

# **New Developments in the Theory of International Trade, the Customs Union Issue**

**Nighat Malik**

International trade and the different problems arising from the various aspects have been the concern of numerous economists for a long time. The case for international trade is established on the ground of three basic contentions:—

1. Differences in factor availability
2. Profitability of the international Division of labour
3. The comparative costs differences in the production of commodities in different countries

It is these fundamental factors which led to the formation of the Comparative Costs doctrine in the theory of international trade by the classical economists during the beginning of the 19th century and lead later to much consideration of this problem. The classical economists, however, believed in the implementation of the free-trade principle due to their firm conviction in the efficiency and automatism of the pricing system, and their assumption regarding the economy normally operating under full employment conditions. These convictions were shaken badly by later events; all the displacements of the factors of production which occurred as the first consequence of the industrial revolution, specially acute in case of labour; the severe upheavals in the price level and a regular occurrence of the trade cycle during the end of the 19th and the first two decades of the 20th century.

All these factors led economists to a reconsideration of the objections that a commercial policy must perform. The trend towards nationalism come gradually but very conspicuously. The countries emerging as new industrial powers resorted to all sorts of arguments to justify restrictive commercial policies for themselves. Free trade was thus no longer the only ruling faith in this field. By and by a conscious formulation of commercial policies on the part of countries appeared as a regular practice throughout the free world. England, during this period, was the only country which did not resort to a restrictive commercial policy until much later.

Before we embark on a detailed discussion of free trade and protection it would be proper to mention certain broad generalizations which usually serve as the basic objectives of commercial policy. Commercial policy of a country may have the following aims:—

1. The achievement and maintenance of full-employment in the country,
2. Allocation and adjustment of scarce means to alternative-ends with a view to maximizing the social net product,
3. An equitable distribution of the national income of the country,
4. Promotion of the economic growth and development of the country.

The basic objective underlying all these four conditions is the achievement of the maximum social welfare with whatever means it may be achieved. This, in other words, is only the promotion of national interest which is the main function of a good commercial policy. Apart from this it has also to have some consideration of the world gain. Under best conditions therefore, commercial policy must serve the interests of the world as a whole. This we may call the ideals or the optimum situation. The classical interpretation would suggest free trade as the best arrangement. But all do not agree with this view. There are the protectionists who have their own arguments and very strong ones, in favour of a restrictionist commercial policy. Economic isolation reached its peak with the Howley-Smoot Tariff Act of 1930 in the U.S.A. and this policy was further strengthened by the depression of 1930s. Liberal tendencies in the form of a revision of these highly restrictive policies came with Hulls Reciprocal Trade Agreements programme of 1934. But the main objects of this programme was not an effort at bringing free trade again to the force, but merely a more specific aim of export promotion for the U.S.A. with a view to meet the severe after-effects of the great depression. Gradually, during this period it was realized that the economies of different countries of the world are closely interlinked, that the particular economic conditions prevailing in one country tend to have a definite influence on the level of employment and income of the other countries through the balance of payments mechanism and that these repercussions have a tendency to recur very often. Hence special attention was given to the balance of payments problem and to the problem of full employment after the 2nd world war by the war-devastated countries as well as the under developed countries of the world. It was with this object in view that many international agencies were established specially with the purpose of setting such conditions right, for the world had emerged out of this war divided in two groups, the debtor countries and the creditor countries. These debtor countries had borne the enormous burden of the war and were suffering acute balance of payments difficulties. On the other hand there was a block of countries the so called under-developed world, which had the same balance-of-payments troubles to face, but due to completely different reasons. So, it is with the background of a disrupted world economy that we hope to build our case for a modified free-trade position, or more precisely, the theory of preferential groups or customs Unions.

Stated in a nut shell, the theory of Customs Union is that tariffs between two, three or a group of countries are abolished in respect of all, or only a few, commodities exchanged between them but restrictions are kept on exchanges with other countries. In other words, it is a sort of discrimination accorded to each other by a few countries as against the rest of the world, "The Full Customs Union, or Zollverien", according to Professor Meade, "is formed largely because the member states feel themselves to have close political ties," and as such, is held to be an extreme form of discrimination. But the word "Largely" is specially notable here and leaves ample scope for other generalizations. We can thus conclude that it may largely be so but it is not exclusively so. It is the broader objective of a reciprocal multilateral reduction of tariff barriers which has led to this special form of multilateralism within a restricted area. Combating economic nationalism and establishing multilateralism, is a much more complicated problem today than it was four decades ago. The movement towards multilateralism in the world of today has not only to fight the old arguments for economic nationalism based on strategic considerations or the desirability of fostering infant industries or the need for protection of new and established industries alike against cheap foreign labour, but some new ones too, based largely on the experience of the 1930s and specially apparent in the post war attitude of some Governments. Any program to reduce economic nationalism as much, and to promote multilateralism must show, through argument and example that the new evils associated with the later policy need no longer be feared. And these new evils are represented by the relationship of the volume of trade with the changes in national which has been more sensitive than the relationship with the changes in the price level.

