Fourth edition

INTERNATIONAL BUSINESS

Stuart Wall Sonal Minocha Bronwen Rees

ALWAYS LEARNING

PEARSON

International Business

BOX 3.5 Customs union: trade creation and trade diversion

As already noted, a customs union is a protected free trade area. Those who favour this approach argue that the setting up of such regional trading blocs can enable individual countries within a broad geographical region to purchase products at lower prices because tariff walls between the member countries have been removed; this is the *trade creation effect*. They also argue that such regional trading arrangements may create opportunities for still deeper integration, such as harmonising tax policies and product standards, while also helping to reduce political conflicts. Supporters also argue that where the world is already organised into trading blocs, then negotiations in favour of free trade are more likely to be successful when individual countries combine to form large and influential trading blocs: a large number of individual countries will, on their own, have little power to bargain successfully with existing trade blocs to secure tariff or subsidy reductions.

On the other hand, the critics of integration warn that regional trading blocs have, historically, tended to be inward looking, as in the 1930s when discriminatory trade blocs were formed to impose tariffs on non-members. Some also argue that member countries may suffer from being inside a regional bloc because they then have to buy products from within the bloc, when cheaper sources are often available from outside – i.e. the *trade diversion effect*. Critics also argue that such regionalism threatens to erode support for multilateralism in that business groups within a regional bloc will find it easier to obtain protectionist (trade diversionary) deals via preferential pacts than they would in the world of non-discriminatory trade practices favoured by the GATT/WTO.

Figure 3.8 looks in more detail at the trade creation versus trade diversion impacts of establishing a regional trading bloc.

We assume that the domestic country initially has a tariff (t) imposed on imports from two separate countries, A and B, both of which are lower (and constant) cost producers, as indicated by their horizontal supply curves S_A and S_B respectively. We assume the tariff (t) imposed on imports from both A and B rules the less efficient country A out from competing in the domestic market altogether but still allows the relatively more efficient country B to compete.

The 'world' supply curve to the domestic market is therefore $S_d + (S_B + t)$, i.e. *LNK* giving a domestic price of P_d and domestic production of $0q_2$, with imports from country B of q_2q_3, but no trade at all with country A.

Suppose now a regional trading bloc, protected by the common external tariff t, is now formed between the domestic country and country A only. All tariffs between the domestic country and country A are abolished (it is a protected free trade area) so that the 'world' supply curve to the domestic market now becomes *LMZ*. Price in the domestic market falls to P'_d, with imports from country A of q_1q_4 but now no imports from country B.

We have in this example both trade creation and trade diversion.

- *Trade creation*: The result of removing the tariff t on trade with country A has created extra trade (with A) of the magnitude $q_1q_2 + q_3q_4$.
- *Trade diversion*: The result of removing the tariff t only on country A (i.e. forming a trading bloc with A) has enabled country A to undercut country B (the more efficient producer) in the domestic market. The volume of trade q_2q_3 previously undertaken with B prior to the trading bloc is now undertaken with the less efficient producer A. Trade has been 'diverted' by the formation of the trading bloc.

Using our earlier ideas of consumer and producer surplus, we can seek to measure gains and losses from trade creation and trade diversion. In Figure 3.8, the reduction in price from P_d to P'_d via creating the trading bloc has increased *consumer surplus* by area ($a + b + c + d$), but reduced *producer surplus* by area a, since domestic production has fallen from q_2 to q_1. The *tariff revenue* ($c + e$) previously earned on trade with country B is also lost as trade is diverted to tariff-free country A.

As long as the *net* benefits ($b + c + d$) brought about from trade creation exceed the losses ($c + e$) brought about from trade diversion, then the formation of the economic trading bloc can be regarded as beneficial overall.

Box 3.5 (*continued*)

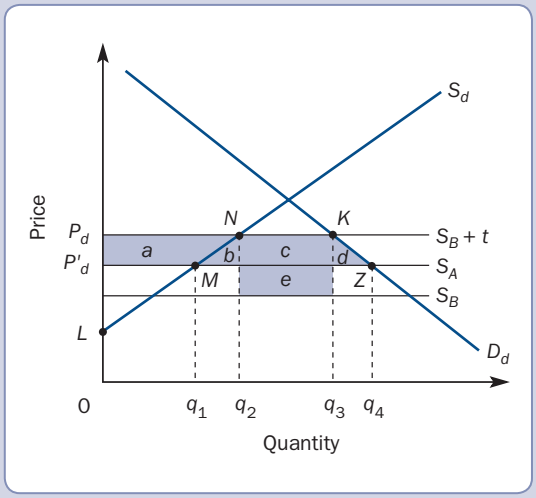

Figure 3.8 Customs union, trade creation and trade diversion

Some general observations can be made from this analysis as to when the above condition is most likely to hold and to support the creation of a trading bloc.

