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# CUSTOMS UNIONS

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A customs union (CU) is a form of trade agreement under which certain countries preferentially grant tariff-free market access to each other's imports and agree to apply a common set of external tariffs to imports from the rest of the world. That is, they enter into a free trade agreement (FTA) and apply a common external tariff (CET) schedule to imports from nonmembers.[1] A CU can be thought of as a deeper form of integration than an FTA, generally requiring more coordination and a greater loss of autonomy.

The aims of this chapter are to provide, from an economics perspective, an overview of the key features of CUs and to examine some design issues that may be of interest to policy makers and (nonspecialist) analysts. The discussions are meant to be relatively conceptual and nontechnical, but real-world illustrations are provided when available.

To begin with, the main economic costs and benefits of opting for a CU, relative to those for an FTA, are discussed, and selected issues regarding the design and determinants of a common external tariff are examined. Although a number of arguments seem to suggest that CUs may be subject to more protectionist pressures than FTAs, the existing literature does not provide an unequivocal answer. There then follows a conceptual discussion of the implications of the various administrative options related to the collection and sharing of customs duties; this, it is shown, is not only a technical issue, but also (and perhaps more important) a question of trust among member countries. The chapter concludes with an overview of a number of systemic aspects of CUs. Readers interested in the more operational and detailed aspects of CUs are referred to the excellent surveys in Development Network Africa (2007) and Keick and Maur (2011).

## A Special Case of PTA

CUs have been around for a long time and were once more prevalent than FTAs. Early efforts toward economic integration were generally driven by the desire to establish a political union, and the members were willing to relinquish some political autonomy.[2] Early examples include the Zollverein, formed in 1834 by several German principalities, which turned out to be a step toward political unification, and the 1847 customs union between Moldavia and Walachia, a precursor to the creation of Romania.

More recently, CUs appear to have become less popular, at least with respect to the number of arrangements. As is thoroughly documented by Acharya et al. (ch. 2 in this volume), almost 85 percent of the regional integration arrangements notified to the World Trade Organization (WTO) through 2009 consisted of FTAs. This trend reflects the nature of the current wave of regionalism, which has been broadly characterized by smaller cross-regional deals, flexibility, selectivity, and, most important, speed.[3] Recent FTAs are inclined to be pragmatic and to focus more on strategic commercial market access and less on geographic considerations or political ambitions.[4] They generally involve a small number of partners (frequently, just two), which are often geographically distant from each other. They tend to achieve significant preferential and reciprocal trade liberalization within a short time while simultaneously preserving a member's sovereignty over its trade policy vis-à-vis the rest of the world, including its option of joining other preferential trade agreements (PTAs).

By contrast, CUs usually involve a relatively large number of geographically contiguous countries (see table 5.1 for a selected listing). They generally take longer to negotiate

**Table 5.1.** Selected Customs Unions, in Force and Planned

| Agreement | Date |
|---|---|
| | *In force* |
| Southern African Customs Union (SACU) | 1910 |
| Switzerland–Liechtenstein | 1924 |
| European Union (EU) | January 1, 1958 |
| Central American Common Market (CACM) | October 12, 1961 |
| Caribbean Community (CARICOM) | August 1, 1973 |
| Andean Community (CAN) | May 25, 1988 |
| EU–Andorra | July 1, 1991 |
| Southern Cone Common Market (Mercosur, Mercado Común del Sur) | November 29, 1991 |
| Israel–Palestinian Authority | 1994 |
| EU–Turkey | January 1, 1996 |
| Eurasian Economic Community (EAEC) | October 8, 1997 |
| Economic and Monetary Community of Central Africa (CEMAC, Communauté Économique et Monétaire de l'Afrique Centrale) | June 24, 1999 |
| West African Economic and Monetary Union/Union Économique et Monétaire Ouest-Africaine (WAEMU/UEMOA) | January 1, 2000 |
| East African Community (EAC) | July 7, 2000 |
| EU–San Marino | April 1, 2002 |
| Gulf Cooperation Council (GCC) | January 1, 2003 |
| Customs Union of Belarus, Kazakhstan, and Russia | July 1, 2010 |
| | *Planned* |
| Arab Customs Union (ACU) | 2010 |
| Southern African Development Community (SADC) | 2010 |
| Economic Community of Central African States (ECCAS) | 2011 |
| Economic Community of West African States (ECOWAS) | 2015 |
| African Economic Community (AEC) | 2019 |
| Arab Common Market (ACM) | 2020 |
| Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) | 2020 |

*Source:* Author's compilation.

