

An *Ex-Ante* Approach to the Profitability of a Customs Union

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ABSTRACT

This paper proposes analytical and prospective approaches to regional integration in the form of a "customs union". Based on Jacob Viner's theory of regional integration, stating that customs unions generate either trade creation or trade diversion effects, we have developed an index that measures the profitability of joining a customs union, from an *ex-ante* perspective. The derived index aspires to determine whether joining a customs union will produce trade creation or trade diversion effects for a country member. It can then serve as a reliable tool for policymakers who design and implement trade policies.

Keywords: Regional integration, Customs union, Trade creation effects, Trade diversion effects, Profitability, Ex-ante analysis.

INTRODUCTORY REMARKS

Since the dawn of time, within primitive societies, the first forms of economic agglomeration within and between tribes and clans have appeared, in order especially to struggle against scarcity, food shortages, and wars. Human collaborations in this framework witnessed developments over time, in line with a series of societal mutations, until the end of the so-termed "Malthusian Trap", when, in 1833, the first formal custom union (*The Zollverein*) emerged between Prussia and the German States.

It imports however to note that the birth of "economic integration", as a new semantically economic concept, occurred only in the mid-20th century. Such concept has to be grasped as a process gathering a group of economies into a wide and sole economic region, through the abolition of discrimination across countries and the fructification of opportunities, thanks to an effective labor division.

Conceptually speaking, Jacob Viner is usually considered as the first economist to construct a rigorous theoretical framework for economic integration, notably through a seminal achievement presented in his 1950-essay, entitled "*The Customs Union Issue*", published by The Carnegie Endowment for International Peace. Our present paper is inspired by Viner's theoretical constructions, particularly his careful distinction between trade creation and trade diversion effects within a customs union.

This research aims to construct an index to measure the profitability that a country can gain from joining a customs union. Such an index can be used *ex-ante*, i.e., before the signing of the customs union agreement. It should also serve as a key instrument for policymakers before the country joins the customs union. It has to be used also for inter-country and/or inter-regional rapprochements from a comparative perspective.

The remainder of the present research paper is as follows. Section 1 presents a literature survey, and section

2 outlines and explains our profitability index.

A LITERATURE REVIEW

a. The Viner's Traditional Customs Union Theory

As widely known, Viner argued that "*customs unions are not important, and are unlikely to yield more economic benefits than harm unless they are between countries of considerable size which practice substantial protection of substantially similar industries*".

Viner was the first economist to distinguish between the advantages and disadvantages of forming a customs union. Viner's so-called "static" analysis identifies, on the one hand, trade creation effects, which refer to the case where trade shifts from a high-cost member country supplier to a low-cost member country supplier after the creation of a customs union. On the other hand, he identifies trade diversion effects, occurring when imports shift from a low-price supplier in a non-member country (third country) to a high-price member country supplier within the Union.

Therefore, a customs union can be seen as an argument in favor of free trade (integration or union) when the trade creation mechanism occurs, because it allows the sources of supply to be moved from a region where costs are high to another region where costs are low. However, in the case of trade diversion, protectionism (*disintegration*) would be more efficient since the country is forced to supply itself at a higher cost within the union than outside.

Viner concluded that customs unions bring both harm and economic gains, a fact supported by the idea that the trade diversion effects of a customs union can outweigh the trade creation effects. Then, he argued that size is quite important, stating that the larger the economic area, the more likely the union is to work well, and the creation effects will outweigh the diversion effects. Thereby, in his theoretical conclusion, Viner pleaded for non-discrimination in trade barriers worldwide.

b. Developments in Viner's Analysis

Effects of Customs Unions on Production and Consumption

Among the most important contributions to the theory of customs unions is the largely known Lipsey's study, which focused on the effect of customs unions on production and consumption. Lipsey's study builds on Viner's analysis, where the effect of trade creation is seen as the "good thing" while trade diversion is the "bad thing" in terms of economic welfare. According to Lipsey, such an analysis is outdated and lacks scientific rigor, in the sense that economic welfare includes both production effects, as Viner argued, and consumption effects.

