

Nienhaus, Volker

**Article — Digitized Version**

## Integration theory and the problems of integration policy in the Third World

Intereconomics

*Suggested Citation:* Nienhaus, Volker (1987) : Integration theory and the problems of integration policy in the Third World, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 22, Iss. 1, pp. 41-48,  
<https://doi.org/10.1007/BF02929794>

This Version is available at:

<https://hdl.handle.net/10419/140063>

### Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

### Terms of use:

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

## Integration Theory and the Problems of Integration Policy in the Third World

by Volker Nienhaus, Bochum\*

**The many groupings of developing countries formed in the fifties and sixties with a view to establishing a customs union have failed to achieve convincing results so far. Would another integration strategy have been more successful?**

The late fifties and the sixties saw the formation of numerous groupings of developing countries, mostly in Latin America and Africa, aimed at achieving closer economic co-operation and integration. It was not uncommon for them to be modelled on the European groupings of the EFTA and the EEC.

In the seventies, however, disappointment and disenchantment were evident in many of the developing country groupings, as it had to be acknowledged that their often ambitious objectives – such as an expansion in intra-community trade, greater independence from the world market or from the industrialised countries and an acceleration of economic growth and development – had not been achieved; indeed, imbalances in trade and in the level and pace of industrialisation were becoming increasingly widespread within the groupings. In many cases efforts at integration came to a standstill, while a few groupings faced an open crisis.<sup>1</sup>

The unimpressive results of past years caused the members of some groupings to open negotiations to amend and supplement their existing co-operation and integration agreements. At about the same time, and no doubt not entirely unconnected with these developments, economic co-operation among developing countries again became a topical issue in the second half of the seventies, mainly as a result of the conferences and declarations of the Group of 77 and the United Nations system. In contrast to earlier efforts at integration, which had been designed to bring together small groups of neighbouring states in a free trade area or customs union, it was now a question of widening economic co-operation to include as many developing countries as possible.

\* University of Bochum.

In the late seventies and early eighties the number of large groups of developing countries with ten members or more increased significantly,<sup>2</sup> from three in the mid seventies to eight at the end of 1986. The larger the grouping, the more likely it is to consist of countries with markedly different economic characteristics, especially as regards factor endowment, market size and the level and pace of development. The greater the dissimilarities, the less probable that all member states will benefit equally from integration; it is more likely that the advantages will be reaped primarily by the larger, more highly developed countries that are better endowed with production factors and resources. Integration theory pays virtually no heed to this circumstance, so that it neither provides a convincing explanation of observed phenomena in large groupings nor offers much help in solving the concrete problems of integration in the real world.

### The "Orthodox" Theory of Integration

In economic literature, "integration theory" is often synonymous with the theory of customs unions. This is generally conceived as a comparative-static allocation theory and has been evolved since the fifties against the background of the integration efforts of the European countries, which as a whole are more highly developed

<sup>1</sup> Nevertheless, only one grouping (aimed at more than sectoral co-operation) has actually been dissolved so far, viz. the East African Community, which was terminated in 1977. Regarding integration groupings in general, see G. Schiavone: *International Organizations*, London and Basingstoke 1983; W. Andersen, W. Woyke: *Handwörterbuch Internationale Organisationen*, Opladen 1986.

<sup>2</sup> For further details, see V. Nienhaus: *Außenwirtschaftliche Integrationstheorie und die Integrationspolitik großer Entwicklungsländer-Gruppierungen*, Berlin 1986/87 (forthcoming).

and less heterogeneous. The theory centres on the analysis of the trade creation and diversion effects of a customs union. In the sixties it came to be widely held that the orthodox theory of integration could not be applied to developing countries.

The main complaint is that the premises on which the theory is based, such as perfect competition, are never fulfilled in developing countries and that they preclude taking account of the very external and scale effects that are of particular importance for economic development. However, numerous variations on the basic models of the customs union theory presented by Viner, Meade and Lipsey<sup>3</sup> have shown that the central tenets of the orthodox integration theory are relatively insensitive to relaxations in a series of restrictive premises. For example, Mundell and Arndt used modified models to

study the welfare effects of a customs union on the assumption that the member countries could influence the world market, in other words that their terms of trade were variable; Corden<sup>4</sup> incorporated the case of falling average production costs (scale effects).