The charter of the International Trade Organization sets down the fundamental propositions as under:—

1. Equal treatment among member nations regarding tariffs and other foreign trade matters (Article 16).
2. Reduced tariff rates on a selective basis (Article 17), and
3. No quantitative restrictions such as import and export quotas, licences, or other measures (Article 20).

But in spite of the fact that these three clauses give multilateralism and wider areas of world trade as the essence and intent of the character, they are subject to numerous exception and escape clauses and one of these qualifying clauses gives birth to the idea of customs Union. A Customs Union as defined in this escape clause of the I.T.O. charter is "The substitution of a single customs territory for two or more customs territories"; duties and other commercial regulations are to be eliminated in trade among members of the Union (Article 16 and Annexes A.K.). A customs Union in effect has a common tariff

as against a free trade area which has separate tariffs for each member but substantially free-trade among members (Article 44, section 4). Such an area must, however, see to it that the duties and regulations against the outside world do not become more restrictive than before the agreement. The formation of such preferential groups discriminating against the rest of the world are also allowed with a view to economic development of countries. Neighbour countries may resort to this method of adjustment of their tariff levels with a view to providing and ensuring a market sufficiently large to develop new industries where none or an insignificant number existed before. Or it may be the method used to achieve the protection of a new industry under certain conditions. These, then, may be the basic criteria for forming a customs Union.

A customs Union may be Partial or Complete according to the aim of the countries forming themselves into such a Union. The more important problem of the analysis of this form of commercial policy is related with the question as to how far does the establishment of a Customs Union result in changes in the national locus of production. Primarily, thus, it is the old discussion of the diversion of the goods produced in a country from higher to lower money costs and of the sources of supply available (Transport-costs are also taken into account when money — costs of production are estimated). Such a Union must fulfil the aim of benefiting:

- (a) Each of the member countries taken separately,
- (b) All the members combined,
- (c) The outside world, and
- (d) The world as a whole,

so that a Customs Union can serve ideally only when all these aims are satisfied.

The Customs Union may be (i) Trade-creating or (ii) Trade-diverting. A trade creating customs union area may come into being when the shift in the locus of production takes place in such a way that the member countries benefit on a large scale in so far as new avenues of low-cost production are discovered by one of the countries concerned or by all. This, as such, is a step in the direction of free-trade to a large extent, though a very careful measured step and its directive force is the shift in the locus of production in the countries concerned. This form of the Customs Union is usually beneficial to all and satisfies most of the above given criteria. On the other hand, the trade diverting Customs Union does not aim at achieving all these results. In fact sometimes it may inflict positive injury upon any of the member countries or upon the outside world or the world as a whole. But a customs Union is more likely to operate in the free trade (the trade creating) direction if:

- (i) the economic area of the Union is large, and therefore, there is a greater potential scope for internal division of labour,
- (ii) the average tariff levels for imports from outside, the Customs Union area are low enough,
- (iii) the degree of 'complimentarily' in the productive pattern of the countries forming such a Union is less or that the degree of rivalry in production is great. This would ensure a highly diversified pattern of trade between the Union members, and
- (iv) finally, if the differences in unit costs of production for protected industries of the same kind in the member countries are considerably high.

These four provisions are important not only to ensure a greater tendency towards free trade within the Customs Union area, but also they are the basic contentions on which the very existence of this issue rests. Countries have to be either actually complimentary but potentially rivals or actually rivals but potentially complimentary in order to make such a Union a success.

To conclude it may be maintained that customs Union can be of immense benefit to countries because they aim at the establishment of free-trade, the achievement of higher levels of employment and economic development. There are however, plenty of difficulties in the way and if it could surmount these difficulties, it would result in easing out many of the balance-of-payments difficulties of the world today as the best compromise between the rigidly restrictive commercial policies on the one hand, and complete multilateralism on the other.

-----