CHAPTER 4

TOWARDS AN INTEGRATED MARKET

Theory of Customs Union

The Second World War left many economies in a devastating position. Nations were left weak on economic, political and social grounds. In order to recover from such devastation, economies felt the need to integrate itself. As a result nations started trading in blocks. Countries' preference moved towards regional groupings within which trade took place. These regional groupings led to the unification of the trade taking place between different nations eliminating trade barriers. This in turn carved way for customs union – a market where trade took place differently from that stated in the traditional trade theory. The traditional trade theory was concerned only with the non-discriminatory tariff changes between the trading countries, whilst the customs unions are discriminatory in nature. Customs Union tends to discriminate between nations belonging to the same group and nations outside the said group. Customs Union is a unique combination of free trade and protection – free trade among countries participating in customs union and protection from the rest of the world.

The movement towards economic integration has evoked a considerable amount of economic literature. This literature on a whole is based on the assumption of static equilibrium. The customs union theory that follows is mainly concerned with the immediate effects of economic integration on trade and welfare. The theory of customs union, explaining trade creation and trade diversion, and its effects on welfare for countries forming customs union, attempts to explain the static effects of economic integration. The theory as explained below consists of the landmarks in this area.

The theory of customs union is that branch of tariff theory which deals with the effects of geographically discriminatory changes in trade barriers. A country engaged in international trade may discriminate between commodities[23] and/or between countries[24].

The earliest theory of customs union articulated that free trade would maximize world welfare. By way of customs union tariffs were reduced which led towards free trade, in turn, increasing world welfare even if it does not lead to maximum world-welfare. Such traditional theories confined themselves with studying the effects of customs union on welfare only.

However, Jacob Viner (1950) considered this argument of welfare enhancing through free trade to be incorrect. Rather, he gave novel ideas of trade creation and trade diversion when countries integrate regionally to trade. His theory of customs union is based on the below mentioned assumptions:

1. Absence of transportation costs
2. Production cost will determine the supply price of goods i.e. cost equates price
3. Tariff is the only source of diversion between price and cost

[23] Commodity discrimination occurs when different rates of duty are levied on different commodities. (Lipsey: 1960)
[24] Country discrimination occurs when the same commodity is subject to different rates of duty, the rates varying according to the country of origin. (Lipsey: 1960)

4. There is full employment in all the countries before and after the formation of customs union

In this respect, his theory can be recalled as depicted in the table.

Table.1 Money Prices (at existing exchange rates) of a single commodity X in three countries

Country	A	B	C
Price	70	60	50

If country A levied 100 percent tariff on imports of commodity X from both the countries B and C, there will be no imports of goods from other countries and the domestic market of country A for commodity X will be well protected. If country A levied a lower tariff say 50 percent on imports of commodity X from countries B as well as C, which is of a non-discriminatory nature, then country A will buy commodity X from country C – a country producing commodity X at the lowest cost.

Now, if country A forms a customs union with country B, all tariff will be eliminated to import commodity X from country B and therefore it will be possible for country A to import commodity X at price 60 (which is lower compared to the price which country A paid in the domestic market). Imports, now, will shift from country C to country B i.e. a shift from low-cost producing country to high-cost producing country because a 50 percent non-discriminatory tariff is still levied on imports from country C. Trade has thus been diverted from country C towards country B. This is how, according to Viner, trade diversion takes place as a result of formation of customs union.

Viner's analysis of customs union between countries A and B gives rise to the following three leeways:

1. Neither country A nor country B produces the commodity X; rather they import it from some other country (rest of the world). In such case the formation of customs union between countries A and B will not change their trade pattern – they will still import commodity X from other country (rest of the world).

2. One of the countries forming the customs union produces commodity X inefficiently i.e. the country is not the lowest cost available source of supply. The union partner would then import from the cheaper source and there will be a trade diversion.