Both the basic model of the orthodox theory of customs unions and its expanded versions which take account of terms of trade and scale effects always assume three countries (two integrating countries and the rest of the world) trading with one another in two commodities. Such "3 × 2 models", which dominate the literature on the subject and are analysed using the two-dimensional graphic tools of general customs union theory, have a built-in asymmetry that is highly problematic, however: in models with only two

<sup>3</sup> See J. Viner: *The Customs Union Issue*, New York 1950; J. E. Meade: *The Theory of Customs Unions*, Amsterdam 1955; R. G. Lipsey: *The Theory of Customs Unions – A General Survey*, in: *The Economic Journal*, Vol. 70 (1960), pp. 496-513.

<sup>4</sup> See R. A. Mundell: *Tariff Preferences and the Terms of Trade*, in: *Manchester School of Economic and Social Studies*, Vol. 32 (1964), pp. 1-13; S. Arndt: *On Discriminatory vs. Non-Preferential Tariff Policies*, in: *The Economic Journal*, Vol. 78 (1968), pp. 971-979; W. M. Corden: *Economies of Scale and Customs Union Theory*, in: *Journal of Political Economy*, Vol. 80 (1972), pp. 465-474.

## PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Eckardt Wohlers/Günter Weinert

### UNTERSCHIEDE IN DER BESCHÄFTIGUNGSENTWICKLUNG ZWISCHEN DEN USA, JAPAN UND DER EG

Vergleichende Untersuchung der Gründe für die unterschiedliche Beschäftigungsentwicklung  
in den USA, Japan und der EG seit 1973

### (DIFFERENCES IN EMPLOYMENT TRENDS IN THE USA, JAPAN AND THE EC

A Comparative Study of the Reasons for the Differences in Employment Trends in the USA,  
Japan and the EC since 1973)

This study was conducted in 1985 for the Federal Ministry of Economics. It describes the differences in employment trends in the USA, Japan and the EC in the period 1973 to 1983 and examines the reasons for these differences. The empirical analysis concentrates on differences between the individual countries in growth rates, in the structure of growth processes, in trends in real wage levels and wage patterns, in the flexibility of labour markets and in basic political concepts as possible reasons for the differences in employment trends. (In German)

Large octavo, 295 pages, 1986, price paperbound DM 48,-

ISBN 3 87895 307 0

VERLAG WELTARCHIV GMBH – HAMBURG

commodities it is impossible that at the same time trade creation and diversion effects emerge and the two members of the customs union trade with one another and the third country (rest of the world). If union member A exports commodity x to the other union member B, in exchange it will import the other commodity y from B. If A also exports x to C, it will import y from C, too. Since it is evidently cheaper to produce x in A than in B and C (and hence A exports to B and C), B could supply only commodity y to C and in exchange import x, but C itself already exports y and imports x, so that no trade will take place between B and C.

### Further Developments

Hence the  $3 \times 2$  models of customs union theory focus on an atypical case that seldom occurs in the real world, namely the case in which two countries that have formed a customs union trade with one another but only one of them has foreign trade links with the rest of the world. To avoid this problematic assumption, one must increase the number of commodities to at least three and switch to  $3 \times 3$  or  $3 \times n$  models. Leaving aside an early paper by Meade, models of this kind were developed only from the mid seventies onwards by economists such as Corden, Riezman, Berglas and Ethier and Horn.<sup>5</sup> These models have provision for "trade modification" effects as well as trade creation and trade diversion as a result of the dismantling of internal tariffs and the erection of external barriers. Integration can cause the commodity pattern of external trade to change, the scale and direction of the modification depending on whether the commodities traded within the union and with the rest of the world are substitutes or complementary. Such structural changes influence the welfare effects of a customs union. However, since it is impossible to make general statements about aspects such as the substitutability or complementarity of externally traded commodities, the  $3 \times 3$  and  $3 \times n$  models contain so many degrees of freedom that their results are no longer clearcut or universally valid.<sup>6</sup> This indeterminateness of the results is the price to be paid for having more realistic models.