and implement than do PTAs, and they entail a certain loss of policy-making autonomy. By 2009, they accounted for less than 10 percent of the regional integration arrangements notified to the WTO. CUs are less numerous than PTAs, but they generally have much larger memberships. They also tend to cover much larger geographic areas. The four main CUs in Latin America—the Central American Common Market (CACM), the Andean Community (CAN), the Caribbean Community (CARICOM), and the Southern Cone Common Market (Mercosur, Mercado Común del Sur)—include almost all the region's economies. The existing and planned CUs in Sub-Saharan Africa—the Economic and Monetary Community of Central Africa (Communauté Économique et Monétaire de l'Afrique Centrale), the East African Community (EAC), the Southern African Customs Union (SACU), the West African Economic and Monetary Union (WAEMU), the Economic Community of West African States (ECOWAS), the Common Market for Eastern and Southern Africa (COMESA), the Southern African Development Community (SADC), and the Economic Community of Central African States (ECCAS)—take in virtually every country in the region. Many countries in the Middle East and North Africa regions are members of the Gulf Cooperation Council (GCC), the Arab Customs Union (ACU), or both.

Although a CU is no longer the most popular option, it remains a central component of regional integration strategy in many developing regions. For many developing countries, the design and implementation of a CET, along with the elimination of intraregional trade barriers, continue to be key drivers of trade policy reform and to occupy an important place in policy debates. Given that customs duties constitute a significant source of government revenues in most of those countries, choosing the appropriate mechanism for collecting and allocating customs revenues is an important challenge for officials.

## Economic Implications of Customs Unions

Chauffour and Maur (ch. 1 in this volume) discuss in detail the economic, societal, and political-economy motives for signing preferential trade agreements. A central issue is whether to opt for an FTA or a CU. By definition, both are preferential in nature and discriminate against third-party (nonmember) suppliers. The primary effect of a customs union, as with an FTA, is the expansion of trade flows among member countries, often at the expense of trade with nonmembers. This expansion, a consequence of the removal of the intraunion tariff barriers, can be decomposed into *trade creation* (more efficient suppliers in CU partners replace domestic suppliers of a given good) and *trade diversion* (more efficient third-party suppliers are displaced by less efficient suppliers located in partner countries, as a result of the discriminatory liberalization).[5] As is well established in the literature, when trade diversion dominates trade creation, CUs and FTAs tend to be welfare reducing (Viner 1950).[6] The likelihood of significant trade diversion is closely related to the degree of discrimination associated with the agreement (see Baldwin, ch. 3 in this volume).

### *Reasons for Choosing a Customs Union*

There are many possible rationales for choosing a CU over an FTA, including political and economic ones. Some regional groupings consider the establishment of a CU a prerequisite for the future establishment of a political union, or at least some deeper form of economic integration, such as a common market.[7] The African Economic Community provides an illustration. The Abuja Treaty of 1991 envisaged gradual implementation in the following stages: (a) creation of regional blocs, by 1999; (b) strengthening of intrabloc integration and interbloc harmonization, by 2007; (c) establishment of an FTA and then a CU in each regional bloc, by 2017; (d) establishment of a continentwide customs union, by 2019; (e) realization of a continentwide African Common Market (ACM), by 2023; and (f) creation of a continentwide economic and monetary union (and thus also a currency union) and a parliament, by 2028.

Some groups, such as CARICOM, consider a CU to be a useful way of pooling market power, coordinating trade policies, and combining efforts to negotiate with the rest of the world. The more intense degrees of coordination and interaction associated with a CU can foster trust and familiarity among the parties and may even decrease the risk of conflicts, as has been the case with the European Union (EU). The fact that the external tariff is agreed with other parties through a legal agreement may help reform-minded governments lock in their trade policies and can shelter them from domestic lobbies.

On a lower level, a customs union can simply be a practical device for avoiding trade deflection while facilitating more fluid trade flows among member states. In the simplest form of an FTA, member countries grant free trade to each other but effectively maintain sovereignty over the conduct of trade policy vis-à-vis the rest of the world. Thus, the tariffs charged to nonmember suppliers will vary across members. This could lead to opportunities for trade deflection—a situation in which goods from outside the FTA are shipped to a low-tariff country and then transshipped tariff-free to the high-tariff country. Such roundabout shipping patterns, which have the sole purpose of exploiting the existing tariff differential, are inherently inefficient and can create friction among members.[8]

One way to avoid such wasteful trade deflection is for the members of the FTA to adopt a rules-of-origin system. Rules of origin can take various forms, but generally they require that goods (or value added) qualifying for tariff-free trade be produced within the FTA and that imports from outside the FTA pay the tariff of the final destination country, even if they pass through another member country (see Brenton, ch. 8 in this volume). In practice, rules of origin are particularly complex, and their implementation costs can be high.[9] They necessitate significant internal border controls to ensure compliance and to collect the relevant customs duties.