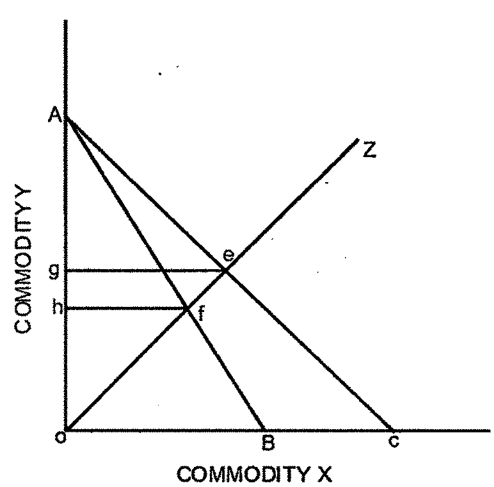
3. Both countries may be producing the commodity inefficiently under tariff protection. In this case the customs union removes tariffs between countries A and B and ensures that the least efficient of the two will capture the union market. In this situation there will be trade creation.

This analysis leads to the conclusion that customs union will cause losses if the countries are complementary in the list of goods that they produce. Viner showed that gains from customs union will arise if both countries are producing the same commodity (and hence customs union may be formed between countries with similar producing products i.e. agricultural country should prefer forming customs union with another agricultural country and industrial country should prefer forming customs union with another industrial country – as in the case of European Union).

Consider a group of commodities produced by each of the two countries under tariff protection. If these groups overlap to a larger extent, then the most efficient of the two countries will capture the union market and there will be a reallocation of resources in a more efficient direction. But, if these groups overlap to a smaller extent, then the protected industry in one country will capture the whole of the union market and there is likely to be a reallocation of resources in a less efficient direction. Thus, the gains from customs union will be greater when the degree of overlapping between the groups of commodities produced under tariff protection in the two countries is greater.

Further, on the demand side, Viner assumed, that there are no possibilities of substitution in consumption i.e. commodities are consumed in some fixed proportion independent of the relative price structure (all price elasticities of demand equals zero). On the supply side, he assumed that the supply elasticities are infinitely large so that all the products are produced under constant returns to scale. It now becomes possible to study the shifts in production between countries as given by trade creation and trade diversion. This can be identified with the following diagram:

Figure: 1

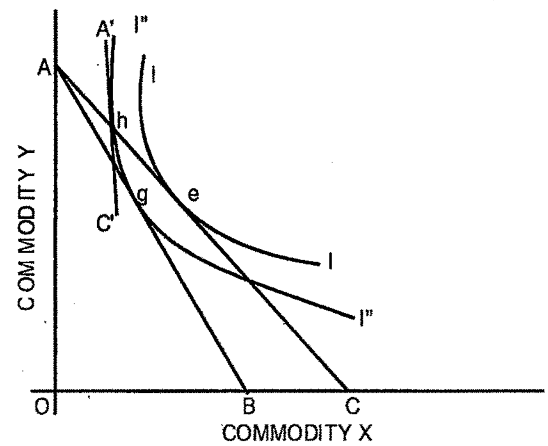


In the above diagram, country A is specialized in producing a single commodity Y. It imports a single commodity X at terms of trade independent of any taxes or tariffs levied in country A. The fixed proportion in which commodities are consumed is shown by the slope of the line OZ – which is the income-consumption and price-consumption line for all finite prices and incomes. OA indicates country A's total production of commodity Y and the slope of the line AC shows the terms of trade offered by country C (the lowest cost producer of commodity X). Under conditions of free trade, country A's equilibrium will be at point e – the point of intersection between AC and OZ. Country A will now consume Og of commodity Y and export Ag in exchange of imports ge of commodity X from country C.

Country A now forms customs union with country B. This will then lead to trade diversion. The new terms of trade offered by country B is the slope of the line AB. Country A still specializes in production of commodity Y and exchanges it for commodity X from country B. After forming customs union the new equilibrium for country A is at point f. Country A now consumes Oh of commodity Y (less compared to Og) and exports Ah in exchange of hf of commodity X from country B – for the reason that country A still consumes along the line OZ. This situation is clearly inferior to the situation before forming customs union as it represents smaller amount of both goods consumed. Thus, A's welfare is unambiguously diminished. Under the assumptions of no substitution in demand, trade diversion deteriorates country A's terms of trade which necessarily lowers A's welfare.

