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The customs union issue: Why do we observe so few of them?[☆]

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ABSTRACT

The number of preferential trade agreements has greatly increased over the past two decades, yet most existing arrangements take the form of free trade areas, and less than 10% can be considered to be fully fledged customs unions. This paper develops a political economy model of trade policy under imperfect competition to provide a positive explanation for the prevalence of free trade areas. In a three-country setting, a representative from each prospective member is elected to determine the tariffs to be applied on imported goods. Under a customs union, the necessity to coordinate tariffs leads voters to strategically delegate power to more protectionist representatives. We show that strategic delegation may imply that free trade areas increase the prospective member countries' welfare compared to customs unions. Moreover, the model also indicates conditions under which free trade areas are more likely to be politically viable than customs unions.

1. Introduction

In the last two decades the world economy has witnessed an impressive increase in the number of preferential trade agreements that entered into force. Interestingly, as reported by the World Trade Organization,[1] over 90% of the agreements effective April 2008 take the form of free trade areas (FTAs) or other limited scope deals, whereas slightly less than 10% are represented by customs unions (CUs) (see Fig. 1). This evidence is in many ways surprising, as the existing literature has indicated that CUs are – at least from the point of view of the welfare of the member countries – the optimal form of preferential agreements.[2]

How can the role of FTAs as the dominant preferential trading arrangement be explained? We answer this question by developing a political economy model of trade policy determination that enables us to analyze the formation of preferential trade arrangements and to compare the social welfare effects and political viability of free trade areas and customs unions. To this end we construct a simple three-country, three-good model, in which two potential member countries strategically interact to choose the tariff levels to be implemented vis à vis each other and the rest of the world, whereas the rest of the world implements most-favored-nation tariffs.

The underlying economic structure is the oligopolistic model used in several analyses of regionalism,[3] and in our benchmark setting each prospective member produces different subsets of final goods (i.e. we have "perfect" geographical specialization), and 'small' countries are

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1 See: http://www.wto.org/english/tratop_e/region_e.h.

2 See Woodland (1982) for an early contribution in a perfectly competitive setting, Saggi (2006) and Ornelas (2007) for more recent models based on an oligopolistic market structure.

3 See Freund (2000), Krishna (1998), Ornelas (2005b), Saggi (2006) and Ornelas (2007) among others.

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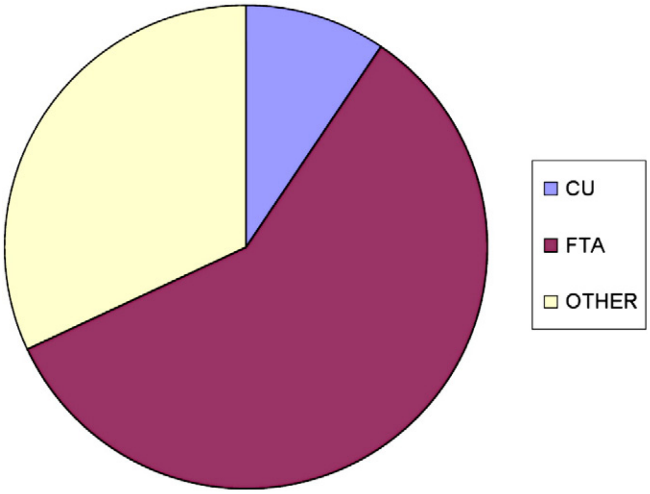

Fig. 1. Preferential trading arrangements by type (April 2008).

able to influence their import prices because markets are segmented and firms are price setters. In each country, individuals derive income from labor supply and from the profits of an oligopolistic firm, whose ownership is unevenly distributed among the citizenry. Building upon this structure, we consider a representative democracy framework in which the policy maker in charge of international trade policy is chosen from among all citizens, and the elected representative is unable to commit[4] ex-ante to a given policy.[5]

We model the choice of the trade policy regime as a four-stage game. In the first stage, each potential member country votes to decide whether a non-discriminatory MFN trade policy, a free trade area or a customs union will be implemented. In the second stage, the citizenry chooses a representative, who will then select the tariff level vis-à-vis the rest of the world in the third stage of the game. The emerging trade policy is non-discriminatory under the MFN regime. If instead a preferential agreement is in place, free trade will prevail between member countries. External tariffs will be coordinated if a customs union is formed,[6] whereas each member will set trade policy autonomously if a free trade area has been established.[7] In the fourth stage, firms compete in quantities, taking as given the trade policy that has been set in the third stage.