Another way to prevent trade deflection is to establish a customs union, which would require all members to apply the same external tariff to imports coming from outside the union. Because of the common external tariff (i.e., the absence of tariff differentials across members), the potential for trade deflection and the need for intra-union border inspections are, theoretically, minimized. In a fully implemented customs union, it is no longer necessary to maintain internal border controls for customs duty purposes or to design and implement the cumbersome and costly rules of origin that are necessary in a free trade area in which members have different external tariff structures.[10] The simplification offered by a CU can greatly facilitate cross-border trade, which is especially relevant because existing CUs generally involve geographically contiguous countries, reflecting the traditional objective of regional integration.[11] In this regard, a CU can approximate a larger single market (as compared with a number of separate markets in an FTA), which can generate greater economies of scale, as well as procompetitive pressures. These, in turn, can greatly benefit consumers and can translate into lower business costs and enhanced competitiveness for member countries.

### *Economic Implications of the Common External Tariff*

As was mentioned earlier, the key difference between a CU and an FTA is the need to adjust the tariff structure applied to third-party suppliers, at least for some members. Countries that join an FTA are not required to change the tariffs they apply to imports from the rest of the world.[12] What will differentiate the effects of a CU from those of an FTA will be the extent to which the external tariff is increased or decreased by a given member with respect to a given good. The net economic effect of a CU crucially depends on how the adjustment of the external tariff affects the degree of discrimination vis-à-vis nonmember countries.

In order to isolate the impact of a CU, it is useful to start with a case in which an FTA is already in place (i.e., trade is already liberalized among the partners) and member countries are considering establishing a customs union by harmonizing their external tariff duties.[13] For ease of presentation, the following discussion assumes that two countries, A and B, are members of an FTA and have decided to form a customs union. Without loss of generality, it will be further assumed that, for a particular good, A has a low tariff and B has a high one. Two possible cases are relevant and are examined here.

One possibility is that the agreed common external tariff (CET) leads to a higher tariff rate for a given CU member (say, country A). The bloc's degree of discrimination is thus enhanced, and the negative impact of trade diversion caused by the FTA is exacerbated. This usually happens when a less advanced member has to implement a CET aimed at protecting the industries of a more developed member.[14] In this case, consumers in country A will lose because they have to pay higher prices for imports from the rest of the world or switch to less efficient suppliers from country B. Despite the higher external tariff, the government in country A could collect less tariff revenues if the higher degree of discrimination leads to a greater propensity for switching the sourcing of imports to duty-free, country B suppliers. Producers of the good in A face less competition from the rest of the world but more competition from B. In fact, the adoption of a high tariff by A effectively extends the protection received by country B producers to country A's markets. These producers may be the only ones to gain from the CU in this scenario. In some cases, and in a more dynamic setting, the expansion of the protected market may lead to some tariff-jumping types of investment in the customs union, motivated by the prospect of taking advantage of the larger, more protected market.

Joining a CU may offer a second possibility to consolidate the existing tariff schedule and adopt a more liberal trade regime. If the establishment of the CU yields a CET that is lower than the pre-CU tariff (say, in country B), the potential for trade diversion is reduced, or even reversed, because there is less potential for switching suppliers. The discriminatory aspect of the FTA is, in a sense, diluted in this case. Starting from an FTA situation, a decrease in B's external tariff would have two effects, both working in the same direction. First, the liberalization will directly increase B's imports from the rest of the world (trade creation). Second, since it effectively dilutes the existing preference margin, it will reduce the attractiveness of sourcing from country A relative to sourcing from the rest of the world (less trade diversion). By reversing the trade diversion caused by the FTA (i.e., by inducing consumers to switch from less efficient suppliers in A to more efficient ones in the rest of the world), country B's tariff reduction will benefit its consumers. It could also help increase government revenues. as dutiable imports from the rest of the world expand (albeit at lower tariffs) and as country B shifts to dutiable imports and away from duty-free imports from A. Domestic producers will face more competition from nonmembers, but this will be offset by consumer gains resulting from lower prices and, potentially, by higher tariff revenues. Although adopting a lower CET may not lead to tariff-jumping investment, the higher returns associated with the more liberal economic environment could attract efficiency-seeking investments. Krueger (1995) has argued that if the CET level is chosen as the union's average tariff for a given commodity, an FTA will not lead to more net trade creation than a CU. Furthermore, as long as the CET is set below the tariff level of the high-cost country, an FTA will not be more welfare enhancing than a CU.