- *The greater the degree of overlap in the economies of the countries contemplating the formation of an economic bloc,* the greater the likelihood that the bloc will be a trade-creating one. If economies do not overlap, as in the case when a basically agricultural producing country joins a mainly manufacturing country, then there is little scope for trade creation but a great deal of scope for trade diversion.
- *The greater the differences in production costs between the potential members in their overlapping industries,* the greater the potential for trade creation. Conversely, if the differences in costs are small, so will be the potential gains.
- *The higher the tariff rates prior to the amalgamation of the economies,* the greater the gains from the associated tariff reductions.

It follows that the greatest gains from the formation of an economic group can be achieved if:

- The economic structure of the economies overlap.
- The industries that are common to both have a wide variation in their costs.
- The level of import tariffs placed by those countries on one another's products is high prior to the formation of the bloc.

Government policies and international business

Government policies can influence international business in a variety of ways, some of which have already been considered in Chapter 2. For example, change in fiscal policies (involving government spending/taxation) or monetary policies (involving money supply/interest rates) will influence the macroeconomic environment in which domestic and international businesses operate. However, sometimes government policies can impact upon international business *indirectly*; for example, changes in interest rates may influence the price of currencies on the foreign exchange markets (see Chapter 4), which in turn may exert a strong influence on the prospects for exporting and importing products across national boundaries. It is to this issue of exchange rates that we first turn our attention.

Exchange rates

We note in Chapter 4 that few governments can now influence their exchange rates directly, via unilateral action. More usually they can only influence such rates indirectly whether

intentionally or unintentionally. For example, high interest rates used as part of an anti-inflationary monetary policy may make a country's currency relatively attractive on foreign exchange markets, the extra demand then raises the price of that country's currency.

A *rise* in, say, the UK sterling exchange rate makes UK exports dearer abroad in terms of the foreign currency, and UK imports cheaper at home in terms of the domestic currency. Suppose, for example, sterling *appreciates* against the euro from £1:€1.10 to £1:€1.40. An item priced at £1,000 in the UK would have a euro-zone equivalent price of €1,100 prior to the sterling appreciation but €1,400 after that appreciation. Not only will exports be dearer abroad but imports will be cheaper at home. An item priced at €1,100 in the euro-zone would have a sterling equivalent price of £1,000 prior to the sterling appreciation but £785.7 after that appreciation.

The impact of higher export prices and lower import prices on business turnover (and the balance of payments) will depend to some extent on *price elasticities of demand* in the export and import markets respectively.

- If *price elasticity of demand for UK exports is relatively elastic* (greater than one), then any rise in euro-zone prices will reduce total expenditure in euros on those items. Since each euro is now worth less in sterling, this fall in the euro value of UK exports will mean a still more substantial fall in sterling turnover for UK exporters.
- If *price elasticity of demand for UK imports is relatively elastic* (greater than one), then any fall in sterling prices will raise total expenditure in sterling on those items. This is likely to imply a loss of turnover and market share from UK domestic producers to euro-zone producers.

Clearly the more elastic the respective price elasticities of demand for UK exports and UK imports, the greater the disadvantage for businesses located in the UK in trading with the euro-zone after sterling appreciates against the euro, and the greater the advantage for businesses located in the euro-zone in trading with the UK.

For illustrative purposes only we have used an example of sterling rising in value against the euro. This has indeed been the case in recent times (see Chapter 10, p. 354), but previously sterling has fallen substantially against both the euro and US dollar.

Pause for thought 3.6

Can you work through the previous analysis if sterling *depreciates* against the euro? (For example, suppose £1 is now worth €1.00 instead of €1.40.)

Import protection/export support

We have already seen how a variety of *protective trade barriers* (such as tariffs and quotas) can be used to discourage imports into a country, whether imposed unilaterally by a country or collectively as part of a regional trading bloc. An example of the latter would be the Common External Tariff imposed on industrial imports into the EU. Domestic producers can also be helped vis-à-vis overseas producers by a variety of support policies directed towards exporters.