Several of the models involving at least three commodities nevertheless produce very similar results in one respect, namely that in a world in which all

countries initially levy customs duties the welfare-maximising strategy for integrating countries whose terms of trade are determined by the world market lies in granting each other tariff preferences, but not in completely dismantling tariff barriers. The creation of a preferential trade area would be preferable to the creation of a customs union. On the other hand, if it is assumed that the country grouping has a certain amount of market power (and can influence the terms of trade), a different strategy may maximise welfare, namely the complete removal of tariffs between members and a common policy on optimum tariffs vis-à-vis the rest of the world. This does entail erecting a highly complicated compensation system among member countries, for the benefits from the common tariff policy may be distributed very unevenly.

### Actual Integration among Developing Countries

At this stage, the following conclusions can already be drawn with a view to real instances of integration among developing countries. First, the results obtained from "traditional" and modified  $3 \times 2$  models can be used only with considerable reservations to justify or evaluate practical policies of integration. Secondly, the  $3 \times 3$  and  $3 \times n$  models suggest that the establishment of a customs union is not the optimum policy for developing countries wishing to maximise static welfare gains. Instead, it can be assumed that even after integration they must accept their terms of trade as given; this appears to be a plausible assumption in the case of fairly small groups, although some doubt may arise with regard to large groupings. In groups of developing countries that wield substantial market power a reduction in internal tariffs might increase welfare, but only if it is combined with a policy on optimum external tariffs and internal compensatory mechanisms. However, a cursory inspection of the reality of large country groupings shows that they are not pursuing an optimum policy with regard to tariffs nor have they made adequate arrangements to distribute the advantages fairly.

The question therefore arises why so many developing countries have joined or remained members of groupings aimed at the establishment of a customs union, when there is a fair probability that this is not the strategy that maximises welfare for them. Their accession in earlier years might perhaps be explained by their belief in the welfare gains supposedly perceived at that time on the basis of  $3 \times 2$  models, for it is only recently that the problems associated with this model

<sup>5</sup> Cf. W. M. Corden: Customs Union Theory and the Nonuniformity of Tariffs, in: *Journal of International Economics*, Vol. 6 (1976), pp. 99-106; R. Riezman: A  $3 \times 3$  Model of Customs Unions, in: *Journal of International Economics*, Vol. 9 (1979), pp. 341-354; E. Berglas: Preferential Trading Theory – The n Commodity Case, in: *Journal of Political Economy*, Vol. 87 (1982), pp. 315-331; W. Ethier, H. Horn: A New Look at Economic Integration, Seminar Paper 221, Institute for International Economic Studies, Stockholm 1982.

<sup>6</sup> The models presented in the literature differ both in the issues they address and in their assumptions about pre-union trade structures, which will be modified by the formation of the customs union.

have become clear. However, that would not explain their remaining in an integrative grouping once their expectations have been disappointed. An answer to this question may be found in those theories that do not view the welfare effects of trade liberalisation as the main benefit of integration among developing countries but instead see the common protection of industrial production as the main objective.

### The "Unorthodox" View of Customs Unions

In the orthodox theory of customs unions the consumption of private goods is the sole determinant of national welfare, and hence also of the advantages of integration. The "unorthodox" models of an integration theory revised to suit the situation in developing countries are different, in that the welfare function is widened to include a public good, namely the industrialisation of the country. Economic integration with other countries is seen as one way of overcoming the problems that the narrowness of the domestic market often poses for the development of industrial capacity, and one that entails less cost than a purely national policy of protection; integration can enable national import substitution policies to be continued at multinational level. Industrialisation behind a common tariff wall should enable countries to obtain the economies of scale and external effects that are regarded as particularly beneficial to development; the decisive element is not trade liberalisation within the grouping but protection against the rest of the world. By contrast with the conventional infant industry argument, the theory of the protective customs union makes no reference to time limits or a gradual reduction of tariff protection once it has been granted; instead, the models assume or imply permanent protection.

The fundamental works expounding this new view of the customs union as a protective mechanism stem from Johnson and from Cooper and Massell.<sup>7</sup> The benefits of common protection as opposed to national protection derive from the expansion in the market for industries that are not internationally competitive, in other words are inefficient by world standards; once tariffs have disappeared within the community and the grouping has erected a protective tariff barrier against third countries, these industries are not restricted to the often very small domestic market of their home country, but can also sell their products in other member countries.