In short, Viner's analysis focuses on the production aspect to the detriment of consumption. To illustrate this, it is important to note that when a customs union is formed, relative prices within the domestic markets of member countries have to change, due to falling tariff barriers. Such price changes are seen to produce two effects:

1. a production effect, as illustrated through the Viner's proposition;
2. and a consumption effect, through which members of the union will obviously increase their consumption of each other's products, while lowering their consumption of goods from countries outside the union.

Moreover, according to Sheer, the weakness of Viner's analysis lies in the assumption that consumption is independent of changes in relative prices. Therefore, even if world production is fixed, there will always be

some changes in world consumption due to changes in relative prices. Lipsey concludes that Viner's theory cannot be used to make judgments about the economic welfare of customs unions. This same view is shared by Gehrels (Gehrels, 1957) and Krauss (Krauss, 1972).

Trade Diversion and Welfare:

Cooper and Massell (Cooper & B. F. Massell, 1965) argue that trade diversion can have positive effects on welfare if it considers both production and substitution effects. In this sense, the welfare losses due to trade diversion with a high-cost supplier country would be offset by the gains that would occur from the elimination of tariffs. Hence, the country would benefit from lower consumer prices and improved welfare. According to Meade (Meade, 1955) the traditional analysis is not entirely complete because it is restricted by conditions of elastic supply facing inelastic demand. He argues that under conditions where demand is elastic, a customs union can increase the volume of trade even though there is trade diversion. This effect is called "trade expansion" as a countermeasure against trade diversion.

The New Theory of Economic Integration

The Vinerian theory concludes that free trade and non-discriminatory trade agreements are more favorable than customs unions in terms of economic welfare (Balassa, 1975). Viner's theory is analyzed through a static approach. Therefore, it is necessary to introduce new effective tools in the analysis of the economic integration effects, especially in a framework of a dynamic effects approach. Sheer has also shown that static analysis tools do not provide any simple insights or maxims.

The Forms of Economic Integration According to Béla Balassa

Table 1: Forms of and conditions for economic integration, according to Bela Balassa

Forms of Economic Integration	Conditions
Free Trade Zone	Total or partial elimination of tariff and non-tariff barriers
Customs Union	Elimination of tariffs <i>and</i> homogeneous trade policies (common external tariff)
Common Market	Free movement of goods, services, capital, and people
Economic and Monetary Union	Single currency and common monetary policy
Total Economic Integration	Coordination of economic and social policies

Bela Balassa is one of the most famous economists who have contributed to the construction of the modern theory of economic integration. In his book entitled "*The Theory of Economic Integration*", he identified the main forms that a customs union can take to achieve the ultimate stage of economic integration. For Balassa, each union must go through five forms of economic integration to achieve total integration (see the table).

Dynamic VS Static Analysis of Integration in Recent Literature:

Balassa, Cooper, and Massell (Cooper & B. F. Massell, 1965) were the first to introduce the concept of the dynamic effects of economic integration. This analysis added a new dimension to this field of study. Balassa's dynamic theory of economic integration proved that static analysis in terms of trade creation and diversion is not adequate to properly analyze the welfare gains from economic integration. However, the empirical findings about the dynamic effects will be developed with the sophistication of tools and the data in the recent literature shedding light on several outputs such as innovation, FDI, and macroeconomic shocks.

Ghosh and Yamarik (Ghosh & Yamarik, 2021) illustrate how economic integration boosts trade among

member states and catalyzes innovation through enhanced competition and knowledge transfer. Their findings suggest that integrated markets promote an environment where firms are incentivized to invest in research and development, improving productivity across various industries. Similarly, Hsu and Wu (Hsu & Wu, 2022) emphasize that regional economic integration initiatives can transform competitive dynamics, allowing firms to scale operations, optimize resource allocation, and invest in innovation.

Moreover, Kawai and Wignaraja (Kawai & Wignaraja, 2021) underline the role of foreign direct investment (FDI) in amplifying the benefits of economic integration, and demonstrate that trade agreements facilitate deeper economic ties that encourage FDI, which, in turn, stimulate growth in member countries. This notion is reinforced by Chen and Novy (Chen & Novy, 2022), who argue that economic integration raises a more favorable investment climate by reducing regulatory barriers and enhancing market access, which leads to increased capital flows and shared technological advancements within the common market.

