Course Title: International Economics

Course Code: ECON3019

Course Instructor: Mr. Bidhubhusan Mishra

Topic: Customs Unions

Economics Integration

- The theory of economic integration refers to the commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together.
- Depending upon the degree of economic integration, there could be a number of arrangements.

Types of Economic Integration

- Preferential trade arrangements provide lower barriers on trade among participating nations than on trade with nonmember nations.
- A free trade area is the form of economic integration wherein all barriers are removed on trade among members, but each nation retains its own barriers to trade with non-members.
- A customs union allows no tariffs or other barriers on trade among members (as in a free trade area), and in addition it harmonizes trade policies (such as the setting of common tariff rates) toward the rest of the world.

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- A common market goes beyond a customs union by also allowing the free movement of labour and capital among member nations.
- An economic union goes still further by harmonizing or even unifying the monetary and fiscal policies of member states. This is the most advanced type of economic integration.

Customs Union and Trade Creation

- Trade creation occurs when some domestic production in a nation that is a member of the customs union is replaced by lower-cost imports from another *member nation*.
- Assuming full-employment, this increases the welfare of member nations because it leads to greater specialization in production based on comparative advantage.

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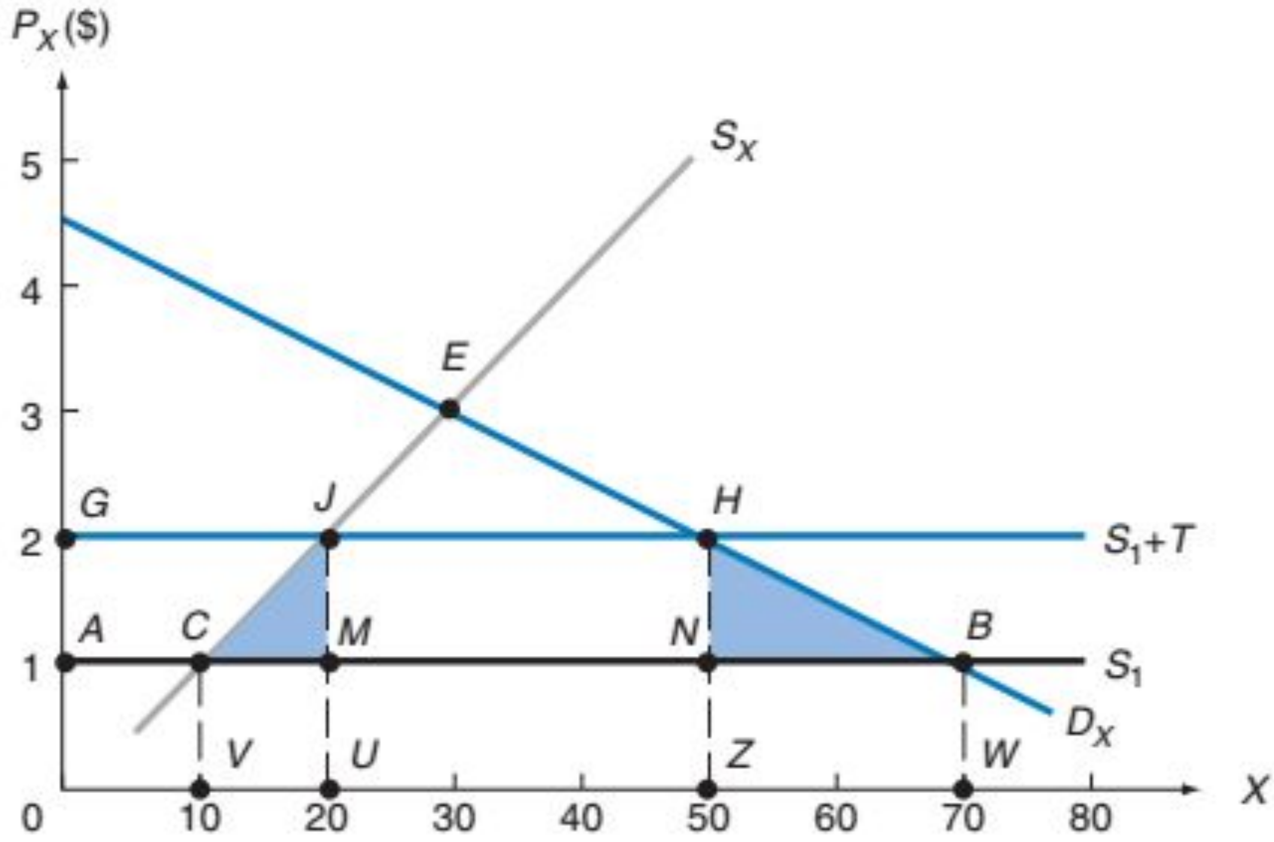