<sup>7</sup> Cf. H. G. Johnson: *An Economic Theory of Protectionism, Tariff Bargaining, and the Formation of Customs Unions*, in: *Journal of Political Economy*, Vol. 73 (1965), pp. 256-282; C. A. Cooper, B. F. Massell: *Toward a General Theory of Customs Unions for Developing Countries*, in: *Journal of Political Economy*, Vol. 73 (1965), pp. 461-476.

Problems always arise if the protected industries in member countries are not complementary or not completely separate from one another but produce substitute goods, in other words are in competition with one another, and if at the same time member countries differ widely as regards the level of development and efficiency. In these circumstances it is not only possible but highly probable that industries in the less advanced countries will be squeezed out by competitors from other member countries. Individual member countries may then suffer a net reduction in industrial output, which will be regarded as a welfare loss, since national industrialisation was an element in the welfare function. Increases in other activities, such as agriculture, cannot compensate for this loss, for they do not appear in the expanded welfare function as "public goods".

### Compensatory Mechanisms

Countries that had to expect such a welfare loss from the very outset would not even join an integrative grouping unless the other member countries offered the prospect of compensation for non-economic (e.g. political) reasons. Countries that have already joined a community and have realised only subsequently that membership is causing national industrial output to fall rather than increase could consider either leaving the community or introducing (more or less overt) national protectionist measures; they could also attempt to win compensation from the other countries. The larger and more heterogeneous a grouping, the more it must be expected that the larger and more advanced member countries will reap most of the advantages of integration, especially in the form of the better utilisation of existing plant or the erection of new industrial capacity. These countries are likely to be more attractive as industrial locations to foreign investors, too. If integration entails (or is supposed to entail) liberalising not only trade but also capital movements,<sup>8</sup> the polarisation of industrial activities is likely to be even more marked. The theory of the customs union as a protective mechanism says virtually nothing about how an adequate system of compensation should look in such cases or whether the disadvantaged countries should be allowed to take internal protective measures. Nor has integration as it is practised developed any convincing solutions so far.

Some of the existing groupings established fiscal mechanisms designed to compensate member

<sup>8</sup> It should be remembered that even in the modified models and those involving at least three products the orthodox integration theory assumes production factors to be immobile internationally, so that it is not applicable to country groupings in which internal movements of capital or labour have been liberalised.

countries for loss of tax and customs revenue. Financial transfers are no "real" substitute for lost industrial output, however. For that reason, some country groups (in Latin America, for instance) have chosen to support less developed member countries by adopting a different approach that may be described as "planned industrial specialisation", whereby negotiations are conducted at government level in an attempt to achieve a more balanced regional distribution of new industrial capacity. This leads to centralised planning of the locations of industries that are particularly important to development on account of their backward and forward linkages. There are several variants on this approach, but in essence they all come down to negotiating at government level a comprehensive industrialisation programme that allots a number of special industries to each of the countries involved. Government support for the establishment of these industries should then be given only in the selected member states; in addition, new industries should be shielded from international competition by common external tariffs.

### Serious Reservations

Although this notion of planned industrial specialisation is becoming popular in an increasing number of country groupings, serious reservations have to be registered about its usage, especially in fairly large and heterogeneous groups of developing countries.

The first problem is that of practicability; the planned specialisation presupposes that every country in the group is allotted at least one industry. Intergovernmental negotiations to identify technically feasible projects and to choose ones that make economic sense while allowing for national interests are likely to be all the more difficult the larger the number of countries involved and the greater their diversity. Assuming that the parties have been able to agree on a specific distribution of new industries, the allocation of locations will depend ultimately on political and not economic criteria (for otherwise there would have been no need of intergovernmental negotiations).

This raises a second problem: if governments wish a particular industry to be established in country A for political reasons, it will be pure chance if the chosen location is also the one that private investors would have chosen on the basis of microeconomic business criteria. Hence as far as potentially profitable industries are concerned, there will always be the danger that private entrepreneurs in another member country (e.g. in B) will set up the same or a similar activity in a more favourable location. If their cost advantage is sufficiently large, it must be expected that they will drive out firms producing

at higher cost (and with government assistance) in the appointed location. If that occurred, the laboriously negotiated balance of regional industrial development would be permanently distorted.