However, Viner's assumptions on the demand side may not hold true when customs union is formed. "A Customs Union necessarily changes relative prices and, in general, we should expect this to lead to some substitution between commodities, there being tendency to change the volume of already existing trade with more of the now cheaper goods being bought and less of now more expensive" (Lipsey: 1960, p. 501). This situation, as presented by Professor Gehrels, can be illustrated with the following diagram:

Figure: 2



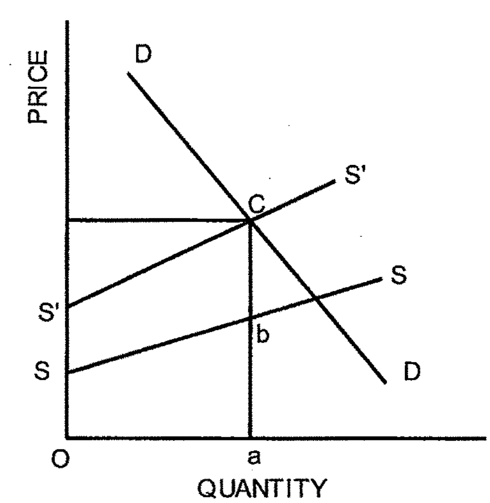
Country A is specialized in the production of commodity Y and produces at point A on the y-axis and hence country A's total production is OA. Before the customs union, it imports commodity X from the cheapest possible source, country C. Line AC shoes the terms of trade offered by country C. If free trade is permitted, country A would consume at point e where indifference curve II is tangent to the line AC. If country A imposes tariff on imports from country C – as indicated by the line A'C' – this will move A's equilibrium position from point e to point h. This will cause a reduction in the imports of commodity X from country C and an increase in the consumption of the domestic commodity Y; as at point h the indifference curve I"I" cuts line AC with a slope equal to line A'C'.

Now, if country A forms customs union with country C; trade diversion will take place worsening country A's terms of trade. Country A still produces OA of commodity Y and imports commodity X. The new terms of trade now is given by the slope of the line AB. The price ratio AB will now rule the domestic market of country A and commodity X is now cheaper than at the tariff-inclusive price ratio at A'C'. Therefore, commodity X will be substituted for commodity Y in consumption and the consumption of Y will now move to point g. As shown in the diagram, point g is on the same indifference curve as point h. Hence, consumers are as well off after the customs union as before. This shows that a customs union, even though leading to trade diversion, could result in consumers being as well off as before. But, if the deterioration in the terms of trade had been less than what is shown by line AB, and the new price line or terms of trade line had been somewhere between AC and AB, the customs union would have led to an increase in consumers welfare and would have put them on a higher indifference curve than I"I". In such case, the customs union would have increased consumers welfare even though it was of a trade diverting kind. This demonstrates that if substitution in consumption takes place, it implies that customs union can lead to an improvement in welfare even if it is of a trade diverting nature. On a whole, Professor Gehrels' analysis establishes a general presumption in favor of gains from customs union rather than losses.

Viner's analysis of trade creation and trade diversion substituted the source of country for commodities to be imported i.e. inter-country substitution. While Gehrels' analysis provided for substitution between commodities because of shift in relative prices i.e. inter-commodity substitution. However, analyzing with just two commodities may not seem to be a real phenomenon as customs union formation gives rise to both kinds of substitution i.e. inter-country as well as inter-commodity. This can be understood from Professor Meade's analysis.

Professor Meade's analysis attempts to classify a large number of possible cases, showing the factors which would tend to cause welfare to increase when a customs union is formed and to distinguish them from the factors which would tend to cause welfare to diminish. In order to measure the gains and losses from customs union, Meade uses an important factor – the height of tariffs. Consider the following diagram:

Figure: 3



The figure shows the demand and supply curves for any imported commodity. Any tariff levied will shift the supply curve upwards i.e. from SS to S'S'; thus raising the price of imported commodity. Equilibrium is then established at point c. At point c, the demand price is different from the supply price by the amount of the tariff levied. If the supply price (ba) shows the utility of the commodity to the producer and the demand price (ac) shows the utility of the commodity to the consumer, then the utility of the taxed import is higher to the consumers than to the producers. And the money value of this difference in utility is the value of tariff (bc).

