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ECONOMIC INTEGRATIONS, COMPETITION AND COOPERATION

Conference Proceedings

Editors:
Vinko Kandžija
Andrej Kumar

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ECONOMIC INTEGRATIONS, COMPETITION AND COOPERATION
Accession of the Western Balkan Countries to the European Union

Publisher and General Editor: **University of Rijeka, Faculty of Economics, Ivana Filipovića 4, HR-51000 Rijeka, Croatia**
For the Publisher: **Heri Bezić**
Technical Editor: **Vinko Zaninović**
First Edition (2013): **200 copies**

Design by: **Tomislav Galović**

ISBN 978-953-7813-16-1

A CIP catalogue record for this book is available from the University Library in Rijeka under number 130230017

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Mislav Jošić
University of Zagreb, Faculty of Economics and Business, Zagreb, Croatia
Hrvoje Jošić
University of Zagreb, Faculty of Economics and Business, Zagreb, Croatia

WELFARE ENHANCING CUSTOMS UNION: KEMP-WAN ISSUE

ABSTRACT

This paper ponders all aspects of Customs Union (CU) formation in order to explain welfare effects on countries involved. Viner's classical model of FTA/CU creation leaves more space for interpretation of welfare issues due to ambiguity of trade creation and trade diversion effects. An absence of tariffs in intra trade guarantees positive welfare effects for integrating countries through higher volume of trade. On the other side, trade diversion from the most efficient producer outside the CU to the less efficient producer in the CU leads to suboptimal allocation of scarce resources. Net effects are the ones that count and are the sum of trade creation and trade diversion effects. In this respect Kemp-Wan theorem is introduced as a mean of achieving Pareto improvement through free trade and lumpsum compensation scheme for all countries that form Customs Union and the world itself. According to Kemp-Wan proposition there exists common tariff vector that leads to competitive equilibrium in which each individual country is not worse off than before the customs union creation. Although theoretically feasible compensation scheme through transfers lacks political approval due to the fact that not all countries would be willing to make trade concessions without reciprocity. Special emphasis in this paper is set on accession of the Western Balkan countries to the European Union and possible consequences that may arise. Moreover, the case of Croatia is analysed as a most probable EU country member in a near future.