In the actual implementation of a CET, an individual CU member will generally have to increase its external tariffs on certain products while decreasing them on others. The overall impact will depend on the balance. Kemp and Wan (1976) demonstrate the existence of conditions that suffice to ensure that a CU is welfare enhancing. In particular, they show that if the CET is chosen so that trade with the rest of the world is kept unchanged, then following the establishment of a CU, welfare could potentially increase for all parties, including nonmembers, contingent on compensatory transfers. This increase occurs because any additional trade between CU members would be welfare-enhancing trade creation. Although this is an important result, it is a "possibility" and does not guarantee that the existing political-economy equilibrium will be a welfare-enhancing one.[15]

## Factors Driving the Design and Level of the Common External Tariff

A well-designed and generally accepted CET is crucial for the sustainability of a customs union.[16] National tariffs must be harmonized at some agreed level, taking into account not only the often-conflicting positions of each member but also the various special interests within each member. Setting the level of the CET in a consensual manner could be a complex undertaking, entailing long and involved negotiations between member country governments, which are themselves subject to lobbying by different interest groups. For instance, it took the EU 11 years (1957 to 1968) to complete its CET, and Mercosur members took four years just to agree on their nonagricultural CET.

In many developing-country customs unions, the difficulties of agreeing on a common external tariff and on the distribution of revenues have proved to be so great that the resulting tariff schedules tend to include numerous country or sector-specific exceptions and sensitive lists. Although the CARICOM CET is largely in place, it allows broad scope for tariff reductions and suspensions, as well as for national derogations. The CET in Mercosur does not cover all sectors, and it includes special regimes for the automotive and sugar sectors.[17] In some CUs, temporary national exemptions are allowed—for example, EAC members Kenya and Tanzania were allowed to unilaterally reduce tariffs on selected grain imports. Derogations and safeguards are widely used in most CUs. Not only can these exceptions reduce the transparency and effectiveness of the CU, but they also can complicate trade negotiations and increase transaction costs. Furthermore, they reintroduce the potential for trade deflection—the very phenomenon that the CU is designed to prevent.

Like most other forms of regional integration agreements, a CU is inherently preferential and is, thus, discriminatory against third parties. As argued in the previous section, the economic impact of a CU will be closely related to the degree of discrimination, which depends on the CET level that is selected. The higher the CET, the more trade diversionary will the union be. An important question is thus whether a CU provides incentives for selecting higher or lower external tariffs than those in, say, an FTA.[18] The existing theoretical and empirical literature does not provide an unequivocal answer to this question. The result seems to depend on the way preferences (or objective functions) are aggregated across members and within each member.

A number of analysts have demonstrated that an FTA may create downward pressure on external tariffs. (See, for example, Richardson 1993; Bagwell and Staiger 1999; Freund 2000.) For instance, Baldwin and Freund (ch. 6 in this volume) argue that preferential trade liberalization in an FTA tends to make tariffs against nonmembers' third-nation tariffs more distortionary and that it creates an incentive for FTA members to reoptimize their most favored nation (MFN) tariffs by making them more uniform and lower. (This is referred to as the "uniform tax rate principle.") In a related fashion, if trade diversion becomes apparent (i.e., if a country sees itself importing a good from a partner country at a higher cost than the cost of similar goods from nonmembers), an FTA member has the flexibility to cut tariffs on these third-party imports.[19] Similarly, the potential for trade deflection may lead high-tariff countries to cut tariffs to just below the level of their partners' rates to prevent imports from going through low-tariff countries that would otherwise capture the tariff revenue. In addition, lowering import tariffs on inputs used in producing exports to other FTA members can render exporters more competitive.[20] Do these arguments apply to CUs?

An often-stated objective of most customs unions among developing countries is to promote a harmonized reduction in internal and external trade barriers in order to better integrate the region into the multilateral trading system. There are, however, arguments that seem to suggest that CUs create pressures for more protectionism. Like other integration initiatives, CUs permit member countries to combine their market size and thereby increase their market power. Since trade policy is set jointly, this measure could strengthen their incentive to adopt high CETs in order to improve their terms of trade.[21] That is, they can reduce global demand for an imported product, and thereby decrease the import price, by charging higher tariffs. The larger the size of the union, the stronger this proprotectionist effect will be.

Furthermore, if CU members negotiate effectively as a bloc, they can pool their negotiating power and enhance it against the rest of the world, thus affecting the outcome of negotiations. Given the mercantilist nature of trade negotiations, increased negotiating power is likely to lead to a more protectionist outcome (in exchange for better market access). It could also be argued that nonmembers will act in a more conciliatory way when negotiating with a (single, large) customs union than with separate FTA members, and the result will be smaller requests for concessions.

