higher-cost sources. But account also has to be taken of shifts between the partners. In this case a customs union is said to increase welfare to the extent that it creates trade by diverting demand from high-cost domestic to lower-cost partners' products; and decreases welfare to the extent that it diverts trade from lower-cost foreign to higher-cost partner sources. This approach of course emphasises the trade aspect, without taking account of inter-commodity substitution, changes in the terms of trade, and other effects of the customs union arrangements.

The traditional postulation that trade diversion invariably reduces welfare has been further modified by the recognition that there is a welfare increasing effect where the trade diversion results also in inter-commodity substitution.^{3/} Further, where there is variability of production, diversion of trade can result in welfare

^{3/} The welfare increasing effect is maximised when the rate of substitution in consumption equates the product transformation rate.

gains, not only in the partner countries, but also in the "home" country. The results of such analyses have been to demonstrate how indeterminate the trade effects can be, the outcome depending on the circumstances of the countries in the union.

A further aspect to take account of is that when a customs union operates more to divert trade from its previous channels, rather than to create new trade, the internal removal of duties operates to increase the protective effect (for high-cost producers) of the duties which remain. This is a consequence achieved not by reducing imports into their own national territory, but by extending the operation of the protective duty in their favour to the territories of the partner countries in the customs union.

If therefore one sums up the orthodox view of customs union the general line of economic reasoning would run. When a customs union is formed, the tariff is taken off imports from the partner countries and the relative price between these goods and domestic goods is brought into conformity with the real rates of transformation. This by itself tends to increase welfare. But on the other hand, the relative price between imports from union partners and imports from the outside world are moved away from equality with real rates of transformation. This by itself tends to reduce welfare. The shift to imports from union partners therefore involves both a gain and a loss. But what most matters is the relation between imports from the outside world and expenditure on domestic commodities. The larger the purchases of domestic commodities and the smaller are the purchases from the outside world, the more likely it is that the union will bring gain.

This welfare argument gives rise to two general conclusions - first that given a country's volume of international trade, a customs union is more likely to raise welfare the higher the proportion of trade with the country's union partners, and the lower the proportion with the outside world. The second is that a customs union is more likely to raise welfare the lower is the total volume of foreign trade; for the lower the level of foreign trade, the lower must be purchases from the outside world relative to purchases of domestic commodities. This means that the sort of countries who ought to form customs unions are those doing a high

proportion of their foreign trade with their union partners, and making a high proportion of their total expenditure on domestic trade. Countries which are likely to lose from a customs union, on the other hand, are those countries in which a low proportion of total trade is domestic, especially if the customs union does not include a high proportion of their foreign trade.

SOME THEORETICAL LIMITATIONS

It would be gathered from the foregoing that most of the enquiries into customs union had been confined mainly to studying the effects of customs unions on welfare, rather than for example, on the level of economic activity, the balance of payments, or the rate of inflation. This aspect assumes importance when it is recognized that gains and losses may arise from a number of different sources:

- (i) new trade creation and/or trade diversion;
- (ii) specialization of production due to comparative advantages;
- (iii) economies of scale;
- (iv) changes in the terms of trade;
- (v) forced changes in efficiency due to increased competition;
- (vi) changes in the rates of economic growth.

However the theory of customs unions has been almost completely confined to an investigation of (i) and (ii) above, with some slight attention to (iii) and (iv). The item (vi) has not been dealt with at all, while (v) is ruled out of the traditional theory by the assumption (often contradicted by the facts) that production is carried out by processes which are technically efficient.

The problem revolves round the difficulty of defining the other effects of customs union operations as additional to trade creation and trade diversion, rather than as component parts of the trade effects. For example, when there is initial production in several partners, and the union allows one or two to capture

the entire union market, the replacement of higher-cost partner production with lower-cost domestic production on the one hand, and the reduction in the cost of production of domestic goods on the other, are both integral parts of the same phenomenon. Nevertheless it is useful to consider the separate elements and the conditions in which they contribute to gains and losses, even while recognizing that the possible gains from a customs union resulting from improvements in the terms of trade, economies of scale, and reductions in disguised unemployment, do not show up as readily as the trade gains.