If we assume that the marginal utility of money is the same for buyers and sellers then if one more unit of expenditure were devoted to the purchase of this commodity, there would be a net gain to the society equal to the proportion of the selling price of the commodity composed of the tariff. In the above figure, the rate of tariff is *bc/ab %*; the supply price is ab and the demand price is bc, therefore the money value if the gains to the society resulting from a marginal increase in expenditure on this commodity is cb. If there is a marginal decrease in this expenditure then there would be losses to the society. This kind of analysis implies that the higher the initial tariffs between the countries forming the customs union, the larger the scope for gain. Conversely, the lower the tariffs with the outside world, the lower should be the losses due to trade diversion. Professor Meade's analysis puts forth some generalizations for customs unions:

1. When only some tariffs are to be changed, welfare is more likely to be raised of these tariffs are merely reduced than if they are completely removed.
2. What matters is the relation between imports from the outside world and expenditure in domestic commodities – the larger are the purchases of domestic commodities and smaller are the purchases from the outside world, the more likely is it that the union will bring gain.

Thus, the size of the trade with a union partner is not the important variable[25].

Meade's analysis, however, suffers from one very important limitation. Unlike the marginal reductions, when there are large changes in many tariffs, as there will be with most of the customs union, it can be no longer assumed that the demand and supply curves will remain fixed. The ceteris paribus assumptions on which they are based will no longer hold, so that both demand and supply curves are likely to shift. When this happens it is no longer obvious how much welfare weight should be given to any particular change in the volume of trade even if we are ready to make all of the other assumptions necessary for the use of this type of classical welfare analysis (Lipsey: 1960, p. 506).

Alleyway to European Union

The economic literature in international sphere confronts many economists who advocate for free trade. Many theories in international economics have proved that trading is always beneficial than autarky (Say's Absolute Advantage Theory, Ricardo's Comparative Advantage Theory, Heckscher-Ohlin's Factor Endowment Theory among others). With further development in the literature of international economics there were thinkers who condemned the idea of free trade. Yet, there were some thinkers who strongly favored trade by arguing that all countries are not bestowed with all the resources that it needs. This fact was aptly embraced by Gaedicke and von Eynern (1933) in their two volume work (Gaedicke, Herbert, and Gert von

[25] For a detailed analysis see Meade, J.E. 1956. The Theory of Customs Unions. Amsterdam: North Holland Publishing Company and Lipsey, R.G. The Theory of Customs Unions: A General Equilibrium Analysis. Ph.D Thesis, University of London. Unpublished.

Eynern. 1933. *Die Produktionswirtschaftliche Integration Europas: Eine Untersuchung über die Aussenhandelsverflechtung der Europäischen Länder*. Berlin: Junker and Dünnhaupt; as cited in Machlup: 1977 p. 7). In their book using statistical data for foreign trade, they concluded that there existed a 'high degree of export integration' in Europe. Trade is one factor that inter-related the countries of Europe through supply of raw materials and intermediary products to each other. Later, with the development of the theories of customs unions the idea of "restricted trade" was emphasized upon "free trade". And to this respect many thoughts have entered the economic literature whether trade would prove to be beneficial or not for the trading countries? Moreover, the theories of customs unions advocated for a regional integration.

Economic integration has attracted immense attention since the post war period. It divides the world into preferred and discriminated partners (Pelkmans: 1997). Therefore, it becomes essential to understand economic integration. Integration is the process of reaching the state of union (Denton: 1969). Denton defines economic integration as "...both the removal of discrimination as between the economic agents of the member countries, and the formation and application of co-ordinated and common policies on a sufficient scale to ensure that major economic and welfare objectives are fulfilled.". Hence, economic union is a state in which discrimination has been largely removed, and coordinated and common policies have been and are being applied on a sufficient scale. In other words, economic integration is the elimination of economic frontiers between two or more economies. This provides for elimination or reduction of discrimination on the mobility of goods or services, production factors as well as communication flows. Economic integration refers both to market integration and policy integration[26].