The Common Agricultural Policy (CAP) of the EU provides a useful illustration of government-directed policies involving import protection/export support which exert a strong influence on the operations of farms and agri-businesses, both inside and outside the EU. Box 3.6 considers the operation of the CAP in rather more detail.

BOX 3.6 Impacts of EU policies on farms and agri-businesses

The formal title for the executive body of the CAP is the European Agricultural Guarantee and Guidance Fund (EAGGF), often known by its French translation of 'Fonds Européen d'Orientation et de Garantie-Agricole' (FEOGA). As its name implies, one of its key roles is in operating the 'guarantee system' for EU farm incomes.

Different agricultural products are dealt with in slightly different ways, but the basis of the system is the establishment of a 'target price' for each product (Figure 3.9(a)). The target price is not set with reference to world prices but is based upon the price which producers need to cover costs, including a profit mark-up, in the highest-cost area of production in the EU. The EU then sets an 'intervention' or 'guaranteed' price for the product in that area, about 7–10% below the target price. Should the price be in danger of falling below this level, the Commission intervenes to buy up production to keep the price at or above the 'guaranteed' level. The Commission then sets separate target and intervention prices for that product in each area of the Community, related broadly to production costs in that area. As long as the market price in a given area (there are 11 such

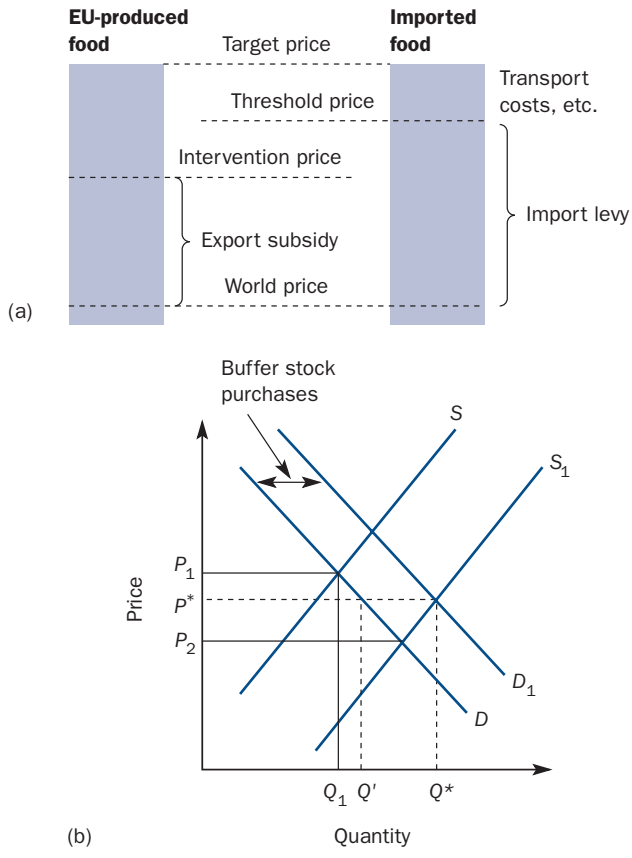

Figure 3.9 **(a) CAP system: world price below target price; (b) Guarantee system: maintaining the intervention price (*P**)**

Box 3.6 (*continued*)

areas in the UK) is above the intervention price, producers will sell their produce at prevailing market prices. In effect the intervention price sets a 'floor' below which market price will not be permitted to fall and is therefore the guaranteed minimum price to producers.

In Figure 3.9(b) an increase in supply of agricultural products to S_1 would, if no action were taken, lower the market price from P_1 to P_2 below the intervention or guaranteed price, P^*. At P^* demand is Q' but supply is Q^*. To keep the price at P^*, the EAGGF will buy up the excess $Q^* - Q'$. In terms of Figure 3.9(b), the demand curve is artificially increased to D_1 by the EAGGF purchase.

If this system of guaranteed minimum prices is to work, EU farmers must be protected from low-priced imports from overseas. To this end, levies or tariffs are imposed on imports of agricultural products. If in Figure 3.9(b) the price of imported food were higher than the EU target price then, of course, there would be no need for an import tariff. If, however, the import price is below this, say at the 'world price' in Figure 3.9(a), then an appropriate tariff must be calculated. This need not quite cover the difference between 'target' and 'world' price, since the importer still has to pay transport costs within the EU to get the food to market. The tariff must therefore be large enough to raise the import price at the EU frontier to the target price minus transport costs, i.e. 'threshold price'. This calculation takes place in the highest-cost area of production in the EU, so that the import tariff set will more than protect EU producers in areas with lower target prices (i.e. lower-cost areas).