The internal process of decision making within the CU could also place upward pressure on tariffs. The joint, consensual determination of the external tariffs may provide incentives to agree on higher CETs, since these imply higher preference margins and benefit partners' firms. (Protection is afforded to all producers in all CU member countries.) CU members will internalize this fact and will choose a higher external tariff (Freund and Ornelas 2010). Accordingly, one can think of a situation in which each CU member feels strongly about protecting a particular sector but would like lower tariffs on the other sectors. As

Winters (1996) argues, this may create a prisoner's-dilemma outcome under which the CET would provide high protection in all sectors, even though each country would be better off with low protection in all sectors.[22]

The establishment of a CU also changes the power of lobbies, but it is not clear whether the result will be stronger or weaker demand for protection. It is possible that lobbying pressure within a CU may be diluted, compared with national lobbying for protection within an FTA. As Winters (1996) suggests, it is more costly to lobby for a tariff increase in a CU than in an individual FTA member country because there may be more opposition to overcome or more representatives to influence. Moreover, the returns to lobbying activities are less under a CU, given that an extra 1 percent tariff protection becomes available to all members. Panagariya and Findlay (1996) provide a formal treatment of the argument that a customs union is a more effective instrument for diluting the power of interest groups than is an FTA. The high cost and low returns of lobbying under a CU could lead to a free-rider problem in lobbying, and all lobbying could end up taking place in one country. The author finds that such a process would yield a lower (common) external tariff under a CU than under an FTA. The larger the size of the customs union, the lower the resulting (lobbied) level of common external tariff would be.

The argument could, of course, cut in the other direction. In some sectors, lobbyists in different member countries may be able to overcome the free-rider problem, pool their resources, and cooperate. This is likely to happen in sectors in which they produce relatively similar goods (say, in agriculture) and where there is little intrabloc trade flow. In this case, the national lobbies would be able to organize themselves into a regional lobby, and the resulting common external tariff would be higher in a CU relative to what would prevail in the individual markets under an FTA.

The degree of "permanence" of the policy outcomes will also affect the incentives for, and the amount of, lobbying. An FTA does not require member countries to immediately adjust their external tariffs, and it preserves discretion for a country to adjust its trade policy in the future. By contrast, a CU requires both tariff adjustments and a relatively longer-term commitment to the trade policy jointly agreed on by the CU members—the CET. It is therefore likely that lobbying for protection would be stronger during the negotiation and establishment of a CU than in the case of an FTA. Also, the difficulties in renegotiating or readjusting the CET could lead to the emergence of less transparent nontariff barriers that would be implemented at the national (instead of the regional) level.

Overall, whether opting for a CU leads to higher external tariffs remains an open question. A number of arguments seem to suggest that CUs may provide more protectionist pressures than FTAs. This, however, remains an empirical question to which the existing literature has not been able to provide an unequivocal answer.

## Allocation and Collection of CET Revenue

For most CUs among developing economies, the potential for losses of tariff revenues constitutes an important negotiation issue. These losses may result from the liberalization of intraunion tariffs, from the adoption of the common tariff schedule, or from changes in trade patterns. Given the significance of tariff revenue for most developing countries, at least two issues need to be addressed when establishing a customs union: (a) Who has a claim on the collected customs duties? (b) Where and how should those duties be collected?

### *Ownership of the Collected Duties*

The use or allocation of the collected duties is an important consideration. Should the customs revenues collected be treated as community property, or as income accruing to each member state? Generally, it is necessary to establish a regional, supranational institution or a secretariat to ensure smooth operations of the union. Although such an institution could be funded through direct contributions from members—for example, WAEMU provides for an additional tax of 1 percent on imports— treating customs revenues as the collective property of the union may be a more useful financing mechanism. In some cases, such as the EU, the union may decide to allocate (a fraction of) these revenues to a joint fund to finance regional development initiatives or to provide support to poorer CU members.[23] Of course, pooling customs revenues necessitates a high level of coordinating capacity and a certain degree of trust among members. This arrangement seems more likely to be sustainable when tariff revenues do not constitute an important part of government revenue for individual members—as is the case in the EU, but usually not for developing economies.