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- Suppose there are three nations i.e. Nation-1, Nation-2 and Nation-3.
- D_x and S_x represent the demand and supply curve of commodity X in Nation-2.
- The free trade price of X is \$1 in Nation-1 and \$1.5 in Nation-3.
- S_1 is the perfectly elastic supply curve of X of Nation-1 to Nation-2.

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- If Nation 2 initially imposes a nondiscriminatory ad valorem tariff of 100 percent on all imports of commodity X, then Nation 2 will have to import commodity X from Nation-1 at P_x = \$2 or from Nation-3 at P_x = \$3 .
- So the obvious choice will be to import from Nation-1
- The supply curve of Nation-1 will shift upward to S_1+ T.

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- At P_x = \$2, Nation 2 consumes 50X *(GH)*, with 20X *(GJ)* produced domestically and 30X *(JH)* imported from Nation 1. Nation 2 also collects \$30 *(MJHN)* in tariff revenues.
- If Nation 2 now forms a customs union with Nation 1 (i.e., removes tariffs on its imports from Nation 1 only), P_x = \$1 in Nation 2. At this price, Nation 2 consumes 70X *(AB)* of commodity X, with 10X *(AC)* produced domestically and 60X *(CB)* imported from Nation 1. In this case, Nation 2 collects no tariff revenue..

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- The increase in the consumers surplus in Nation 2 resulting from the formation of the customs union is equal to *AGHB.*
- However, out of the total increase in consumer surplus of AGHB, the area *AGJC* represents a reduction in rent, or producer surplus, while *MJHN* represents the loss of tariff revenues. This leaves the sum of the area of shaded triangles *CJM* and *BHN* , or $15, as the net static welfare gain for Nation 2

Customs Union and Trade Diversion

- Trade diversion occurs when lower-cost imports from outside the customs union are replaced by higher cost imports from a union member.
- This results because of the preferential trade treatment given to member nations.
- Trade diversion reduces welfare because it shifts production from more efficient producers outside the customs union to less efficient producers inside the union.