General economic integration of the economies refers to the entirety of economic activities of the region, country, block, or world. If the government of countries intend to integrate their economies they will have to remove restrictions on the movement of people, funds, and goods; pursue policies designed to correct wrong signals of the free market and to strengthen the effects of correct signals; and to create permanent institutions without which the integrating forces of free markets may be too weak to be effective (Machlup: 1977) i.e. to go for both positive as well as negative integration.

Europe witnessed two devastating world wars and the Great Depression of the 1930s. This led the European economies to alter their trade relationships with each other as well as with the rest of the world. This in turn led to regional and economic integration of the countries of Europe. The European Union is not the first historical experiment of greater economic integration, but it is definitely one of the most successful and far-reaching illustrations. It is a revolutionary project that radically transformed the economic and political map of Europe. Hence, what follows next is a brief summary of the journey to the European Union.

[26] Market integration is a behavioral notion indicating that activities of market participants in different regions or member states are geared to supply and demand conditions in the entire Union. Policy integration may cover very different types of economic policies, using different kinds of instruments (Pelkmans: 1997 p. 6)

Formation of the Union – From the BENELUX to The European Union

Adolf Hitler was the main catalyst of the European Community. He brought together, by the strength of sword, virtually the entire area of the original European Economic Community (EEC). The governments of the Netherlands, Belgium, and Luxembourg decided in 1944 that their economic futures were inextricably disheveled. The Benelux Union came into force on 1st of January 1948 as a customs union and was the oldest post-war regional integration in Western Europe. The USA and the Soviet Union both gave the nations of Western Europe a thrust in the direction of unity. The fighting of World Wars left the Western European countries in crisis, as a result of which all the Western European nations had to accept the Marshall Aid from the USA[27]. In order to evenly divide the flow of the US aid under the Marshall Plan, the Organization of European Economic Co-operation (OEEC) was set up in 1947. The aid program was completed over three years, but the OEEC continued as a forum for promoting economic co-operation and free trade among Western European countries. Later its membership was extended to include all industrialized non-communist nations and the name was changed to Organization for Economic Co-operation and Development (OECD) in 1961. The domination on the countries of Eastern Europe by USSR forced several West European countries to come together and unite into larger groups – more powerful and protective than the traditional nation state. As early as 17th March 1948, the Treaty of Brussels was signed providing for a 50 years

[27] The Marshall Plan transferred about $12.5 billion to Europe in grants, loans, and conditional aid.

agreement between the UK, France, Belgium, the Netherlands, and Luxembourg which was known as the Western European Union (WEU). WEU was later joined by Germany and Italy in 1954. The Franco-West German dispute over the Saarland, which was largely fuelled by French, feared that if its iron and coal industries were integrated with those of the rest of the West Germany it would once again dominate the economy of Europe. France had tried unsuccessfully to annex the Saarland, which was overwhelmingly German in population, and as in the post-1919 period, this attempt had poisoned relations between the two countries. In order to reduce the prospects of subsequent major military conflicts, an alternative was brought to the fore as a part of a wider political initiative. Jean Monnet (principal architect of European Union and the then head of the French Planning Organization) succeeded in capturing the ear of the French foreign minister, Robert Schuman, to put forward his (Monnet's) proposal of Franco-West German reconciliation. Monnet's proposal was put forward as the 'Schuman Plan'[28] by the French government. It was considered as a functional approach towards the unity, embodying a gradual progression. As per this plan, the West German and the French coal and steel industries – then considered as strategic sectors of the economy - should be placed under a single High Authority which should supervise their development. West Germany, and later Italy and the Benelux countries (the Netherlands, Belgium, and Luxembourg), quickly responded to the invitation to join the Plan, and the Treaty of Paris was signed on 18th April 1951. The Treaty of Paris formally established the European Coal and Steel Community (ECSC), which came into

[28] The Schuman Plan was launched on 9th May 1950.