On this question of the economic benefits arising from other causes, e.g. economies of scale, or through forced efficiency, there have not been as comprehensive enquiries as for trade effects. Some analytical advances have however been made and some situations identified. For example, on economies of scale, it is fairly evident that if the market is expanding all the firms in a given industry could grow and economies of scale could be realised, but if the market is static then growth can be achieved only at the expense of competitors. [However a distinction has to be drawn between the costs of production proper, and the costs of selling - for if the cost of selling is rising faster than cost of production is falling, then there is not likely to be expansion, and economies of scale would not be realised.]

Similarly as regards possible gains through forced efficiency, the thesis is that firms which may not be adopting methods known to be technically more efficient, when thrown into competition with firms in partner countries, will be forced to adopt more technically efficient methods -- and thereby the efficiency in the use of resources may increase, (and could turn out to be a significant source of gain).

SCALE OF PRODUCTION

The assumption is often made that so far as customs unions have effects on trade they are mainly limited to trade creation and trade diversion, even where these effects are redefined to include both a production and a consumption component. This of course holds true for industries and firms where the money costs of production, per unit of output, is increasing over the long run relative to the economy as a whole. But there are firms and industries where the reverse is true and

unit costs decrease as output expands. In this latter category falls the situation where a small country by itself may be unable to reach a scale of production large enough to make low unit cost of production possible, but two or more such countries combined may provide a market large enough to make low unit cost production possible.

However, it does not seem probable that the prospects of reduction in unit costs of production (as the result of enlargement of the tariff area) are ordinarily substantial even when the individual member countries are quite small in economic size; for it is the supply conditions of factors of production which are the relevant restrictive factor on expansion of output if it is to be achieved without increase of unit costs. Unless the customs union operates so as to appreciably increase the inter-member mobility of factors of production, it does not in this sense increase the "scale" of the economy from the point of view of production conditions, even if it does increase it from the point of view of the size of the protected market for sales.

TERMS OF TRADE

There is, theoretically at least, a possibility of economic benefit from tariffs which countries may be able to exploit more effectively combined in a customs union, than if they operate as separate tariff areas. A customs union by increasing the extent of the territory which operates under a single tariff, tends to increase the effect of the tariff as a means of improving the terms of trade of that area vis-à-vis the rest of the world. This derives from the recognition that if a country is large enough to affect the terms at which its trade takes place, the imposition of a tariff improves its terms of trade.

Another consideration is that a tariff does not merely divert consumption from imported to domestically produced commodities, but it also alters, in favour of the tariff-levying country, the rate at which it exports exchange for the imports which survive the tariff. In short it works in the direction of improving the terms of trade. Any improvement in the terms of trade for the

country, carries with it an increase to the country in the total benefit from trade. The greater the economic area of the tariff levying unit, the greater is likely to be (other things being equal) the improvement in its terms of trade with the outside world, resulting from its tariff.

A further aspect is that a customs union by bringing more centralization of tariff levying authority, facilitates the development of a more effective tariff bargaining policy. This aspect can be important for small countries which are at a serious disadvantage in commercial relations with large ones. The larger the bargaining unit the more effective its bargaining can be; and the effectiveness is further heightened by the extent to which commercial policy can be managed under a centralised control. This consideration has been an important element in fostering aspirations on the part of small countries for customs union. But it has to be borne in mind that where the area is too small to influence the external prices, it abstracts from the terms of trade effects, and they are not likely to be realized.

ADMINISTRATIVE ECONOMIES

Finally, more practical than theoretical, are the gains that may be made through administrative economies.

There are broadly two types of savings that can be achieved:

(a) reductions in the costs involved for exporters and importers in meeting the customs requirements, (due to having one set of requirements in the place of several sets of requirements); and

(b) reduction in the costs involved in tariff levying and in administering the customs machinery (due to the reduction in the proportion and volume of imports requiring customs inspection and clearance).