In our setting, the individual with the median ownership share in the firm is the pivotal player. Assuming that the median voter receives a fraction of the profits which is lower than the population's average, we show how the distribution of income in each country relates to the choice of trade policy regime. We establish several interesting results. First, we find that the necessity to coordinate tariffs in customs unions leads the median voter to strategically delegate power to a more protectionist representative.[8] This does not occur when a free trade area or an MFN regime is chosen, as no tariff coordination occurs and markets are segmented. Second, we show that strategic delegation may lead customs unions to be welfare-dominated by free trade areas if the degree of income inequality is sufficiently low.[9] Moreover, in our model, free trade areas raise the member's welfare relative to the MFN regime independently of the distribution of income, while customs unions decrease their welfare relative to the MFN regime if the degree of income inequality is sufficiently small.

We also investigate the political viability of the trade regime in the first stage of the game. Since the median voter has a lower than average stake in the oligopolistic firm, profits derived from high tariffs are less important for political viability than for social welfare. We show that under our benchmark assumption of perfect geographic specialization, customs unions are not politically viable,[10] whereas free trade areas are politically viable if income inequality is sufficiently low.[11] We turn next to consider a more general setting, in which the two prospective member countries might share similar production structures, i.e. geographic specialization is less than perfect. Interestingly, we show that as long as the production structures are not too different, and income inequality within each country is not too extreme, a customs union might actually emerge in the political equilibrium.

Two important messages thus emerge from our analysis. On the one hand, countries characterized by geographically specialized production patterns are more likely to form a free trade area, the smaller is the income inequality within each country. On the other hand, countries whose production structures are very different are unlikely to form customs unions, independently of the income distribution. Only if production structures are sufficiently similar and income inequality within each prospective member is not too extreme, will customs unions emerge. Thus, our model suggests a possible explanation for why we observe only few customs unions around the globe, and why they typically involve – like in the case of the European Union – "similar" countries.

The rest of the paper is organized as follows. In Section 2 we introduce the model and determine the equilibrium prices and quantities taking as given the tariff levels implemented by each country. In

[4] Maggi and Rodriguez-Clare (1998, 2007) have highlighted how international trade agreements can work as a commitment device. As pointed out by one of the referees, the mechanism we describe in our model is different though, as commitment is obtained not simply by entering a trade agreement, but by selecting a particular citizen type to carry out the negotiations.

[5] Thus, we follow the basic framework of Besley and Coate (1997), where citizens in democratic systems choose representatives (politicians) rather than directly voting for policies. Our setting is well suited to describe, for instance, the working of the European Union's common commercial policy (CCP), whereby each member state is represented by a minister in the trade policy making body (the Council of Ministers).

[6] In the case of the European Union, the leading example of a customs union, external trade policy is set by the Council of Ministers and the EU Commission. Trade policy decisions in the Council of Ministers – the "legislative body" – are taken by a qualified majority in the case of trade in goods, whereas unanimity is instead required in the case of trade in services.

[7] In the case of NAFTA, an important free trade area between Canada, Mexico and the United States, the Free Trade commission is the main institutional body, responsible for assisting in the resolution of disputes emerging between member countries on the interpretation of the NAFTA agreement. Importantly, neither the Free Trade commission, nor any other NAFTA institution has authority on the external trade policies adopted by NAFTA members.

[8] The idea that a principal might benefit from delegating decision making power to an agent who is "tougher" than himself had been suggested already by Schelling (1956). Jones (1989) and Segendorff (1998) have formalized it in a general bargaining setting, while Willmann (2006) and Laussel and Riezman (2005) have applied it to the endogenous formation of trade policy for respectively a small and a large country. Conconi et al. (2012) have considered the role played by strategic delegation in the U.S. congress's decision to grant or not fast track authority to the President. Gatsios and Karp (1991) have instead highlighted the potential role it can play – within a customs union – in attributing to one member country the power to set the common external tariff.

[9] A similar result has been obtained also by Melatos and Woodland (2007). In this paper, the authors employ a coalition formation game where preferential trade agreements may emerge in equilibrium depending on their effects on social welfare in a setting with heterogeneity in consumer preferences and in endowments across countries. Interestingly, they show that free trade areas may block the formation of customs unions if consumer preferences are sufficiently different across member countries.

[10] In a stylized lobbying model Richardson (1994) has reached a similar conclusion, arguing that an FTA might be more desirable from the point of view of a lobby than a CU, since "…in an FTA a domestic industry need to lobby only the domestic government for a particular tariff, whereas, in a CU, a given tariff requires that a larger legislative group be courted".

[11] Notice that only welfare enhancing free trade areas can be sustained as an equilibrium in our framework. Our findings thus strengthen an earlier, similar result obtained by Ornelas (2005a), in a setting where trade policy is driven by pressure groups' activities. For a more pessimistic view, in which pressure groups' activities can lead to the formation of welfare reducing free trade areas, see Grossman and Helpman (1995) and Krishna (1998). The key difference between the two sets of models is that in the latter tariff rates toward non-member countries are assumed to be fixed, while in Ornelas (2005a) they are endogenous.