Additionally, in a dynamic effect study, Baier and Bergstrand (L. Baier & H. Bergstrand, 2016) analyzed the long-term effects of regional trade agreements and found that increasing trade volume leads to sustainable economic growth through cooperation and greater market access. In the context of developing economies, the work of Jansen and Nordås (Jansen & Nordås, 2019) reveals that regional integration can help lower trade costs and improve access to larger markets, thereby enhancing competitiveness and enabling smaller firms to thrive. Furthermore, Mendez and Maria (Mendez & Maria, 2023) highlight the dynamic impacts of economic integration on labor markets, wherein increased mobility and skill transfer can alleviate unemployment and underemployment in developing regions. A recent work by Orefice and Rocha (Orefice & Rocha, 2022) examines how economic integration can enhance resilience against global shocks, such as pandemics or financial crises, by diversifying supply chains and facilitating collaborative responses among member states. Their analysis shows that integration can lead to more coordinated policy responses and shared resources, ultimately strengthening economic stability.

To summarize, one can understand that the above-presented developments outline the main contributions of the traditional and modern theories of economic integration. On the one hand, we found that the traditional theory largely represented by Viner, argues that economic integration does not produce positive effects on countries unless the value of trade creation is greater than the value of trade diversion. However, this theory did not emphasize the non-trade effects that integration implies. Thus, the modern theory of economic integration intervenes to fill this gap by capturing the dynamic effects of economic integration, due to the recent changes shaping the world economy after the liberalization of financial markets: economies of scale, foreign direct investment (FDI), and acceleration of capital movements.

THE PROFITABILITY OF A CUSTOMS UNION: AN EMPIRICAL *EX-ANTE* PROFITABILITY INDEX

What would be the impact of regional integration (in the second phase) form on national economies? This is a major question that arises from the outset. Indeed, on the one hand, we have Viner's theory, analyzing economic integration in its second phase (according to Balassa), arguing that a customs union produces both trade creation and trade diversion effects. On the other hand, the new post-Vinerian theory and the recent trends criticize Viner for neglecting dynamic analysis, especially in the context of the subsequent phase of liberalized movements of individuals, capital, and the resulting benefits.

In this regard, concerning Viner's theory, we have constructed an index that measures the profitability that a country can derive from joining a customs union. We have chosen to refer to Viner's theory for several reasons:

i) first, most regional integrations are of the "customs union" or "free trade area" categories, which relativizes the hypothesis of dynamic effects on which the new theory is based after the transition in the

initial time t , towards the common market, and then the economic union;

ii) Second, the consumption expansion effects, as advocated by the new theory of integration, do not prevent the deterioration of economic welfare. In this sense, despite the increase in the volume of consumption between economic agents residing within the union, these agents may not all be winners.

Moreover, our profitability index should be used in the *ex-ante* phase of the formation of the customs union, i.e. before the country concerned signs the agreement on integration into the customs union. Such an index can also be used as a tool for comparing a country's trade flows with several regions.

a. The Origin of the Concept

As already mentioned, our index is inspired by the Vinerian theory of customs unions, which states that customs unions produce: i) trade creation effects when trade shifts from a high-cost non-member supplier country to a low-cost member supplier country; ii) trade diversion effects that occur when imports shift from low-priced suppliers in a non-union country (third country) to a high-priced member supplier country within the union.

b. A Theoretical Construction Attempt

We aim to construct an index that measures the impact of joining a Vinerian customs union (trade creation effect VS trade diversion effect). To do this, our original idea is to compare a country's relative terms of trade between the union to be integrated and other non-union regions, while eliminating the trade restrictions that the union is expected to entail.

Terms of Trade

Terms of trade are defined here as the aggregated ratio of the export price index to the import price index, expressed in the same base year. According to Rostow (W.W. ROSTOW, 1950), the concept of terms of trade is based on the fundamental theory of international trade. It also measures the price competitiveness of a given country; while making it possible to know how much exports create import capacity.

The debate around the usefulness of the terms of trade seems to be controversial. Baldwin (Baldwin, 1955) considers that an improvement in the terms of trade would lead to gains for the country, but this hypothesis goes back to the classical analysis which seems to ignore other external factors. However, Kowalczyk and Riezman suggest that changes in trade policy undoubtedly affect a country's terms of trade and, consequently, its economic growth (Kowalczyk & Riezman, 2009).