In addition however, if a customs union were "complete" or "perfect" so that the tariff walls are removed between its members, aside from the removal of the duties themselves, there is a reduction of administrative expense to the governments due to the frontiers between them no longer having to be watched for customs purposes. Given the economic area of the customs union, the larger number of tariff frontiers eliminated, the greater the administrative economies (per unit volume of trade).

A customs union however, even if "complete", results in the full elimination for administrative purposes of tariff frontiers, only if and to the extent that the territories are contiguous. The existence between the territories of "high seas" is sufficient to cut down the administrative economies of customs union. Unless the territories comprising the customs union are contiguous, the customs union arrangement cannot make any significant contribution to the reduction of costs incurred in administering tariff frontiers.

Further, it has to be recognised that the administrative changes would not all involve economies. To the extent that there are additional burdens of negotiation, the need to maintain a machinery for the co-ordination of customs administration codes, provisions for mutual supervision where this is deemed desirable, or machinery for the settlement of disputes, there would be reductions in the net benefits that might be gained. It also follows, if there are no substantial gains from reduction of customs inspections and trade frontiers administration, and there are added costs attributable to co-ordination requirements, that there could be an economic loss deriving from higher cost of administration.

II. BASES AND APPLICABILITY

GENERAL SITUATION

The package of analytical conclusions reviewed in the first section rests on a range of assumptions, different ones of which are employed for the purpose of analysing particular aspects of customs union operations. These various assumptions may be listed as: (there being)

1. static conditions in that the working force, the capital stock and the technology, are treated as given;
2. maximum of competition among the economic agents/firms;
3. factors of production that are homogenous and easily substitutable;
4. no internal or external dis-economies;

5. no uncertainty, with perfect foresight and access to raw materials and inputs;
6. free access to the full range of technologies throughout the union;
7. complete information for producers about the market and for consumers about the products;
8. perfect intra-national factor movements but no inter-country movements (e.g. direct investments);
9. no new goods produced;
10. no government interference in the economies, except at the customs border, and only with tariffs.

Such assumptions are useful for simplifying the analyses, but because some of them may not obtain in actual situations, the various effects and their likely magnitude seldom emerge in the particular way one might expect. Most important, the often stated prime objective of achieving increase in the rate of growth cannot be articulated in the static framework. For example, to explain an increase in the rate of growth through exploiting technical economies of scale, presupposes some increased investment in physical capital even if the products are relatively standardised and there are plants operating below the minimum efficient scale. In this example, clearly economic growth hinges on the correspondence between the rate of growth of manufacturing output and that of overall productivity.

Similarly, the theoretical concepts of trade creation and diversion which depend totally on cost assumptions, in fact can be due to changes in efficiency in the resources used up in production. The efficiency effects have their counterpart in changes in trade flows; but there is nothing like a one-to-one relationship. Dependent on the underlying cost situation, the net efficiency gain could be negative while the net effect on trade flows could be positive.

Several of the ten assumptions would not apply to a wide range of ECCM production situations, especially the last, in view of the need for governments to influence the type and speed of development. In general

the analytical package is helpful when it is applied to fairly standardized products, where there is perhaps workable competition, where the technologies being applied are widely known in the area, and so on. But despite such deficiencies, those a priori analyses do help to demonstrate, within limits, how customs union operations result in a range of consequences, and what they are likely to be.

It has to be borne in mind too, that much of customs unions theory has expanded along with emergence of the European Economic Community, and much of it is influenced by characteristics in the developed countries. This explains the focus on the consequences for trade and on the allocative effects to industry. Some attempt has been made to develop a theoretical frame for developing countries; but even here, aside from the gains that could be derived from the protective effects, little is really known of how customs unions enhance under-developed countries.

There still is no conceptual frame that might project the consequences where there is economic growth in some but not in other partner countries. It might be assumed that under some circumstances the growth process in a customs union might be favourably interactive, growth in one country stimulating growth in partner countries. But it is equally probable there could be conditions that result in polarisation with some partners benefiting to the exclusion of others. What the range of underlying conditions might be and how they interact is still a subject for enquiry. Equally unknown is the manner in which the balance of payments may develop as between partners and as against third countries, as a result of the distributive effects of the union, under varying conditions.