### Regional Monopolies

To illustrate the third problem, let us assume that the producers receiving state aid are not forced out of business but are able to consolidate their market position. Regional monopolies for particular types of product would then develop and would be protected from international competition by the common tariff. In all probability, enterprises that are not exposed to any perceptible competition will be operating inefficiently. One of the effects of inefficiency may be that a considerably larger workforce is employed than would be needed if the firm were run efficiently. The additional cost resulting from such inefficiency must be borne by the monopolist's customers in the form of higher prices.

In the case of a regional monopoly in a fairly large country grouping it is in no way improbable that inefficiency is welcome to the government of the industry's home country, since it leads to higher employment and higher national income there at the expense of purchasers of the product, most of whom live in the other member countries. Even though it is beyond dispute that inefficiency leads to welfare losses for the group as a whole, a government interested in national welfare (which includes "industrial production" as a public good) is highly unlikely to advocate a policy that would eliminate the inefficiency (as the reduction of protective tariffs might be expected to do) since the inefficiency is considered advantageous from the national point of view, given that its cost has to be borne largely by others.

It is also very doubtful whether governments can be persuaded to change their attitude towards (their own) regional monopolies by the recognition that they are themselves paying the price of inefficiency in regional monopolies in other member countries; the cost is often not directly visible, and the first country to begin reducing inefficiencies at home would place itself at a disadvantage, for it would have to bear the full costs, whereas the benefits would accrue principally to purchasers in the other countries. Political reasoning and economic sense are clearly at odds.

Particularly in those cases where the regional monopolies have strong backward and forward linkages (as they should if they have been selected according to development criteria) the inefficiencies will be spread across wide areas of the economy and will give "false"

price signals to numerous industries. Planned industrial specialisation can thus ultimately lead to a wrong specialisation that disregards the actual comparative advantages and can hardly be deemed a positive contribution to the development of member countries.

### Development Hampered by Specialisation

Integration can lead to the expansion and protection of markets and thus foster the development of industries in the community in question. However, this benefits primarily the more advanced countries, whose industries can hold their own in competition within the community. One approach used to achieve a more balanced distribution of the advantages of integration is planned industrial specialisation, but over the longer term this can prove to be a constraint on development.

The problem that this approach apparently does not solve is that of finding a method of expanding narrow domestic markets by means of regional integration, if production for the world market is not an initial aim (since products are uncompetitive or excluded from industrialised countries by increasing protectionism), without strongly polarising industrial production in a few more advanced countries at the expense of the other member states. It is probably neither possible nor sensible to achieve an even distribution of the advantages of integration among all the member countries. However, it does seem essential to ensure that a country is not in a worse position as a member of an economic community than it would have been had it not joined and had continued instead to pursue its national policy of foreign trade or import substitution.

### The Customs-Drawback Union

One way of achieving the desired result was proposed in outline by Elkan in the sixties but has not been pursued further in the literature or tested in practice.<sup>9</sup> In essence, his proposal for the establishment of a "customs-drawback union" amounts to conditional trade liberalisation, to be achieved by a system of freely negotiable customs certificates.

In a conventional customs union the protective tariffs in force at the time of inception are formally removed, but in a custom-drawback union they remain in place, even for trade within the community. In practice, however, they should lose their protective effect within the group if trade in industrial goods develops in a balanced way; this will occur if one country is at a competitive disadvantage in particular industries and switches from domestic production to imports to meet its needs but at the same time expands other industries and exports their output to the other member countries, so that there is no net deficit in trade in industrial products (or an existing deficit is not increased). Such shifts in the industrial structure as a result of competition within the community encourage efficiency and are therefore to be assessed positively from the point of view of development. If trade growth is balanced, the industrial sector of the country in question needs no protection against other member countries; goods from these countries should be allowed to enter duty free, in other words, remaining customs tariffs should be neutralised.

