

Common Market

A *common market* differs from other preferential trading arrangements such as a free trade area or a customs union, in that, in addition to free trade in goods and services among members, there also is free mobility of factors. The European Union (EU) is a prominent—although imperfect—example of this form of integration.

Global free trade and global factor mobility allow the most efficient allocation of resources and, therefore, yields a *first-best* situation. In contrast, a common market, which restricts trade and factor mobility between members and non-members, has to be seen in a *second-best* context. As in any preferential trading arrangement, a common market leads to welfare-reducing trade-diversion effects to go along with its welfare-enhancing trade-creation effects. These effects apply to factor mobility as well. To the extent that intra-bloc capital movement or labor migration might improve factor allocation within the union, it is efficiency enhancing. On the other hand, if factor mobility within the union leads a country to replace factor inflows from non-members with less-efficient factors from members, it will be welfare reducing. Finally, as with goods, the prices for mobile factors might differ in a common market, thereby conferring terms-of-trade losses or gains to member nations.

In the presence of foreign factors of production, many of the conventional welfare results of international trade break down. Bhagwati and Brecher (1981) highlight the role of the *differential trade volume* phenomenon and the *differential trade pattern* phenomenon in leading to apparent paradoxes. The trade volume for the home nation as a whole will, in general, differ from the corresponding volume for the nationals (excluding the immigrant factors of production) only. This is referred to as the

differential trade volume. It is also possible that, while the country is a net exporter of (say) a capital-intensive good, the nationals are net importers of the same good.

Bhagwati and Brecher (1981) call this the *differential trade pattern*. A terms-of-trade improvement for the country can be an adverse movement for the nationals because of this effect. Similarly, even with the same trade pattern, an adverse terms-of-trade movement will be amplified if the nationals' volume of trade is disproportionately large (compared to the country's as a whole). This can reduce the income of the nationals, even if the aggregate income (including that of the immigrants) rises. Overall, they conclude that even if standard trade theory may suggest that a nation will gain (or lose) from a certain change, the effect on its citizens might be ambiguous in the presence of immigrant factors. In light of this discussion, we infer that factor mobility can lead to conflicts between member-nation interests. Policies that might be good for the union need not raise the national income of each member. In such a situation, welfare-enhancing policies might only be feasible if members can coordinate and set up compensation mechanisms that allow for appropriate intra-bloc transfers.

Wooton (1988) considers the effects of moving from a customs union to a common market. To the extent that factor mobility leads to superior resource allocation within the union, efficiency rises. However, given that trade taxes exist between the union and the rest of the world, factor mobility can amplify or reduce distortions. For example, consider a good that is subject to an import tariff by the union. When factors move within the bloc, production of the good will fall in some nations and rise in others - through changes in their respective production possibility frontiers. If the net effect is such that production of the good falls at the union level, more will be imported by the

union, thereby moving the outcome closer to the free-trade level. In such a situation, a common market will improve upon a customs union. If not, then the opposite will occur. The welfare issue is more complicated at the national level: Even if the union as a whole gains, some member nations might lose because of adverse terms-of-trade movements in product and/or factor markets. For an individual member nation, the extent of gains or losses from such movements will depend on its volume of trade. Furthermore, because a common external tariff restricts trade, a member nation will gain if factor mobility induces an expansion of trade with non-members. Kowalczyk (1993) focuses on related issues and, in addition to the terms-of-trade and volume-of-trade issues related to trade taxes, considers the role of non-tariff barriers (NTBs). He points out that intra-union trade in goods or factors is often subject to NTBs that do not generate revenues. Consequently, the welfare gains related to NTB removal depend on the initial volume of trade and not the change in the volume, which is scaled by the tariff rate. Viewed in this context, a union which already has a large volume of trade in factors is likely to gain significantly from the removal of impediments to factor mobility.