In this respect, the terms of trade may be affected by trade policy measures, particularly in the arena of customs tariffs. Bhagwati and Johnson have shown within this framework that a country's terms of trade deteriorate or improve, depending upon the economic structure of each country and the elasticity of demand for imported products.

c. Formulation

The index of the terms of trade (ITT_t), in a point t in time, may be defined as the index of export prices ($\frac{PX_t}{PX_0}$), divided by the index of import prices ($\frac{PM_t}{PM_0}$), 0 being the base year. Formally, one can write:

$$ITT_t = \frac{\frac{PX_t}{PX_0}}{\frac{PM_t}{PM_0}} = \left(\frac{PX_t}{PX_0}\right) \left(\frac{PM_0}{PM_t}\right)$$

Assuming that there is no domestic tax on exports, and since there are neither foreign tariffs on exports, nor domestic tariffs on imports within the free trade zone (or a customs union), the *ITT* above will remain unchanged. Indeed, while writing the foreign tariff rate on domestic exports within the free trade zone as " $trx_{ft}^* = 0$ ", and writing the domestic tariff rate on imports within the free trade zone as " $trm_{ft} = 0$ ", one can express the index of the terms of trade (ITT_{ft}) within the free trade zone as:

$$ITT_{ft} = \frac{\frac{PX_t [1 + trx_{ft}^*(t)]}{PX_0 [1 + trx_{ft}^*(0)]}}{\frac{PM_t [1 + trm_{ft}(t)]}{PM_0 [1 + trm_{ft}(0)]}} = ITT_t;$$

for $trx_{ft}^*(t) = 0$; $trx_{ft}^*(0) = 0$; $trm_{ft}(t) = 0$; and $trm_{ft}(0) = 0$

Therefore, the nullity of trx_{ft}^* within the free trade zone will make prices of domestic exports lower for the consumers and investors in the free trade zone partner countries, especially if domestic inflation in the exporting country turns to be moderate when compared to inflationary pressures abroad.

In this framework, the above-mentioned ITT_{ft} behaves here as a specific exchange rate. This means that the country is seen as competitive when the index of its export prices does not increase dramatically in comparison with its free trade zone partner countries, notably when the traded goods and services are somewhat similar.

Note also that even though the nullity of tariffs on imports may be considered as a financial shortfall for the budget of the domestic government, it can help domestic consumers to enjoy lower prices as well as investors to benefit from affordable prices of imported investment goods, and then to produce goods and services with lower prices, allowing thereby to better improve the competitiveness of exports.

Let us now reconsider the general equation of the terms of trade:

$$ITT = \frac{\frac{PX_t}{PX_0}}{\frac{PM_t}{PM_0}}$$

What will happen when we are interested in trade with countries outside of the free trade zone? Obviously, in this case, the trading partners would have the willingness to impose tariff and non-tariff rates on the country' exports. Thus, while formally writing such foreign tariff and non-tariff rates as $tntrx_{oft}^*$, and accounting for a domestic common tariff rate (trm_{oft}) on imports stemming from countries outside the customs union, the *ITT* becomes:

$$ITT_{oft} = \frac{\frac{PX_t [1 + tntrx_{oft}^*(t)]}{PX_0 [1 + tntrx_{oft}^*(0)]}}{\frac{PM_t [1 + trm_{oft}(t)]}{PM_0 [1 + trm_{oft}(0)]}}$$

In fact, in this case of figure, $ITT_{ft}(t) = ITT_{oft}(t)$ if and only if:

$$\frac{1 + tntrx_{oft}^*(t)}{1 + tntrx_{oft}^*(0)} = \frac{1 + trm_{oft}(t)}{1 + trm_{oft}(0)};$$

or, equivalently:

$$\frac{[1 + tntrx_{oft}^*(t)][1 + trm_{oft}(0)]}{[1 + tntrx_{oft}^*(0)][1 + trm_{oft}(t)]} = 1$$

Therefore, with respect to the terms of trade, the profitability of a customs union for a country turns to be the same as in a situation where trade is done with countries outside the customs union, if the two previous equivalent equations hold.

It imports to note nevertheless that it is often difficult, if not impossible, for a country trading with partners outside of a customs union, to fully offset the tariff and non-tariff barriers on its exports by corresponding barriers on imported goods and services.