### Negotiable Customs Certificates

In a customs-drawback union this can be achieved automatically without discretionary economic policy intervention by instituting negotiable (import) customs certificates. By way of illustration, let us assume that four countries – A, B, C and D – form a customs-drawback union; for simplicity, let their bilateral trade accounts in industrial goods be in equilibrium at the outset, so that trade growth within the community would be balanced if their trade accounts remained in equilibrium and no deficits developed (which would indicate losses in the industrial sector). Assume that a firm in A imports industrial goods from B. The customs authorities in A will issue the importer with a customs assessment of the amount due on a stated date (say in

<sup>9</sup> Cf. P. G. Elkan: How to Beat Backwash – The Case for Customs-Drawback Unions, in: *The Economic Journal*, Vol. 75 (1965), pp. 44-62; P. G. Elkan: Blueprint for an Area of Quantitatively and Structurally Balanced Free Trade, in: *Journal of Common Market Studies*, Vol. 5 (1966/67), pp. 1-12.

## KONJUNKTUR VON MORGEN

The short report on domestic and world business trends and raw materials markets published every fortnight by HWVA – Institut für Wirtschaftsforschung – Hamburg

Annual subscription rate DM 120,-

ISSN 0023-3439

VERLAG WELTARCHIV GMBH – HAMBURG

two months' time). In a customs-drawback union they will also issue him with a customs certificate with a face value corresponding to the assessed duty, valid for a specified period (say, three months) and attesting to the origin of the imported goods (B in our example). The certificates should be named after the stated country of origin, so that the customs authorities in A can issue B, C and D certificates. In the present example the importer in A therefore receives B certificates.

The customs authorities of the member countries declare their willingness to accept customs certificates drawn on their country in lieu of payment of assessed duty; the face value of the certificates accepted is set against the customs liability. If the face value of certificates presented exceeds the customs assessment, the excess is not reimbursed but is ignored or lapses. The certificates importers receive are not accepted by the issuing authorities but can only be presented for offsetting against duty in the other countries. Hence, B certificates are initially worthless to an importer in A, and he must try to swap them for A certificates that he can have set against his customs assessment. Importers in other member countries who have bought industrial goods from A will have received A certificates.

The "swapping" of certificates could take place in a market organised along the lines of an exchange. The crucial factor is the expected level of certificate prices, for this will determine the effective rate of import duty. Let us assume that A's imports from B exceed B's imports from A, so that A has a trade deficit and B a corresponding surplus. This leads to an oversupply of certificates acceptable in the surplus country (B certificates) and a shortage of certificates acceptable in the deficit country (A certificates). The certificates will become worthless after a certain time, and due to competition among sellers their price will fall to a minimum and will tend towards zero if there is oversupply; conversely, the price of certificates for which demand exceeds supply will rise to a maximum and will tend towards face value. This means that certificates acceptable in a country with a trade surplus can be purchased at minimal cost, whereas those accepted in deficit countries will trade at almost face value.

### **Protection and Incentive Effects**

This system of certificates has various protection and incentive effects on trade within the community, depending on the effective incidence of customs duties paid by importers, in other words the difference between, on the one hand, the assessed duty and the

cost of purchasing eligible certificates and, on the other, the proceeds from selling customs certificates importers have themselves received.

Importers in a country with a trade deficit need customs certificates that are in short supply and trading at or near face value. Hence, for the importer it makes no appreciable difference whether he pays the assessed duty in full or offsets part of it with customs certificates that are only available at face value. Conversely, in respect of their imports their customs authorities have issued them with certificates that are recognised in a surplus country; since they are in oversupply, the sale of these certificates produces no substantial income that can be set against payments of duty or the cost of purchasing certificates. Imports into a deficit country thus continue *de facto* to bear the same duty that was levied under a purely national (import substitution) policy before the establishment of the customs-drawback union. If the earlier policy of protection is in effect maintained, no deficit country can claim that its deficit – and hence the associated loss of industrial output – is the result of integration, in other words that other countries have gained at its expense.

In a country with a trade surplus, the certificates importers need in order to settle their customs liability are in oversupply and can therefore be acquired for next to nothing, so that goods can be imported effectively duty free into surplus countries. In addition, the certificates issued for imports from deficit countries are in short supply and hence trade at or near face value. This operates like an export subsidy to the deficit country, but without placing a burden on the latter's exchequer.