***Keywords**: customs union, trade creation, trade diversion, Kemp-Wan theorem, lumpsum transfers*

***JEL classification**: F14, F15*

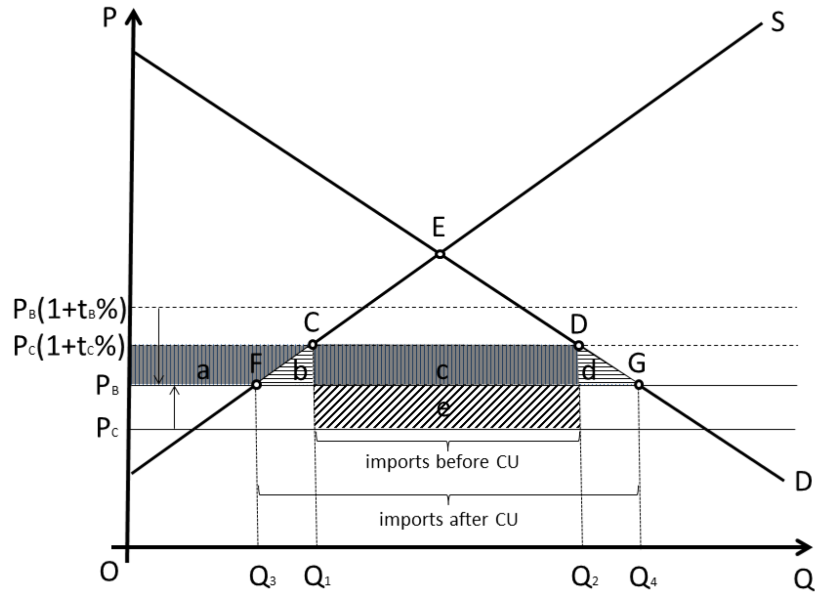
1. INTRODUCTION

The need for country integration in one common trade area started with the research lead by Canadian economics Jacob Viner, an advocate of Chicago School of Economics. His first paper on the issue of customs union formation was published in 1950 (Viner, 1950) as a result of new trade rules incorporated in GATT in 1948. So far, tariffs were used as a common tool of protection in international trade resulting in distortions in the goods and input markets as well. International trade theory suggests that free trade should be the first best solution for all countries involved in trade. In this respect competitive markets lead by Mr. Smith's "invisible hand" should allocate resources in a Pareto optimal way. This postulate is known as the First fundamental theorem of welfare economics and is valid only under certain assumptions. These assumptions rely on ideal conditions that aren't always met in practice.

Positive effects of trade integrations are known as trade creation effects that arise as a result of tariff nullification. Lowering tariffs to zero level in intra trade also lowers import prices of goods meeting the perfect market hypothesis. Trade creation effect displaces domestic production of goods from the less efficient to the most efficient producer of goods and thus redistributes real income from less efficient country to the most effective country according to Stolper-Samuelson theorem. Negative effect can be seen through the prism of trade diversion effects. Formation of FTA, or Customs Union specifically, diverts part of the trade from the most efficient country outside the union to the less efficient producer in the union. This diversion of outputs is merely a result of artificial change in prices through tariff nullification without any change in productivity levels or factor abundance in a country. In this way trade flows are directed by affecting the prices of tradable goods. With common external tariff rate set to the goods flow from the outside non-member countries it isn't possible to violate the rules of origins principle. In this paper we ponder on all aspects of trade policy resulting in welfare changes caused by trade shifting.

How can one nation be left unharmed if all others experience improvement in national welfare due to trade creation effects seriously reconsiders the Second fundamental theorem of welfare economics. Is it really possible to make one better off without someone being worse off? In order to solve this dilemma compensation scheme can be introduced by enacting lump-sum transfers to those countries with net welfare losses from customs union formation. The work of Murray Kemp and Henry Wan (1976) in the area of compensation might give us a solution to the welfare redistribution problem. In the following text static analysis will be provided through Viner's general equilibrium model of customs union formation. Let us assume there are two countries (A and B) involved in customs union formation where the third one (country C) is partner country outside the CU with the lowest price of production. Eliminating tariff barriers between country A and country B leads to trade creating and trade diversion effects graphically shown in Figure 1.

Figure 1: Viner's model of customs union formation



Source: Authors

Country A is importing $|\overline{CD}|$ amount of goods at the price $P_C(1+t_c\%)$ from Country C which is the most efficient producer of the same good. With existing tariffs government collects budget revenues shaded by rectangle c. If Country A and Country B form a customs union tariffs are levied and intra trade is increased to the extent that imports equal $|\overline{FG}|$. These imports now come from Country B that has higher costs of production but lower price which is perplexing and paradoxical at the same time. This increase in volume of trade is called *trade creating effect* which substantially increases consumer's surplus, decreases producer's surplus and nullifies government revenues. Net effect represents welfare gains shown as shaded triangles b and d that are known as Harberger's triangles. Along with positive effects there are some concerns regarding the trade flows that are diverted from the most efficient producer outside the union to the less efficient producer in the union, i.e. from Country C to Country B. Rectangle e represents *trade diversion effects* that is interpreted as a loss of national welfare due to suboptimal reallocation of production inputs. According to Jacob Viner customs union has positive effect on national welfare as long as trade creating effects dominate trade diversion effects. Because all member countries of customs union share common tariffs to the outside countries, it is possible for some members to have higher efficiency losses than gains. In order to maintain the same level of welfare for integrating countries some kind of compensation mechanism is needed to improve disequilibrium situation. The solution to this problem is formulated by Murray Kemp and Henry Wan.

According to Kemp and Wan (1976) it is always possible to have Pareto improvement for individual countries in integration that will not negatively affect outside countries. Full compensation scheme generates implicit costs that are to be calculated in net effects of customs union formation.

