

CUSTOMS UNION

A **customs union** is an agreement between two or more neighboring countries to remove **trade** barriers, reduce or abolish **customs** duty. Tariffs are the common element in **international trading**. ... Such **unions** were defined by the General Agreement on Tariffs and **Trade** (GATT) and are the third stage of economic integration. Unlike in free trade agreements, a common external tariff is imposed on non-members of the union. When countries outside the union trade with countries in the customs union, they need to make a single payment (duty fee) for the goods that have crossed the border. Once inside the union, they can trade freely with no added tariffs.

Purpose of Customs Unions

The purpose of a customs union is to make it easier for member countries to trade freely with each other. The union reduces the administrative and financial burden of barrier trading and fosters economic cooperation among nations.

However, member countries do not enjoy the liberty to form their own trade deals. The countries in the customs union usually restructure their domestic economy and economic policies in order to maximize their gain from membership in the union. The [European Union](#) is the largest customs union in the world in terms of the economic output of its members.

A customs union generates trade creation and diversion that helps with economic integration. Below are the advantages and disadvantages of customs unions.

Advantages of Custom Unions

Customs unions offer the following benefits:

1. Increase in trade flows and economic integration

The main effect of a free-trade agreement is that it increases trade between member countries. It helps improve the allocation of scarce resources that satisfy the wants and needs of consumers and boosts [foreign direct investment \(FDI\)](#).

Customs unions lead to better economic integration and political cooperation between nations and the creation of a common market, monetary union, and fiscal union.

2. Trade creation and trade diversion

The effectiveness of a customs union is measured in terms of trade creation and trade diversion. Trade creation occurs when the more efficient members of the union sell to less efficient members, leading to a better allocation of resources.

Trade diversion occurs when efficient non-member countries sell fewer goods to member countries because of external tariffs. It gives less efficient countries in the union the opportunity to capitalize on their position and sell more goods within the union.

If the gains from trade creation exceed the losses from trade diversion, that leads to increased economic welfare among member countries.

3. Reduces trade deflection

One of the main reasons a customs union is favored over a free trade agreement is because the former solves the problem of trade deflection. This occurs when a non-member country sells its goods to a low-tariff FTA (free trade agreement) country, which then resells to a high-tariff FTA country, leading to trade distortions. The presence of a common external tariff in customs unions helps avoid problems that arise from tariff differentials.

Disadvantages of Customs Unions

Along with the advantages, customs unions also come with a few drawbacks:

1. Loss of economic sovereignty

Members of a customs union are required to negotiate with non-member countries and organizations such as the WTO. This is necessary to maintain a customs union; however, it also means that individual member countries are not free to negotiate their own deals.

If a country wants to protect an [infant industry](#) in its market, it is unable to do so by imposing tariffs or other protective barriers due to the liberal trading policies. Similarly, if a country wants to liberalize its trade outside the union, it is unable to do this due to the common external tariff.

2. Distribution of tariff revenues

Some countries in the union do not receive a fair share of tariff revenues. This is common among countries like the UK that trade relatively more with countries outside the union. Around 20%-25% of the tariff revenue is retained by the member who collects the revenue. It is estimated that the cost of collecting this revenue exceeds the actual revenue collected.

3. Complexity of setting the tariff rate

A common problem faced by customs unions is the complexity of setting the applicable tariff rate. The process is very costly and time-consuming. Member countries often find it hard to forgo the trade of certain goods or services because another country in the union is producing it more efficiently. The problem is usually faced by developing countries and is a major issue that the UK is dealing with during [Brexit](#).

The establishment of customs unions is beneficial to economies in the long term. It helps small economies tap industries that may not have been accessible with domestic trade only. They can achieve large external economies of scale within the union from transport and infrastructure.

Faced with competition from other economies, domestic markets will be more inclined to increase efficiency. Customs unions help foster growth and unite economies with liberal trade policies.