In other cases, CUs treat customs revenues as the property of individual members. Collected duties are allocated either according to the final destination or in line with an agreed sharing formula. Such a formula could provide for a simple reallocation based on negotiated and fixed shares, or it could involve a more complex range of economic and demographic variables. SACU, for instance, has a fairly complicated revenue-sharing system in which the share accruing to each member is calculated from three basic components: a customs pool, an excise pool, and a development component. The customs pool is allocated according to each country's share of total intra-SACU trade, including reexports. The excise component is allocated on the basis of gross domestic product (GDP). The development component (fixed at 15 percent of the total excise pool) is distributed to all SACU members according to each country's per capita GDP; that is, countries with lower per capita income will receive more (WTO 2003).

Most existing customs unions allocate revenues according to the final-destination principle. This method, although apparently simple in theory, requires a mechanism for identifying the final destination of each shipment entering the union; the destination country would then claim the appropriate duty amount. One way to handle this procedure is to keep the imported shipment in bonded facilities until it reaches the country of ultimate consumption. This may work for whole shipments of final goods that are entirely consumed in the destination country, but it may not be the appropriate mechanism for an imported shipment that undergoes transformation in an intermediate country before reaching its final destination. Indeed, incentives could emerge for some members to collect revenues on imports that are then wholly transshipped or minimally "transformed" or "repackaged" before being exported duty-free elsewhere in the CU. In such cases, burdensome internal border controls, guarantee mechanisms, or even some rules of origin are needed within the CU to determine what fraction of the collected duties should go to which member. This could be an important issue for small landlocked economies that rely on their larger coastal neighbors for transit and that could lose revenues as a result of leakages or fraud. When trade flows are sufficiently symmetrical, a member's losses could be offset by the gains it realizes when goods imported into its territory (for which it collects the tariff) are consumed in a neighbor's.[24]

### *Collection of Duties*

At what point should customs duties be collected—at the initial port of entry into the CU or at the final import destination? Collecting import duties at the first port of entry into the CU (say, in the coastal member with the more developed port and transit facilities) could be one way of ensuring freer movement of goods within the CU and minimizing intra-CU border controls.[25] Indeed, if all trade taxes were collected at the point of first entry and administered or distributed centrally, member countries would not need to monitor the passage across their borders of goods originating outside the CU for duty collection purposes.[26] This method would greatly enhance efficiency by reducing transaction costs at internal border posts, but it requires the existence of the appropriate institutional capacity to administer the revenues and, most important, a high level of trust among members. Both of these measures tend to be harder to achieve as the number and diversity of member states increase. The mechanism is more likely to be sustainable if customs duties are deemed to be community property of the CU and are used for collectively determined community purposes, or if members can devise a mechanism for identifying imports according to their final destinations.[27] A potential issue is the possibility of some diversion in revenue collections (and even economic activity) away from landlocked and less developed countries and toward the more developed trading hubs in the region.

Alternatively, customs duties could be collected at the final destination or the final consumption point.[28] Although conceptually straightforward, this type of agreement can be complex to implement and can be very costly. In fact, to be workable, it requires that significant border controls remain or that goods be shipped in some sort of transit and bonding facility all the way to the final destination, where duties would be collected.[29] Not only would the logistical costs of running such facilities be substantial, but they would also tend to diminish some of the expected gains from establishing a CU. For instance, they could discourage the establishment of regional value chains or processing chains (using imported inputs) or the generation of retail and wholesale services in intermediate locations between the initial port of entry and the final destination.

It is clear from the foregoing discussion that the collection and allocation of customs revenue in a customs union setting are not only technical issues, but also (perhaps more important) a question of trust. Good technical coordination and enforcement generally promote trust among CU members. Conversely, lack of trust would require more stringent and cumbersome controls on intrabloc transit and stricter application of the agreed disposition of revenue. This is clearly an area in which harmonization of border management (customs procedures), cooperation, modernization, and capacity building could be very useful (see Keick and Maur 2011; Dawar and Holmes, ch. 16 in this volume).

## Conclusions

The conceptual discussions in this chapter demonstrate that CUs generally require a much greater degree of policy coordination among members than do FTAs. This is because they require member countries to agree to a common external tariff and to set up institutional mechanisms to collect and distribute the tariff revenue. When a country joins a customs union, it agrees to relinquish some of its national sovereignty with respect to the formulation and implementation of trade policy. The fact that a country is willing to surrender such autonomy over trade policy suggests that it considers this loss to be more than offset by the economic benefits of securing access to a larger and more harmonized regional market and of enhancing the depth and effectiveness of the ongoing regional integration. The loss of autonomy may also be acceptable to members because in most cases, CUs are driven by objectives that go beyond trade, such as economic and monetary unions or even political integration, and that require supranational institutions.