2. KEMP-WAN POSTULATE

The Kemp-Wan proposition is independent on a number of countries involved, their size or development levels and as such is very useful in the analysis of customs union formation.. The Kemp-Wan proposition (Kemp, Wan, 1976) states: *"Consider any competitive world trading equilibrium, with any number of countries and commodities, and with no restrictions whatever on the tariffs and other commodity taxes of individual countries, and with costs of transport fully recognized. Now let any subset of the countries form a customs union. Than there exists a common tariff vector and a system of lump-sum compensatory payments, involving only members of the union, such that there is an associated tariff-ridden competitive equilibrium in which each individual, whether a member of the union or not, is not worse off than before the formation of the union."*

If we assume there are *n* countries in the world willing to form a customs union then there is a finite number of steps possible to differentiate any welfare change between these steps. Every step leads to a new, enlarged customs union where no country is worse off than before its creation. The last step leads to the world that is one large customs union and no outsiders aside that could generate welfare losses in terms of trade diversion effects. The formal proof of Kemp-Wan theorem is based on a second fundamental theorem of welfare economics analysed in details by Debreu (1959). The pioneering work by Jacob Viner in 1950 was highly contributed by Lipsey (1957) with the introduction of Second Best Solution (SBS) in customs union creation. Lipsey assumed that there's always a unique solution which is not always Pareto optimal but can be Pareto improving. Dixit and Norman (1980) extend the analysis by showing that Pareto improvement in Kemp-Wan model can be made without the use of lump–sum compensation. Furthermore, they suggest taxes on intra trade of goods and use of subsidies. Panagariya and Krishna (2002) gave their contribution to the analysis of Kemp-Wan theorem by applying it to FTA creation. If any number of countries freeze their tariffs to the rest of the world countries along with lump-sum transfers and correct use of rules of origin it is indeed possible to have Pareto improvement.

3. IMPLICATIONS OF WESTERN BALKAN COUNTRIES ACCESSION TO THE EU

Is the Kemp-Wan applicable in practice and how it should be used properly is the key question of this paper. Will Western Balkan countries benefit from customs union creation while leaving CEFTA is also a legitimate question. Some of the raised issues of Kemp-Wan proposition are the direct result of failure to communicate the following problems:

- How do we decide who will be our trading partners?

- The lack of political agreement to compensate on countries that do not experience Pareto improvement in customs union creation.
- The complexity of tariff structures when choosing a common external tariff.
- Implicit costs associated to compensation and the need of financing them.

Current research in the area of trade creation and trade diversion effects associated with Western Balkan countries is mostly based on gravity model approach along with the use of factor proportion model. Current EU27 member countries differ among themselves in terms of relative factor abundance. Most of the new acceding countries are relatively abundant in labour which makes them attractive for labour intensive production with labour as a relatively cheaper factor of production. The structure of trade is also based on differences in relative abundance according to Heckscher-Ohlin's neoclassical model of trade.

In the last enlargement step Bulgaria and Romania joined European Union in 2007 while simultaneously leaving CEFTA that is mostly constituted of Western Balkan countries (Croatia, Macedonia, Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo). Western Balkans enlargement issue was recognized at the European Council summit in Thessaloniki in 2003 where potential problems and probable solutions were identified. All Western Balkan countries had to sign Stabilisation and Association Agreement (SAA) before starting the negotiation process. Current EU enlargement process is focused on Croatia that is to enter European Union on 1st of July, 2013. As of today the following Western Balkan countries are recognized as official candidates: Iceland, Macedonia, Montenegro, Serbia and Turkey while Albania, Bosnia and Herzegovina and Kosovo remain potential candidates.

Bulgaria and Romania, two subsequent countries that joined EU on 1st of January, 2007 were forced to leave CEFTA changing their position in the integration from free trade area (CEFTA) to customs union (EU). Expected trade flows according to Viner's static model of CU formation should reflect in both trade creation and trade diversion effects. On contrary, empirical findings for Bulgaria and Romania do not corroborate theory which is shown in the tables below.

