Preferential Trading Arrangements: The Traditional and The New

Robert Z. Lawrence

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Robert Z. Lawrence is Albert L. Williams Professor of International Trade and Investment, the Center for Business and Government, John F. Kennedy School of Government, Harvard University.

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Abstract

This paper contrasts regional preferential economic agreements of the traditional sort with those that have emerged in recent years. In addition, it assesses the implications of the Euro-Med initiatives for the Middle East.

The paper argues that the new preferential trade agreements (PTAs) have the potential to generate greater economic growth impacts than traditional free trade agreements. Recent PTAs are characterized by a general process of increased openness to trade and investment, rather than import substitution, protection of markets, and managed trade. The new regionalism is pursued by countries seeking deeper integration with partner countries and increased participation in the world economy, thus inferring greater reliance on market forces, export to world markets, and foreign capital and services.

Nevertheless, the agreements being concluded between the EU and Mediterranean countries, while having the potential to become deep integration arrangements, are perhaps better characterized as more traditional trade agreements. As a result, until the agreement liberalizes services and investment, its welfare implications may be driven largely by classic trade diversion and trade creation tradeoffs.

ملخـــــــص

الترتيبات التجارية التفضيلية: بين المفهوم التقليدى والمفهوم الحديث

تقارن هذه الورقة بين الاتفاقيات الإقليمية الاقتصادية التفضيلية بصورتها التقليدية، وبين هذه الاتفاقيات بالصورة التى ظهرت عليها فى السنوات الأخيرة. وتقيم الورقة آثار اتفاقيات التجارة التفضيلية بين أوروبا ودول البحر المتوسط على منطقة الشرق الأوسط.

وتذهب هذه الورقة إلى أن اتفاقيات التجارة التفضيلية الجديدة يمكن أن تحقق معدلات أعلى للنمو مقارنة باتفاقيات التجارة الحرة التقليدية. فالاتفاقيات الجديدة تتسم بانفتاح أكبر فى مجالات الاستثمار والتجارة بدلا من سياسات الاحلال محل الواردات وحماية السواق وادارة التجارة. إن الدول التى تتضمن لهذه التكتلات هى دول تسعى لتحقيق تكامل أعمق مع الدول الأخرى ومشاركة أوسق فى الاقتصاد العالمى من خلال الاعتماد على قوى السوق ورأسالمال الأجنبى والتجارة فى الخدمات. ومع ذلك، فإن الإتفاقيات التة وقعت بين الإتحاد الوروبى ودول البحر المتوسط، بينما تملك إمكانية تحقيق تكامل اعمق، تندرج أكثر تحتح مفهوم الاتفاقيات التجارية التقليدية. وبالتالى، فإن آثار هذه الاتفاقيات على تكامل الرفاه الاقتصادى فى المنطقة ستتحدد بما يترتب عليها من خلق أو تحويل للتجارة، وستظل كذلك حتى تتجقق حرية التجارة فى الخدمات وحرية الاستثمارات.

1. Introduction

Over the past decade, a large number of regional economic arrangements have been negotiated. The most well-known are the program of the European Union to complete its internal market program (EC92) and the United States, Canada and Mexico to form the North America Free Trade Agreement (NAFTA). These were the most prominent of a rapidly growing number of preferential economic agreements which have emerged or been revitalized in recent years. A list of such agreements compiled by the International Monetary Fund numbered 67 in 1994.[1] It covers all five continents, running virtually the full alphabet from the ASEAN Free Trade Area (AFTA) and the Andean Pact (ANCOM) to the Central African Customs Union (UDEAC) and the West African Economic and Monetary Union (WAEMU). It is estimated that about 90 percent of all GATT contracting parties are signatories to such arrangements.[2]

Some pessimists see the current situation as an ominous precursor of what has come before. They believe that the world trading system is fragmenting in the same way it did in the 1930s.[3] The rule-based multilateral trading system that has developed under the General Agreement on Tariffs and Trade (the GATT) will be destroyed as Europe, North America and Asia become "fortresses" in which some trading partners obtain refuge, while others are excluded. In his best-selling book *Head to Head*, Lester Thurow (1992) proclaimed that "the GATT is dead" and argued that the world would shift to a tripolar system, with three blocs centered on Europe, the United States and Japan, conducting free trade internally but managed trade among them.

Multilateralists, such as Jagdish Bhagwati, are not willing to give the GATT its last rites, but remain concerned that the expansion of regionalism will undermine the multilateral system and weaken its thrust towards liberalization.[4] Bhagwati fears that if some countries are given a vested interest in preferential arrangements, they will have less incentive to press for complete free trade. If leaders devote resources and political capital to their regional arrangements, they could be diverted from investing in the multilateral system. He concedes that regional arrangements may have played a role in spurring the completion of the Uruguay Round, but he argues that now that the round has been

1. IMF (1995).

2. Japan, Hong Kong, and India among a mere 10 or so exceptions. (Japan 1995, page 304).

3. For estimates of the impact of a fortress EC or USA, see Stoeckel (1990).

4. See Bhagwati (1992), Bhagwati (1994), and Bhagwati and Krueger (1995).

successfully completed, the World Trade Organization (WTO) should be the sole locus of future trade liberalization. Bhagwati therefore calls for greater disciplines on preferential arrangements and a more exclusive reliance on global initiatives.