Ceding the control of some aspects of national trade policy may yield economic benefits, to the extent that it shelters the trade policy–making process from the influence of special interests, at least at the national level. Committing to a regionally agreed trade policy regime can serve as an effective lock-in mechanism for trade reform efforts and can send a strong signal to investors regarding the predictability of the policy environment.[30] In some cases, it may be more practical for a country to delegate the conduct of trade policy to another (larger) CU member or to a supranational agency. In others, a larger member country can impose its own trade policy or tariff structure on that of the union. In this case, there may be grounds for establishing a regional mechanism, such as a development fund, to compensate other member countries for adopting a tariff structure that is not inherently in their own economic interests.

It should be noted that the loss of autonomy implied by a CU also covers certain aspects of national trade policies, going beyond external tariffs. For instance, whereas FTA members retain full flexibility with regard to future PTA partners, CU members may be limited in their individual choices for future partners Indeed, membership in a CU, at least in principle, prevents an individual member from acting individually, since any agreement with a third party or any change to the CET needs to be decided by the CU as a whole. It can be argued that CUs could help prevent the emergence of a hub-and-spokes trading pattern (see the discussion in Baldwin and Freund, ch. 6 in this volume).

In a world of criss-crossing and overlapping trade agreements, the issue of the loss of autonomy can severely constrain members of CUs in using trade agreements as an effective commercial instrument—at least in theory. In the current wave of regionalism, in which flexibility and speed are valued, membership in a CU, if played by the rules, could constitute a straitjacket for some countries.

In reality, of course, there are numerous cases in which a CU member alone negotiates an FTA with a third party. Examples of such a situation include the FTAs between the EU and South Africa (a member of SACU) and between the United States and Bahrain (a member of the GCC). Similarly, Bolivia, Colombia, Ecuador, Peru, and the República Bolivariana de Venezuela form the Andean Pact (a CU), while Colombia and the República Bolivariana de Venezuela have joined with Mexico to make up the Group of Three, an FTA. In some instances, one CU may overlap another. For example, Lesotho, Namibia, and Swaziland belong to COMESA while also belonging to SACU, and Tanzania is a member of both the SADC and the EAC. Multiple and overlapping memberships in regional trade agreements can create difficulties because different groups can have conflicting operational or liberalization modalities, and so member countries will have to make different, incompatible commitments. This not only could render CUs less effective but could also confuse traders (and even customs officers) as to which commitments or tariff schedules apply to a particular shipment. Unnecessary transaction costs will be created because traders are obliged to find their way around a number of trade regimes with different tariff schedules, different rules of origin, and different procedures.

## Notes

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1. GATT Article XXIV:8(a) defines a customs union as a single customs territory substituting for two or more customs territories and having two characteristics: (a) duties are eliminated on substantially all trade between the constituent territories, and (b) substantially the same duties are applied by each member to trade with nonmembers.

2. Historically, the early academic literature on regional integration tended to focus on customs unions; classic works are Viner's *The Customs Union Issue* (1950) and Meade's *The Theory of Customs Unions* (1955).

3. Fiorentino, Verdeja, and Toqueboeuf (2007) suggest that CUs are "out of tune with today's trading climate."

4. In some cases, PTAs are driven by narrow foreign policy or diplomatic considerations.

5. In practice, tariff liberalization could be accompanied or complemented by a rationalization of border management policies. See Keick and Maur (2010) for a thorough survey of the border management issues facing CUs.

6. Interestingly, although the seminal work by Viner (1950) focused on CUs, the analysis studied the removal of the intrabloc tariff while assuming that other policies (e.g., external tariffs) remained constant. Thus, it was more a study of FTAs than of CUs.

7. In the traditional literature on regionalism, the degrees of economic integration correspond to different stages: preferential trading area, free trade area, customs union, single market, economic and monetary union, and complete economic integration. These stages were generally thought to be a progression, with political union as the ultimate

objective. Nowadays, this progression seems a bit outdated, as many existing FTAs have no ambition to move to the next stage.

8. This situation effectively reduces the tariff of every FTA member to that of the lowest (plus the transport cost involved in roundabout importing).

9. Given that rules of origin have to take into account tariffs on imported intermediate goods used in the products manufactured within the FTA, as well as the extent of value addition, they tend to be complex to administer. Rules of origins also raise other issues; they can, for instance, create incentives for regional buyers to purchase high-cost inputs from partner countries, thus exacerbating trade diversion, and they can be captured by interests that favor protection in the form of stringent requirements. Robson (1998) argues that even with rules of origin, the problem of trade deflection is not entirely solved, as the low-tariff partner may meet its own requirements for a product from the rest of the world and can then export a corresponding amount of its own production to its partners.