Perhaps the best case for customs union in developing countries may be stated in this fashion. Considering that in each member country there are economic activities of varying efficiency, some of which produce for export and others of which must be protected if the country is to obtain its optimal total amount of domestic production, a customs union can operate as a maximising strategy for the governments acting together. Under the most favourable circumstances each country can offer its partner an increase in exports and

production without suffering a loss of its own; thereby inducing a re-allocation of domestic resources from the less-efficient import-competing sector to the more efficient export sector so as to benefit from comparative advantages. Clearly in this situation there would be gains to the separate units, and all-round gain to the customs union.

But such a rounded situation would be unusual, and one is left to judge the effects on each of the members in terms of the allocation of benefits deriving from the union in less than perfect conditions. Such argument, moreover, minimizes the problems encountered by developing countries in the process of industrialization. It seems implicit that the industries would already have to exist for the countries to capture the gains that depend on the development of specialization. Further it would imply that any item produced in the union would be produced in the low-cost country, and also that the lowest cost industries would be able to operate at the total union level of output. By this means each member gains by specializing on that product in which it has an intra-union comparative advantage.

CONSIDERING THE ECCM

Inadequate basic data makes the attempt to fit the ECCM customs union operations into any such set of analytical inter-relationships more intuitive than empirical. And it is relevant that the concepts and methodology for analysis turn largely on industrial production and its locus, an area of economic activity still nascent in the ECCM.

Further, to consider the ECCM customs union operations in the light of such analyses, it is important to take account that the customs union elements in the ECCM Agreement were supplemented by a wide range of policy integration provisions. That is, in addition to the abolition of restrictions in intra-group trade flows, the jointly agreed national abolition of discriminatory measures, and the steps to unify trade policy toward third countries, there are positive decisions to stimulate intra-group flows of capital, technology, and to a more limited extent labour. Included in this are the nucleus for a common competition policy in the provisions concerning "export drawback" and "dumped and subsidised imports" (Articles 9 and 10 of the ECCM Agreement) supplemented by the provisions for instituting a common

industrial policy (Article 13).^{4/}

But perhaps even more important for the customs union operations is the high degree of unification in monetary aspects achievable through having in place a common currency (legal tender) and a common Central Bank with a common reserve policy. This eliminates problems of exchange rates movements and related monetary adjustments in intra-union relations.

Now taking account of the ECCM customs area to identify the probable economic effects, gains and losses, the key characteristics may be summarised as follows. Consisting of seven island territories of varying sizes, with a total market of just over half a million persons, primary dependence is on agriculture and tourism. Light manufacturing industry which is generally at a low stage of development, more established in some islands than in others, is in the main agro-industrial with a few assembly type plants, several being of the enclave type. Only a small proportion of the total trade is accounted for by transactions with partners, due very largely to the goods that are in wide demand not being produced by the countries in the group.

Immediately it is evident that the potential for the creation of new trade, or the diversion of trade to ECCM sources, is limited - the partners being poor sources of supplies for the goods imported from abroad. In fact the scope for significant trade effects depends not so much on adjustments in the level of output of existing economic units, as on the expansion into additional production activities. A second aspect is that to the extent there can be trade effects, it is likely to be a diversion from lower-cost external suppliers to higher-cost area suppliers. There would be some possibilities for shifts from higher-cost home suppliers to lower-cost partner suppliers, but the scope for this is limited by the narrow range of products, and the relatively

^{4/} The initiatives do not go so far as to include some elements that might reasonably be expected in a complete common market such as common business law to overcome disparities in national legislation, harmonization of legislation affecting labour (including social benefits etc.), or a common regional policy to overcome any induced imbalances (which could incorporate a common fund).

low levels of output (i.e. low in relation to demand requirements). In addition account has to be taken of the limitations imposed by apparently inadequate inter-island transportation and the relatively undeveloped marketing mechanisms. So altogether significant gains from trade cannot be expected in the short term, at least not until expansions in output have been achieved.

