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European Journal of Political Economy 23 (2007) 416–422
European Journal of POLITICAL ECONOMY
www.elsevier.com/locate/ejpe

Normative comparisons of customs unions and other types of free trade association

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Received 26 January 2007; received in revised form 4 April 2007; accepted 5 April 2007
Available online 2 May 2007

Abstract

In the present paper it is shown that the Kemp–Wan proposition concerning customs unions can be extended to cover free trade associations other than customs unions and that sense can be made of the common conjecture that a customs union is more beneficial or less harmful to the world economy than a comparable but distinct free trade association that is not also a customs union.

JEL classification: D60; F13; H20

1. Introduction

Free trade associations (FTAs) are the best known and have been the most closely examined of all preferential trading arrangements (PTAs); and, in the general class of FTAs, special attention has been focussed on customs unions (CUs), in each of which the member countries share a common tariff vector. Perhaps the most widely accepted proposition concerning CUs is the so-called Kemp–Wan proposition; see Kemp and Wan (1976, 1986), also Ohyama (1972). Indeed, for a long time, it was the only available proposition of any generality; its only competitor was the rather vague Vinerian proposition that a CU might be either 'trade diverting' or 'trade creating'. In quite recent times, however, there has developed an interest in two normative questions closely related to each other and to the Kemp–Wan proposition.

(i) Can we find a result parallel to the Kemp–Wan proposition but applying to FTAs that are not also CUs?

(ii) Can it be shown that a CU is more beneficial or less harmful to the world economy than a comparable but distinct FTA that is not also a CU?

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0176-2680/$ - see front matter
doi:10.1016/j.ejpoleco.2007.04.001

The first of the above questions has already been addressed by Michihiro Ohyama (2002) and by Arvind Panagariya and Pravin Krishna (2002). They answered the question in the affirmative. However in both papers it was assumed that each member country chooses its tariffs so that the vector of that member's aggregate trades with non-member countries remains unchanged at its pre-FTA level.

Proposition 1. *(Ohyama and Panagariya–Krishna): An FTA in which each member country adjusts its tariffs so as to keep the quantity of its trade with non-member countries at the pre-FTA level is beneficial to the world as a whole.*

Evidently the assumption in Proposition 1, that the country-specific FTA tariffs maintain the pre-FTA trade vector of each member country with the rest of the world, is much more restrictive than is the assumption of Kemp and Wan, that the aggregate trade vector of member countries is maintained at its pre-FTA level. Thus the results obtained by Ohyama and by Panagariya and Krishna for FTAs are not parallel to or closely similar to the Kemp–Wan proposition.[1] Whether it is necessary to assume that each member country chooses its tariffs to preserve its pre-FTA trade vector with the rest of the world remains an open question.

It is often implicitly assumed that the second question also can be answered in the affirmative. However, standing in the way of effective analysis of the question have been vagueness about the constituency (whose welfare is at issue?) and about the sense in which a CU and an FTA may be described as comparable. The question has been formally addressed only in a very brief note by Kemp (2000). However Kemp's method of attack on the second question throws new light on the first question. In the present paper, then, I offer a coordinated re-examination of both questions. It will be shown in Section 2 that if the compensated excess demand functions of member countries are differentiable then, except in a singular case, there always exists a Pareto-improving FTA in which the pre-FTA aggregate trade vectors of member countries with non-member countries are preserved: The more restrictive condition imposed by Ohyama and by Panagariya and Krishna is unnecessary. It will be shown also that corresponding to each FTA there is a Pareto-preferred and feasible CU (strongly preferred if the FTA is not also a CU).

In Section 3 and in the Appendix it will be shown that the new proposition is valid whether or not excluded countries respond to the formation of an FTA by adjusting their own tariffs. And, finally, Section 4 summarizes the findings of the paper and provides several cautionary remarks, technical as well as political-economic, concerning the interpretation of the findings.

2. Analysis

Consider an Arrow and Debreu (1954) world economy containing N, $N>2$, countries which trade in two or more commodities. (Since each commodity is distinguished by its date of delivery, international borrowing and lending are implicitly accommodated.) Let $\boldsymbol{N}=\{1,\ldots,N\}$. Initially, each country maintains an arbitrary tariff vector and there is a tariff-distorted world equilibrium (TWE), not necessarily unique. Sontheimer (1971) has provided sufficient conditions for the existence of equilibrium; see also Kemp and Wan (1995).

The initial TWE is disturbed by the formation of a Kemp–Wan CU comprising a subset $\boldsymbol{N}'$ of the trading countries. Among the defining characteristics of the CU is a common tariff vector and a scheme of lumpsum compensation, restricted to households in the CU, such that (a) the pre- and post-CU equilibrium aggregate net import vectors of the member countries are identical and (b)

[1] For a contrary opinion, see Raimondos-Møller and Woodland (2006, p. 80).