10. The implementation of a customs union does not necessarily mean the abolition of border posts. These facilities serve many other (trade-related or nontrade-related) purposes, including collecting other taxes, controlling the movement of persons, and enforcing compliance with domestic standards and health and safety requirements.

11. The contiguous pattern of CU formation contrasts with the proliferation of cross-regional PTAs that characterizes the current wave of regionalism.

12. Although PTA members are not required to change their external tariffs, there may be strong political-economy pressures or incentives for adjusting them after the removal of intrabloc tariffs. See Winters (1996) and Freund and Ornelas (2010) for useful reviews of the literature on this topic.

13. This method is of course a simplification. In many CUs, many transitional tariffs and not-so-transitional nontariff barriers on intrabloc trade remain. Even the EU only removed the last physical, technical, and tax-related obstacles to intraunion trade in 1993, 36 years after the community was founded. The free trade area component of the East African Community (EAC) completely abolished tariffs on trade between Tanzania and Uganda and on exports from these two countries to Kenya. Many goods exported from Kenya to Tanzania or Uganda, however, continue to be subject to tariffs (Development Network Africa 2007). In Mercosur, there is not yet free internal trade in sugar, and most favored nation tariffs are applied with a 20 percent preference for intrazone trade.

14. In Mercosur, for instance, the smaller economies (Paraguay and Uruguay) preferred a CET structure with low tariffs, whereas Argentina and Brazil successfully pressed for higher rates.

15. As Hoekman argues in chapter 4 of this volume, real-world PTAs do not select their CETs in a Kemp-Wan manner, nor do they have access to large compensatory or lump-sum transfers.

16. A poorly designed CET can create divisive tensions among CU members. Adams (1993) provides an interesting example of how external tariffs triggered conflicts between the North and the South in the antebellum United States.

17. Mercosur allows members to temporarily deviate from CET rates under specific conditions and with some limitations. Following the peso crisis, Argentina raised tariffs to 35 percent on numerous consumer goods and cut the tariff on capital goods to zero.

18. Note that CETs are, in principle, subject to multilateral rules. GATT Article XXIV:5(a) stipulates that the duties (in this case, the CET) and other trade regulations imposed on trade of nonmembers shall not, on the whole, be higher or more restrictive than the general incidence of duties and other trade regulations applicable in the participants prior to the formation of the CU. Under the usual interpretation, this implies that the common tariff of a CU should not be higher than the preunion average.

19. Bohara, Gawande, and Sanguinetti (2004) provide some empirical evidence for this argument in the context of Argentina's external tariffs under Mercosur.

20. Winters (1996) suggests that Canada's decision to reduce 1,500 tariffs on inputs shortly after the initiation of the North American Free Trade Agreement was driven by this consideration.

21. This possibility is demonstrated, for instance, by Kennan and Riezman (1990) and by Krugman (1990).

22. This situation is illustrated by the disproportionate influence of EU members on policy in sectors in which they claim "vital interests." Other members strategically and willingly accommodate, in anticipation that the favor will be returned when their own "vital interests" come up.

23. It should be noted that in the case of the EU, tariff revenues constitute a small portion of government revenue, which is why EU members are more willing to forgo them and cede them to the commission.

24. On a related note, Dawar and Holmes (ch. 16 in this volume) argue that CUs provide incentives for stronger regional cooperation in the area of trade facilitation. Indeed, there is a need for harmonization of the quality of border enforcement across CU members to ensure that the weaknesses of one member do not undermine the tax collections of other members (since imports may be diverted to the border where enforcement is weakest).

25. In SACU, for instance, most customs duties are collected by South Africa, the dominant economy and trading hub of the bloc.

26. In this context, it should be noted, again, that in addition to import duties, other taxes may be collected by customs at the border and that the establishment of a CU does not mean abolition of all border controls. Keick and Maur (2010) discuss the issues related to border management in the context of CUs.

27. Of course, no existing customs union allocates tariff revenues according to where imports first enter the union. The EU allows member states to keep 10 percent of the tariffs they collect.

28. Conceptually, setting up a CU among countries that have already established an FTA among themselves does not necessarily require any changes in the procedure for collecting customs duties. In most cases, duties are collected on a destination basis before and after the establishment of a customs union.

29. Some customs unions allow for members to establish customs facilities in the territories of other member states in order to collect the customs that are due to them at the first point of entry. In practice, duties paid on imports from the rest of the world could still be collected by the country of final destination.

30. This argument is generally true for international trade agreements, whether bilateral, regional, or global. The need for agreeing on the CET makes it stronger in the case of customs unions.

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