4 Common Markets and Economic Unions

INTRODUCTION

The analysis of customs unions (CUs) needs drastic extension when applied to common markets (CMs) and economic unions (EUs). Firstly, the introduction of free factor mobility may enhance efficiency through a more rational reallocation of resources but may also result in depressed areas, therefore creating or aggravating regional problems and imbalances – see Mayes (1983a) and Robson (1985). Secondly, fiscal harmonisation may also improve efficiency by eliminating non-tariff trade barriers (NTBs) and distortions and by equalising their effective protective rates. Thirdly, the coordination of monetary and fiscal policies which is implied by monetary integration may ease unnecessarily severe imbalances hence resulting in the promotion of the right atmosphere for stability in the economies of the member nations.

These CM and EU elements must be tackled simultaneously with trade creation and diversion as well as economies of scale and market distortions. However, such interactions are too complicated to consider here – the interested reader should consult El-Agraa (1983a; 1984a; 1985b). Hence, this chapter will be devoted to a brief discussion of factor mobility, fiscal harmonisation and monetary integration.

FACTOR MOBILITY

The analysis of CMs requires a discussion of factor mobility; this is the only consideration that distinguishes them from CUs. With regard to factor mobility, it should be apparent that the removal (or their harmonisation) of all barriers to labour \((L)\) and capital \((K)\) will encourage both \(L\) and \(K\) to move. \(L\) will move to those areas where it can fetch the highest possible reward, i.e. the highest ‘net advantage’ since pecuniary rewards are not the only consideration; tax allowances, health benefits, housing allowances, etc. have to be taken into the calculations. This encouragement need not necessarily lead to an
increase in actual mobility since there are socio-political factors which normally result in people staying near their birthplace – social proximity is a dominant consideration, which is why the average person does not move. If the reward to $K$ is not equalised, i.e. differences in marginal productivities ($mps$) exist before the formation of a CM, $K$ will move until the $mps$ are equalised. This will result in benefits which can be clearly described in terms of Figure 4.1 which depicts the production characteristics in countries $H$ (the home country) and $P$ (the potential partner country). $M_H$ and $M_P$ are the schedules which relate the $K$ stocks to their $mps$ in $H$ and $P$ respectively, given the quantity of $L$ in each country, assuming only two factors of production.

Prior to the formation of the CM, the $K$ stock (which is assumed to remain constant throughout the analysis) is $Oq_2$ in $H$ and $Oq_1^*$ in $P$. Assuming that $K$ is immobile internationally, all $K$ stocks must be nationally owned and, ignoring taxation, profit per unit of $K$ will be equal to its $mp$, given conditions of perfect competition. Hence the total profit in $H$ is equal to the areas $b + e$ and $i + k$ in $P$. Total output is, of course, the whole area below the $M_P$ curve but within $Oq_2$ in $H$ and $Oq_1^*$ in $P$, i.e. areas $a + b + c + d + e$ in $H$ and $j + i + k$ in $P$. Therefore, $L$'s share is $a + c + d$ in $H$ and $j$ in $P$.

Since the $mp$ in $P$ exceeds that in $H$, the removal of barriers to $K$ mobility or the harmonisation of such barriers will induce $K$ to move away from $H$ and into $P$. This is because nothing has happened to affect $K$ in $W$. Such movement will continue until the $mp$ of $K$ is the same in both $H$ and $P$. This results in $q_1, q_2$ ( = $q_1^*, q_2^*$) of $K$ moving

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**Figure 4.1** The economic implications of free $K$ mobility in $H$ and $P