Table 1: Trade creation and trade diversion effects in Bulgaria (2007-2012)

Partner country	2007 imports in bn EUR	2012 imports in bn EUR	2012/2007 change
CEFTA	1,6	2,3	43,7%
EU27	12,9	14,9	16,7%
World	21,9	24,3	11,3%
Total share in World imports			
CEFTA	7,2%	9,3%	
EU27	58,5%	61,3%	
Rest of the World	34,4%	29,4%	

Source: Eurostat

Table 2: Trade creation and trade diversion effects in Romania (2007-2012)

Partner country	2007 imports in bn EUR	2012 imports in bn EUR	2012/2007 change
CEFTA	1,2	2,3	99,5%
EU27	36,6	40,1	9,6%
World	51,3	51,7	0,8%
Total share in World imports			
CEFTA	5,3%	9,5%	
EU27	71,3%	77,5%	
Rest of the World	23,4%	13,0%	

Source: Eurostat

According to data gathered from Eurostat both countries have experienced an increase in total imports in selected period. Bulgaria increased its imports from EU27 member countries by 16.7% as a result of liberalised trade regime and zero intra trade tariffs. This effect is the direct result of trade creation effect. The same country didn't experience trade diversion effect from CEFTA countries as expected, but from the rest of the world[1] countries instead. Thus, net effect in Bulgaria is strictly positive due to an absence of trade diversion effect. The same conclusion can be made for Romania. Romania increased its imports from both EU27 and CEFTA countries increasing the total imports share from 76.6% to 87.0% consequently leading to trade diversion effects only from the rest of the world countries. In the case of these two countries Kemp-Wan compensation scheme is nonessential and customs union formation results only in positive welfare changes for acceding countries.

Today's EU trade policy is based on WTO principles of multilateralism and nondiscrimination in international trade. All members of WTO (EU members included) have agreed to lower their tariff barriers against other trading partners in order to achieve higher volume of trade, and consequently higher national welfare. EU currently stands for world's first exporter accounting for 15.5% of world trade in goods and is ranked first as the FDI recipient with €241.7 bn inflow of funds (EC, 2013). Regional trade agreements made with rest of the world FTAs and persistent EU enlargement process lead to trade creation effects while some of the trade is diverted due to common external tariff imposed on imports outside the EU. The possibility of compensating welfare losses in Kemp-Wan context is not considered in the official EU trade policy nor is it being implemented in the world trade system through WTO rounds of negotiations.

4. CONCLUSION

World trade order governed by WTO insists on lifting trade barriers and replacing the existing ones with tariffs. The final result in this process would be a creation of one large customs union where there will be no preferential treatment in trade nor there will

[1] Excluding EU27 and CEFTA member countries

be discrimination against others. Today's world trade trends reflect in FTA creation where multilateral agreements overlap. This *"spaghetti bowl"* results in distortion effects where different tariff rates apply to outside countries. Customs union as a more advanced type of economic integration goes further with introducing common external tariff vector. Positive welfare gains known as trade creation effects are usually complemented with trade diversion effects. Part of the trade is diverted from the most efficient producer of the good outside the union to the less efficient producer of the same homogeneous output inside the union. This leads to suboptimal allocation of scarce resources and unwanted loss of national welfare. Lumpsum transfers and appropriate compensation scheme used to compensate losing countries is in the heart of Kemp-Wan proposition. A possibility to compensate country with negative net gains from customs union formation is always a challenge. According to Kemp and Wan it is always possible to have Pareto improvement for individual countries in integration that will not negatively affect outside countries. Forming economic integrations doesn't necessarily result in negative net gains in practice. Empirical findings that exhibit only trade creation effects make Kemp-Wan suggestions inapplicable and impractical. The case of Western Balkans countries questions static effects of Viner's model and opens up space for further investigation in the area of international trade.

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