There is the prospect that some gains could be derived from larger sized economic units established to serve the whole market area, (as opposed to smaller unit sizes in each of the partner countries). The scope for such gains from economies of scale would however be modest, to the extent that there is restricted mobility of production factors; that is, the greater the mobility of factors, the greater the potential for gain. In addition, the potential for gain would be greater to the extent that the economic units are of a size to meet area demand and in addition supply exports for external markets.

Clearly location of production is important as the magnitude of the gains would depend on the scope for taking advantages of low factor costs. Where the economic activity is resource-oriented, production would be located where the resources are; but to a large extent, production, particularly manufacturing activity, depends on inputs imported from external sources; and in such cases the gains would derive from efficiencies through taking advantage of the best composition of production facilities. This in turn would mean that products using relatively higher capital and relatively lower labour inputs should gravitate to lower-cost capital sites, while products requiring a large labour input gravitate to relatively lower-cost labour areas. The general proposition would be that the greater the extent to which activities can be located in least cost areas, the higher the gains are likely to be. An important qualifying factor is the extent to which there might be tendencies towards equalising labour rates, labour productivity and government "subsidies" to production units.

Taking account of the conditions of inter-island transport, the gains from location would also be affected by the bulk and unit price of the products. To the extent that they are bulky and of low unit value there are advantages to be gained from locating the activity close to the larger groups of consumers, which has the added advantage of facilitating the gearing of product lines to localised demand, where this is of importance.

As regards the possibility of gains from terms of trade effects, there is not the prospect that much can be realized as the result of the common external tariff itself. This is attributable to two facts first the low level of the tariff, and second that the market area is too small to influence external prices. However, the facility for collective bargaining should improve the transactions-relationship of the ECCM territories, as against external trading partners.

On the question of gains deriving from economies in the administration of the unified customs area, the geographical disposition of the countries nullify the possibility of there being very substantial gains from the reduction in the number of customs frontiers. However some modest gains may be possible from the reduction of inspection and clearances on area trade - the greater the reduction the greater the gains. This however has to be offset by increased costs of administration attributable to co-ordination of customs operations throughout the area. A preferential arrangement between countries not contiguous to each other, whether or not they are in the same region, cannot make any significant contribution to the reduction of the administrative costs of tariff barriers.

Up to this point the treatment has been primarily to review the customs union as a whole - which leaves open the question of effects gains and losses in respect of the individual territories. An important aspect, and one of the ECCM objectives, is to achieve a fair distribution in the allocation of benefits derived from the common market. Determination of actual benefits attributable to the common market is in itself a specific empirical exercise, that lay outside the scope of this paper. It is immediately worth noting however, that attempts to measure the possible effects of customs union have been limited mainly to establishing the possible gains from new trade and the possible gains from specialization.^{5/}

^{5/} Concerning the possible gains from new trade, the general conclusion is that the gain would approximate to the increased quantity of trade multiplied by the proportion of the purchase price made up of tariff. Regarding gains from specialization, such estimates as have been made show small changes of the order of less than 1 percent of national income.

It is of some importance that gains and losses are not seen entirely in the perspective that the relative increase in trade which each of the units secure with each other is a measure (from the standpoint of the individual territories) of the success or failure of the operations, considered within the wider setting of the common market. In fact, bearing in mind that factor movements and commodity movements are partial substitutes for each other, the issue turns on utilising the real possibilities that are opened up to institute wider dimensions of co-operation. Much of this is provided for in the aspects that go beyond customs union per se.

But at the same time, it has to be borne in mind that the nature of the economies is important in the degree of success that can initially be achieved in a customs union. Where there is the absence of important industries operating under tariff protection, high similarity of major export products, the absence of any important basis for the development of trade between the partners (whether in high-cost or low-cost products), the likelihood is that initially the union may have only moderate significance for its members, and minor significance for the external trading partners, regardless of its terms. However, it is generally expected that in a common market with mobility of production factors there would be in the medium term movements of capital and labour; and in the long term relocation of industry to gain the benefits from comparative advantages.

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