Thus, in terms of price-competitiveness, and assuming that the country's exports consist mainly of manufactured goods, i.e. the phenomenon of the degrading terms of trade does not hold; and merchandises and services traded across countries are almost similar, a customs union would be more profitable, especially under the condition that:

$$\begin{aligned} ITT_{ft} < ITT_{oft} &\Leftrightarrow \frac{\frac{PX_t}{PX_0}}{\frac{PM_t}{PM_0}} < \frac{\frac{PX_t[1 + tntrx_{oft}^*(t)]}{PX_0[1 + tntrx_{oft}^*(0)]}}{\frac{PM_t[1 + trm_{oft}(t)]}{PM_0[1 + trm_{oft}(0)]}} \\ &\Leftrightarrow \frac{1 + tntrx_{oft}^*(0)}{1 + tntrx_{oft}^*(t)} < \frac{1 + trm_{oft}(0)}{1 + trm_{oft}(t)} \end{aligned}$$

By contrast, for trade to be more profitable with trading partners outside of the customs union, the hereafter inequation should hold:

$$\begin{aligned} ITT_{oft} < ITT_{ft} &\Leftrightarrow \frac{\frac{PX_t[1 + tntrx_{oft}^*(t)]}{PX_0[1 + tntrx_{oft}^*(0)]}}{\frac{PM_t[1 + trm_{oft}(t)]}{PM_0[1 + trm_{oft}(0)]}} < \frac{\frac{PX_t}{PX_0}}{\frac{PM_t}{PM_0}} \\ &\Leftrightarrow \frac{1 + tntrx_{oft}^*(t)}{1 + tntrx_{oft}^*(0)} < \frac{1 + trm_{oft}(t)}{1 + trm_{oft}(0)} \end{aligned}$$

d. Implications of Findings and Policy Recommendations

The findings from the analysis of the profitability of customs unions presented in this paper carry significant implications for policymakers considering regional integration. First and foremost, the developed ex-ante profitability index serves as an important tool for assessing whether joining a customs union will yield trade creation or trade diversion effects for a country. This index allows policymakers to make informed decisions regarding trade agreements, facilitating a better understanding of the potential economic impacts before committing to integration. By quantifying the expected outcomes of joining a customs union, governments can strategically weigh the benefits against potential drawbacks, such as increased reliance on higher-cost suppliers within the union.

In light of these findings, several policy recommendations emerge. First, governments need to conduct comprehensive assessments using the profitability index before entering into customs union agreements. This assessment should include a detailed analysis of potential trade diversion effects and their implications for domestic industries. Policymakers should also prioritize the establishment of complementary policies that enhance the benefits of integration, such as investing in infrastructure, fostering innovation, and supporting workforce development to ensure that domestic firms can compete effectively within the integrated market.

Furthermore, the profitability index presented in this paper serves as a foundational tool for evaluating the economic implications of joining a customs union, but it also holds significant potential for more research in the field of economic integration. While the current analysis has focused specifically on customs unions, the framework of the index can be expanded to cover other phases of economic integration, such as common markets, and economic unions. Future research could refine and develop the index by incorporating additional variables and indicators that capture the nuances of these various integration forms. By expanding the scope and the adaptability of the index, researchers can create a more comprehensive and useful tool that not only assesses the profitability of different integration phases but also provides insights into the dynamic interactions between trade, investment, and economic development.

This potential for further development makes the index a valuable starting point for scholars aiming to explore the intricate landscape of economic integration more holistically.

CONCLUDING REMARKS

In this research paper, the authors have tried to conduct analytical and prospective approaches to regional integration in the form of a customs union, using insights from theories of economic integration.

Based on Viner's theory of regional integration, arguing that customs unions generate either trade creation or trade diversion effects, we design an index that measures the profitability of joining a customs union, from an *ex-ante* perspective.

The index we have constructed has a specific objective to assess whether joining a customs union will deliver trade creation or trade diversion effects for a country member.

From a policy implication perspective, our research paper may be considered a useful instrument for policymakers in the arena of design and implementation of trade policies.

the current focus of the index is on customs unions, its potential extends beyond this scope. The framework established in this paper offers a solid foundation for future research in the broader field of economic integration.

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