being on 10th August 1952[29]. The ECSC was the European contribution to the foundation of the European Union and an institutional innovation that allowed recovery to continue in Europe. It was created to stabilize prices, ease the distribution of coal during the post-war boom, provide new markets for iron ore and steel, and coordinate competition. All import and export duties, subsidies, and other discriminatory measures were immediately abolished on the trade of coal and steel among the six member countries. The ECSC was unique in being provided with a supra-national High Authority which was given wide powers to determine the direction of two key industries throughout the member nations. However, the UK declined to join the ECSC as her coal and steel industries had been nationalized immediately at the end of the war by the Britain's labor government. Moreover, the UK never participated in the continental steel cartels before World War II (Neal: 2007). The absence of the UK facilitated the construction of a community that was different from the many other international organizations established during this period, such as the Council of Europe, the North Atlantic Treaty Organization (NATO) or the General Agreement on Tariffs and Trade (GATT). Monnet had intended that the ECSC would be paralled by a common European Defense Force, which would supersede national armies and facilitate the rearming of West German force. France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg signed a treaty in May 1952 providing for a creation of a European Defense Community (EDC)[30]. However the creation of EDC was a failure. The failure of EDC had two significant consequences. Firstly, West German rearmament proceeded on a national basis and secondly, West

[29] Jean Monnet was the first president of ECSC.
[30] However, the French National Assembly declined to ratify the treaty in August 1954.

Germany was admitted as a full member of NATO (North Atlantic Treaty Organization) in October 1954. From this, Monnet concluded that the path towards European unity lay through economic rather than military co-ordination. He (Monnet) then headed the Action Committee for the United States of Europe (ACUSE) which included leading figures from the six member nations. The foreign ministers of these six nations met in Messina in June 1955 and appointed a committee under the chairmanship of the Belgian foreign minister, Paul-Henri Spaak, to investigate establishing a common market. This committee produced a report which was the basis of the Treaty of Rome signed on 25th March 1957, establishing the European Economic Community (EEC)[31] as a Customs Union. All six parliaments ratified the treaty which came into effect on 1st January 1958[32]. The greatest achievement of the EEC has been the progressive lowering of barriers, both economic and psychological, between the Member States (Minshull: 1978). However, the UK decided not to join the EEC as a member. Instead the UK with other six members of the OECD (Austria, Denmark, Norway, Portugal, Sweden and Switzerland) formed the European Free Trade Agreement (EFTA) by signing the Treaty of Stockholm in 1959. The EFTA was a free trade area, as opposed to the Customs Union, with a common external tariff i.e. providing for gradual reductions and eventual abolition of quotas and tariffs on imports from member countries, leaving their tariffs on imports from other countries unaffected and a political agenda. The three communities – the ECSC, Euratom, and the EEC – were formally amalgamated on 1st July 1967. They

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[31] A separate treaty signed on the same day in Rome established the European Atomic Energy Community (Euratom).
[32] Walter Hallstein of Germany was the first president of EEC Commission.

were jointly known as the European Community (EC), or sometimes the European Communities. The meeting of European Council at Maastricht in December 1991 set the grounds for the Treaty on European Union. After much political hassle, the Treaty on European Union finally came into force on 1st November 1993. It provided a new dimension to the development of European economy. Since then the European Community has been generally known as the European Union (EU). It can thus be said that the Maastricht Treaty opened the doors to a broader pathway – economically, politically, financially and institutionally – to European Union (EU).

The European Union as the reincarnation of the three old communities (the ECSC, the EEC, and the Euratom) in a much more developed form and with wider membership has clearly emerged as the most important regional organization, an organization which almost all European countries aspire to join (Tsoukalis: 2003). The European Union is far more the largest customs union formed. And all the member nations tend to benefit from this regional integration in one or other form.

In this chapter, we saw the theories of Customs Union which are considered to have triggered the economic literature on the subject area of (regional and economic) integration. Based on the arguments put forward by these theories, it was quite clear that forming a Customs Union would benefit the member countries by increasing welfare, ultimately elevating economic growth of the member economy.

In view of this, I intent to study whether forming a Customs Union have had an impact on the economic growth of its member countries. Since the

European Union is one of the oldest forms of Customs Union, it has been chosen for the analysis purpose. Further in this chapter, we saw, the factors that led to the formation of the European Coal and Steel Community and how it has been elevated to the present state of a complete European Union.

This takes us to the study of various economic conditions that have been faced and prevail in the selected member nations of the European Union. In the light of this, the next chapter explains the economic status of the selected EU countries since Second World War.