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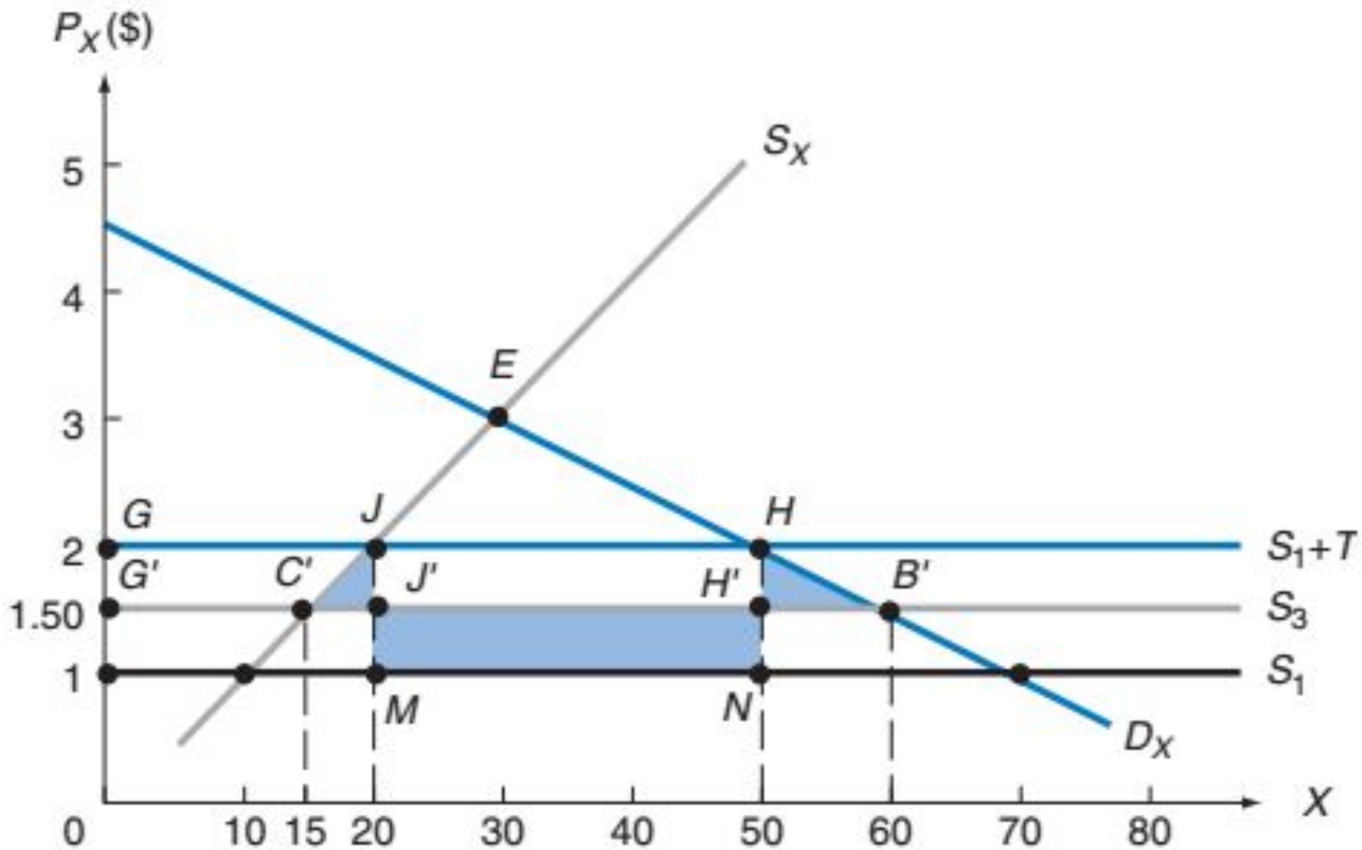

P_X ($)
5
4
3
2
1.50
1
0
10
15
20
30
40
50
60
70
80
X
S_X
E
G
J
H
S_1+T
G'
C'
J'
H'
B'
S_3
S_1
M
N
D_X

Continued....

- Suppose there are three nations i.e. Nation-1, Nation-2 and Nation-3.
- D_x and S_x represent the demand and supply curve of commodity X in Nation-2.
- The free trade price of X is $1 in Nation-1 and $1.5 in Nation-3.
- S_1 and S_3 are the perfectly elastic supply curves of X of Nation-1 and Nation-3 respectively to Nation-2.

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- If Nation 2 now forms a customs union with Nation 3 only (i.e., removes tariffs on imports from Nation 3 only), Nation 2 finds it cheaper to import commodity X from Nation 3 at P_x = \$1.50.
- At P_x = \$1.50, Nation 2 consumes 60X *(G'B')*, with 15X *(G'C')* produced
  domestically and 45X *(C'B')* imported from Nation 3. In this case, Nation 2 collects no tariff revenue.
- The imports of commodity X into Nation 2 have now been *diverted* from the more efficient producers in Nation 1 to the less efficient producers in Nation 3 because the tariff discriminates against imports from Nation 1 (which is outside the union).
- Note that Nation 2's imports of commodity X were 30X before formation of the customs union and 45X afterward. Thus, the trade-diverting customs union also leads to some trade creation.

- **Reference:**

Salvatore D (1998), International Economics, Prentice Hall.