Journal of International Economics 60 (2003) 387–416

Journal of
INTERNATIONAL
ECONOMICS

www.elsevier.com/locate/econbase

Rules for the disposition of tariff revenues and the determination of common external tariffs in customs unions

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Received 12 December 1995; received in revised form 25 July 2001; accepted 29 March 2002

Abstract

This paper is about the determination of common external tariffs (CETs) in customs unions (CUs). We first examine how the relationship between preferences over CET levels, technology and the distribution of factor ownership in a CU is conditioned by the rule that determines the disposition of tariff revenues. We then explore how majority voting at the country level translates these preferences into an equilibrium CET. Among other things, we find that, when revenues are partitioned in proportion to members' imports, tariff preferences may be polarized, the trade patterns of some CU members may be endogenous, and, as a result, their payoff functions may not be single-peaked. This leads to voting outcomes that dramatically differ from those arising under other sharing rules (e.g., the 'population' and 'consumption' rules) and raises the possibility of a Condorcet paradox.

Keywords: Customs unions; Trade policy preferences; Sharing rules; Factor ownership; Median voting country

JEL classification: F11; F13; F15; F42

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0022-1996/02/$ – see front matter
doi:10.1016/S0022-1996(02)00046-6

1. Introduction

In his pioneering work, *The Customs Union Issue*, Jacob Viner (1950) prepared the ground for his analysis with these words:

> It has been generally agreed that a perfect customs union must meet the following conditions:
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> 1. the complete elimination of tariffs as between the member territories;
> 2. the establishment of a uniform tariff on imports from outside the union;
> 3. apportionment of customs revenue between the members in accordance with an agreed formula. (Viner, 1950, p. 5).

These ideas also echo in Lipsey's (1970) seminal contribution to customs union (CU) theory and in Corden's (1984) valuable section on preferential trade arrangements (PTAs). The first two conditions are familiar to students of regional integration. Still, little is known about the third condition and much less about its implications for trade policy.[1] But why should policy analysts care about rules for the disposition of customs receipts? In this paper we advance the view that an eminently important reason is that these rules play key roles in the determination of national preferences over common external tariff (CET) levels and ultimately in the formation of actual trade policy.

Suppose policymakers aim at maximizing national welfare. If Pareto-efficient transfers between members in a CU were feasible and policy planners could agree on a social welfare function, there would be no disagreement between them on the CET level. In actuality, however, the requisite coordination on efficient transfers may be non-trivial and, perhaps more importantly, such transfers may fail to be lump-sum because they are costly to implement (for example, they may involve considerable informational, administrative, political, and rent-seeking expenditures) and may be subject to manipulation.[2] Furthermore, consensus on a social

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[1]This is puzzling because Viner documented the historical relevance of several prominent rules for sharing tariff revenues, paying special attention to the practical difficulties policymakers encountered in implementing them. Almost a quarter of a century later, Corden felt compelled to reemphasize the real world relevance of these rules, to point out the relative lack of theory on them, and to urge scholars to include them in their research plans. In his words, ''... One other aspect of the CET must be mentioned, namely the disposition of the tariff revenue. This is a most important matter, as all observers of the European Economic Community know, but there has not been much theory about it. The models all assume that the revenue is redistributed to the partners in proportion to their absorption of imports. But, of course, in the absence of such full automatic redistribution, the welfare effects on the partners separately cannot be analyzed without adding the effects that follow from formulae for use and distribution of the tariff revenue.'' (Corden, 1984, p. 119).

[2]Intra-union transfers may fail to be lump-sum even when aggregate CU income (not just tariff revenues) is apportioned in accordance with some predetermined rule that depends on prices.