Issues of tax competition and coordination also arise when there is factor mobility between union members (see Haufler, 2001). Broadly speaking, as long as there are differences in national policies within a union, there will be incentives for labor and/or capital to move to take advantage of the differences. By the same token, nations can anticipate such movements and adjust their policies accordingly. In the absence of coordination at the union level, factor mobility can lead to tax competition between nations and to inefficient policy outcomes for an individual member and perhaps for the union as a whole. Competition for mobile capital is an example: Consider two nations

that are competing to have capital locate within their borders. Assume also that capital-tax revenues go towards financing a public good. If one nation raises its tax rate on capital, the other nation will benefit as some of the capital will relocate to it. In other words, the tax imposed by one nation causes a positive externality on the other, which experiences an increase in tax revenue, and public-good provision, without increasing its tax rate. In a non-cooperative Nash taxation equilibrium, this leads to tax rates and public-good provision that are too low from the perspective of a union of these two nations. Tax coordination between the nations will help to alleviate this problem. However, asymmetry between nations can make such coordination difficult. It is possible that the coordinated outcome is not superior for a nation that stands to benefit from tax competition. Therefore, for heterogeneous unions, coordination can be harder to achieve.

Although capital and labor mobility are treated symmetrically in the discussion above, there is evidence that actual movements of labor within a common market is relatively small compared to the movement of capital. Dustmann et al. (2003) note that the introduction of mobility between Greece, Portugal, and Spain with existing EU members did not lead to large migration flows from these nations to the rest of the EU. This is significant, because these acceding countries differed substantially in their economic conditions (for example, much lower per capita incomes) relative to the existing EU nations. Qualitatively similar conclusions are reached by Zaiceva (2004) regarding accession of East European nations to the EU. No major jumps were anticipated and, indeed, as income levels converge over the long run migration flows are expected to fall. As an explanation for the low levels of labor migration following

integration, Dustman et al. suggest that it is not only current conditions, but also expectation of future conditions that can determine such flows. To the extent that agreements like EU expansion creates optimism in a new member nation about its own economy, it might dampen the desire of a potential migrant to incur the costs that are associated with migration.

Harris and Schmitt (2005) contrast intra-EU mobility with the relatively high mobility between states in the US and note that labor market shocks in the EU generate changes in the labor market participation rate without affecting migration significantly. The EU experience might not immediately generalize to other groupings of nations. For example, mobility between Canada and the US has been high historically and is likely to strengthen with potentially deeper labor market integration (see Harris and Schmitt, 2005). Similarly, labor market integration that includes Mexico might also lead to large flows. The migration pressure between Mexico and the US is readily seen in the large existing stock (and flow) of legal and illegal immigration across these borders. However, at least in the context of NAFTA, the recent immigration reform proposals, and the debate surrounding them, suggests that a common market with full mobility of labor seems unlikely to be politically feasible in the near future.

See Also: Customs Union, Free Trade Area, Regionalism.

Further Reading:

Brecher, Richard A., and Jagdish N. Bhagwati, 1981, Foreign Ownership and the Theory of Trade and Welfare, *Journal of Political Economy*, 89(3), 497-511. A theoretical contribution qualifying standard trade theoretic results in an economy with immigrant factors of production.

Dustmann, Christian, Maria Casanova, Michael Fertig, Ian Preston and Christoph M Schmidt, 2003, The Impact of EU Enlargement on Migration Flows, Home Office Online Report 25/03, Center for Research and Analysis of Migration (CReAM), UK. A Report assessing potential migration flows to the UK due to EU enlargement.

Harris, Richard G., and Nicolas Schmitt, 2005, Labour Mobility and a North American Common Market: Implications for Canada, in S. Easton, R.G. Harris and N. Schmitt (eds), Brains on the Move: Essays on Human Capital Mobility in a Globalizing World, (Toronto: C.D. Howe Institute), Chapter 9, 133-174. A contribution focused on greater labor mobility within NAFTA and its implications for Canada.

Haufler, Andreas, 2001, Taxation in a Global Economy, Cambridge University Press, Cambridge, UK. A book that brings together different policy coordination issues that may arise within an economic bloc like the EU.

Kowalczyk, Carsten, 1993, Integration in Goods and Factors: The Role of Flows and Revenue, *Regional Science and Urban Economics*, 23, 355-367. A theoretical contribution comparing revenue generating barriers to trade to non-tariff barriers, in the context of a common market type of trading bloc.

Wooton, Ian, 1988, Towards a Common Market: Factor Mobility in a Customs Union, *Canadian Journal of Economics*, 21(3), 525-538. A theoretical assessment of efficiency gains for members of a customs union, who plan to move to a common market type of integration.

Zaiceva, Anzelika, 2004, Implications of EU Accession for International Migration: An Assessment of Potential Migration Pressure, CESifo Working Paper #1184. An empirical contribution that forecasts migration flows from accession nations to EU member states due to eastern enlargement.

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