Moving on from the two-country example to consider customs-drawback unions with four member states or more, it will be seen that surplus countries may trade with other surplus countries as well as deficit countries and that deficit countries also exchange goods with one another. If countries have intra-community trade balances with the same sign, the prices of the certificates importers need will be comparable to the prices of those they receive – either face value in the case of two deficit countries or close to zero in that of two surplus countries. This means that bilateral trade between countries with trade balances in the same direction is *de facto* free of customs duty.

In a customs-drawback union there operates an automatic system of penalties and incentives which in cases of unbalanced intra-community trade signals the need for a reversal of trade flows and a reduction of imbalances, since its net result is to make imports more

expensive for deficit countries and cheaper for surplus countries. Forces of this kind acting against an increase in disequilibria do not operate in conventional free trade areas and customs unions.

### **Influence on Location of Industry**

The mechanism of the customs-drawback union can also have a noteworthy influence on firms' decisions about the location of investment, an effect that is absent from conventional forms of integration with "unconditional" trade liberalisation. In the conventional type of community, the mere fact that one member country, typically a more advanced one, offers certain locational or agglomeration advantages, such as the possession of a highly developed financial, communications and transport network or the greater availability of skilled labour, is sufficient to attract investors from third countries, or from other member countries if capital mobility is possible within the group. In a customs-drawback union, on the other hand, compensatory forces are at work that induce investors to be clear about the quantitative importance of the agglomeration advantages; they must weigh them against the advantages they might be able to draw from the system of certificates if they choose a location in a less developed country that expects to be running a deficit on intra-community trade over the medium term. If a factory is built in one such deficit country and subsidiary trading companies supply the markets of the other member states, particularly the surplus countries, the group of companies not only effectively has duty free access to the markets of all member countries but also enjoys the *de facto* subsidies on exports to surplus countries resulting from the sale of high-priced customs certificates.

This does depend on locating the manufacturing company in a country with expectations of a deficit over the medium term. It is plausible to assume that the agglomeration advantages will lie not here but in the surplus countries. Companies must now quantify these advantages and compare them with the *de facto* subsidies they would have to forego. Such business calculations are not necessary in a community with generalised internal free trade, and even marginal agglomeration advantages can determine the choice of location. In a customs union, the opportunity costs of agglomeration advantages are practically nil, whereas in a customs-drawback union they equal the *de facto* subsidies. It is therefore to be expected that the regional distribution of industrial production will be more even in a customs-drawback union – i.e. industrial polarisation less marked – than in a free trade area.

### **Institutional Advantage**

Finally, the customs-drawback union offers an institutional advantage that can be particularly important in large groups of countries. Multiple membership is not uncommon in large groupings; some countries will have joined with other member states or non-member countries to form other groupings that have introduced a common external customs tariff or intend to do so. In conventional free trade areas this is bound to conflict with the efforts of the larger grouping to remove all tariff barriers to internal trade. A country cannot levy the smaller group's common external tariff on imports from a country belonging only to the larger grouping and simultaneously admit imports duty free. The customs-drawback union, which provides for the formal maintenance of all tariffs, could solve this problem as well.

A customs-drawback union allows part of the efficiency and welfare gains resulting from a widening of the market to be realised. In a conventional free trade area the efficiency gains may certainly be greater, but they would be obtained at the cost of a greater regional concentration of industrial activities; some countries could therefore campaign against the integration that had already been achieved by arguing that others had expanded industrial output at their expense.

### **More Even Distribution of Benefits**

A customs-drawback union avoids situations such as these and can help distribute the advantages of integration more evenly, or at least prevent the balance of disadvantage tipping too far in one direction. This and the other characteristics mentioned make it appear sensible to put the concept of the customs-drawback union back on the agenda for discussion. A number of more technical questions remain to be solved, such as that of the appropriate way of organising the certificates market or that of operational criteria for equilibrium in intra-community trade and that of the classification of the industrial goods to which the mechanism would initially apply. Since governments that accept customs certificates are foregoing customs revenue and private importers may instead be able to cash in on the sale of certificates, issues relating to the necessary freedom of movement of payments or capital and possible exchange rate effects (allowing for trade with the rest of the world) would also have to be discussed. Despite many questions remaining open, no conclusive argument has yet been put forward that can touch the central element in the concept of the customs-drawback union.