Should an EU producer wish to export an agricultural product, an export subsidy will be paid to bring his receipts up to the intervention price (see Figure 3.9(a)), i.e. the minimum price he would receive in the home market. Problems involving this form of subsidy of oil-seed exports have been a major threat to dealings between the EU and the USA, with the latter alleging a breach of WTO rules. The system outlined above does not apply to all agricultural products in the EU. About a quarter of these products are covered by different direct subsidy systems, e.g. olive oil and tobacco, and some products such as potatoes, agricultural alcohol and honey are not covered by EU regulation at all.

Reforms of the CAP over the past decade or so have modified this system which has proved an expensive method of supporting farm incomes. For example, Maximum Guaranteed Quantities (MGQs) have now been set for most agricultural products. If the MGQ is exceeded, the intervention price is cut by 30% in the following year. Further CAP reforms were also agreed in 2003, which came into effect from 2007 onwards. For example 'compulsory modulation' has been introduced whereby payments directly related to agricultural production have been progressively replaced by payments for a wide range of environmental protection activities by EU farmers.

Taxation policies

The ability of 'footloose' multinational enterprises to take advantage of tax discrepancies between countries or regions is well known, as in the examples of 'transfer pricing' (see Chapter 9, p. 331). Indeed the issue of 'tax havens' has risen to greater prominence in an era where governments are seeking greater tax revenues to fund their increased budget deficits from 'bailing out' endangered domestic firms and organisations during the so-called 'credit crunch'. There has been growing hostility to the tiny states and islands around the world that harbour an estimated $6,000 billion of offshore assets. The US adopted the *Stop Tax Haven Abuse Act* in 2007 and the *Incorporation Transparency and Law Enforcement Assistance*

Act in 2008, which seeks to make it easier for investigators to 'see through opaque corporate ownership structures' and stop the flow of offshore funds to the US from hedge funds and private equity that are 'of unknown origin' but do not have to pass money-laundering checks. It was noted that one building in the Cayman Islands supposedly housed 12,000 US-based corporations!

However, tax havens are not limited solely to developing economies. Delaware is a state in the US which is infamous for allowing corporate financial secrecy of the kind that regulators worldwide are seeking to overcome in offshore financial centres. Arguments over Delaware – whose more than 600,000 registered companies compare with an estimated 865,000 inhabitants – are part of a broader fight over what many havens see as rich-country double standards in international action to tackle money laundering and tax evasion. Delaware's corporations are under no obligation to file names of shareholders or beneficial owners, as the state offers a structure known as a limited liability company, which can be registered with not much more than a name and address.

Pause for thought 3.7

Examine the costs and benefits that might result from government policies to remove 'tax havens'.

Case 3.4 examines tax-related issues involving Luxembourg, seen by many as a source of tax distortion within the EU.

CASE 3.4 Luxembourg tax regime: under siege

Amid the rolling wooded farmland of the Ardennes, the highway from Brussels briefly hugs the Luxembourg frontier at Martelange, a small town famous for the border that runs down the middle of the busy main street. On one side – in low-tax Luxembourg – is a profusion of petrol stations offering some of the most lightly taxed fuel in Europe. It is a striking example of the 'gas pump tourism' that boosts Luxembourg's exchequer at the expense of its neighbours.

This is one face of Luxembourg: a tiny country at the crossroads of Europe that built a significant part of its wealth on its appeal to other countries' taxpayers. Its low fuel duties are just one facet of a distinctive tax system that has helped make its society one of the richest in the world. There is another face to Luxembourg. Its agility and financial expertise has built the world's second-largest fund administration industry. It has a reputation for stability and professionalism, demonstrated by the resilience of its huge banking sector in the financial crisis. But the rumbling discontent over Luxembourg's tax practices is now threatening its prosperity. The world's last Grand Duchy has already bowed to pressure over accusations it helped other countries' citizens hide from the taxman. Xavier Betel, its prime minister, is 'fed up with being accused of being a defender of a tax haven and a hotbed of sin'.

Luxembourg is not overly a low-tax country for businesses: more than two-thirds of OECD countries have rates lower than its 29.2 per cent. But there are numerous deductions. Indeed, Luxembourg has been battling with its neighbours on tax matters for decades. As long ago as 1973, France and Germany demanded a crackdown on its 'letter box' subsidiaries – structures governed by a 1929 tax law that were often used to avoid tax. It was not until 2006 that the regime was outlawed under the European Commission's state aid rules.