



Endogenous tariff creation and tariff diversion in a customs union

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Abstract

The common external tariffs of the EEC declined after it was formed. We label as ‘tariff diversion’ the four forces pushing down external tariffs after EEC formation (endowment effects of capital deepening, reduced EEC versus country industry concentration, general industry prosperity and greater export specialization). We label as ‘tariff creation’ the three forces pushing up external tariffs after EEC formation (terms of trade effects, increased industry concentration and industries hurt by rapid growth in intra-EEC imports). There was virtually no evidence that EEC tariffs increased because of terms of trade effects. We quantify these forces using Magee et al.’s (1989) endogenous tariff model and Lee’s (1996) model of free riding and find that even after adjustment for GATT tariff declines, the common external industry tariffs of the EEC declined in the first 15 years after formation (from 1968–1983) because the tariff diversion effects exceeded the tariff creation effects. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Academic work on regionalism by Bhagwati (1991, 1993), Bilal (1998), Grossman and Helpman (1995), Krueger (1995), de Melo et al. (1993), Panagariya and Findlay (1996) and Richardson (1993, 1994, 1995) have very mixed results on whether trading blocs are more protectionist than the former individual countries. Jagdish Bhagwati (1993) and Paul Krugman (1991, 1993) are leading spokesmen for a view that customs unions may lead to increases in tariffs on external trade.¹ On the other side of the debate are most writers in a conference volume published by de Melo and Panagariya (1993), who argue that regionalism reduces protection and increases welfare.

This paper explains why there is such disagreement over whether regionalism leads to increases or decreases a customs union's common external tariff. The results here indicate that there are conflicting forces which can make the results go either way.

We find that the endogenous common external tariff of a customs union formation will rise because of 'tariff creation' effects and will decline because of 'tariff diversion' effects, borrowing language from Viner (1950).² Our econometric estimates using two-stage least squares indicate that after adjusting for GATT effects, the tariff diversion effects dominated the tariff creation effects in the first 15 years after the European Economic Community (the EEC) was formed. Thus, even after adjusting for GATT effects, the common external industry tariffs of the EEC declined in the period 1968–1983.

The debate over whether regionalism increases or decreases protectionism ignores (1) the endogeneity of regionalism itself and (2) the endogeneity of the common external tariff of a region once it is formed. The proper focus is to explain (1) the free trade forces which explain regional trading bloc formation and (2) the forces driving the external tariffs of trading blocs after their formation. Section 2 of the paper discusses the first question – endogenous regionalism and the exogenous forces which led to complete trade liberalization within the EEC in 1968. We also explain why the EEC chose to be a customs union rather than a more protectionist free trade area.

¹ Krugman (1991) finds that tariff rates are high and world welfare is minimized with three large trading blocs because of terms of trade effects. By implication, any increase in the size of existing trading blocs is welfare reducing. Another vocal opponent of regionalism is Bhagwati (1993, p. 46) whose weakest statement is that '... the revival of regionalism is unfortunate'.

² Viner (1950) invented the terms 'trade creation' and 'trade diversion'. Trade creation increases welfare because intra-union trade expands with the abolition of tariffs on imports from member-countries. Trade diversion decreases welfare because importers switch from low-priced world sources to higher priced member country sources after tariffs drop to zero on intra-union trade.

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