There are, however, more sanguine views of the process. Regional arrangements have also been presented as a complement and supplement to liberalization under the multilateral trading system. Indeed, this is the traditional view enshrined in Article 24 of the GATT, which permits the formation of preferential trading arrangements such as free trade areas and customs unions, provided they meet certain conditions. It is also the view of many American and European trade officials. By following *both* regional and multilateral approaches, they argue, world trade liberalization can proceed more rapidly.[5] Such a multi-speed approach to freer trade can achieve greater gains for those willing to proceed faster, and at the same time put pressure on the multilateral track to perform better.

2. Traditional Theory

Both economic theory and experience provide reasons why this controversy is not easily resolved. A central result of international trade theory is that in a competitive global economy, complete free trade will maximize global welfare. However, theory provides a more ambiguous verdict of the welfare implications of a preferential trade agreement which removes the barriers between only a few trading partners.

Superficially, it appears plausible that if free trade is optimal for the world, any movement towards free trade will improve global welfare. Removing the trade barriers between a group of countries without raising barriers to other trading partners seems to be a step in the right direction. However, theory has demonstrated that such measures do not necessarily make the world better off, and do not even necessarily make those concluding such agreements better off.

The possibility that aggregate global welfare can be damaged, even though the world as a whole is moved closer to free trade, is a quite startling result with more general implications. It was thinking about the example of preferential trading agreements which led Lipsey and Lancaster to enunciate the "general theory of the second best" which states that reducing some distortions while others remain in place does not necessarily increase welfare. (Lipsey and Lancaster 1956) "If it is impossible to satisfy all the optimum conditions, (in this case, global free trade) then a change

5. According to Mickey Kantor, the United States Special Trade Representative, "...regionaltrading arrangements...can prepare developing nations for admittance to the global trading system ..[and]..they can complement global trading and lubricate negotiations". 'Global Village Gathers Speed' in *Financial Times*, October 13, 1993, page 11.

which brings about the satisfaction of some of the optimum conditions (in this case an FTA) may make things better or worse".[6]

As Jacob Viner (1950) emphasized, eliminating the internal trade barriers in a customs union will lead to more trade between the partners, and this "trade creation" should add to welfare. But a customs union could also reduce trade between the members and the rest of the world. This "trade diversion" could misallocate global resources. If outside producers are actually more efficient than those inside the agreement, global efficiency declines when the producers within the agreement expand production and the producers in the rest of the world contract production.[7]

This argument can be illustrated by an example. Assume that prior to implementing a free trade agreement with Europe, all TV sets purchased in Egypt are subject to a tariff of 10 percent. Assume that Japan produces TV sets under competitive conditions, which it sells at $100, but Europe can only produce such sets at $105. Initially, all TV sets sold in Egypt and elsewhere would be Japanese. These would be imported at a price of $100 from Japan and sold to Egyptian consumers for $110, with the additional $10 representing the tariff paid by Egyptian consumers to their government. Assume now that a free trade agreement is signed between the EU and Egypt which removes tariffs between Egypt and the EU, but retains Egypt's tariffs on other countries. Egyptian consumers will now have a choice between buying European TVs which will sell in Egypt at $105 or Japanese TVs which will sell at $110. They will buy European TVs and be better off. However, the Egyptian economy as a whole will be worse off. Prior to the agreement Egypt bought its TVs from Japan. While consumers laid out $110, $10 was just a transfer from Egyptian consumers to the Egyptian government. The economy as a whole, therefore, spent only $100 per TV. After the agreement, however, Egypt is spending $105 per TV, and TV prices in Egypt do not reflect their social opportunity costs. The impact of the agreement is to expand TV production in the EU which is relatively less efficient, and to reduce it in Japan which is relatively more efficient.[8]

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6. If trade barriers were the only market imperfection in the world, their elimination would improve aggregate welfare. However, if not all barriers are removed, or if there are other market imperfections in addition to trade barriers, we cannot be sure that removing some barriers will be welfare improving. The reason is that in a world in which market imperfections remain after the trade barrier has been removed, prices will not reflect social opportunity costs. Resources could therefore shift away rather than towards their optimal allocation.

7. Viner's original presentation of this theory was couched purely in terms of the costs of production. As Meade (1955) and Lipsey (1957) later pointed out, the removal of tariffs also brings a benefit from less distorted consumption. Thus welfare in an FTA member *could* rise, even though it is buying from a higher cost source, if the benefits from more efficient consumption exceed the loss of tariff revenues.

8. Cooper and Massell (1965) point out, in this example, that instead of forming a customs union, Mexico could achieve higher welfare (the same levels of production and consumption with more government revenue) by imposing a non-discriminatory import tariff equal to two dollars. See however Wonnacott and Wonnacott (1981).

Of course, not all of the increased trade between partners will represent the expansion from a less efficient source. Pure trade creation could also result. Assume in the example that initially Egypt could produce TV sets for $107. In this case, prior to the agreement Egypt would not have imported them from Japan, but instead would have supplied these TV sets domestically. In this case, Egypt would benefit from the agreement which would allow it to pay only $105 per TV by buying from the EU—although it would have done even better by liberalizing fully and buying the sets from Japan.[9]

An implication of this theory is that the rapid growth in the internal trade between members of a customs union does not necessarily imply the union's welfare is being enhanced. The insights from this theory lead naturally to the prescription that only those free trade agreements which are net trade-creating should be concluded.[10] This has led economists to generalize about which countries are best suited to form preferential trading arrangements, and about rules which would offset some of the negative effects of these agreements. These have included (a) regional partners—since geographic proximity generally promotes trade, trade creation could be large; (b) partners at similar stages of development—since intra-industry trade flourishes between developed countries; and (c) large PTAs—since the more varied the members, the greater the opportunities for specialization.[11] However, an important insight that emerges from theory is that there are no rules that are foolproof. Indeed, it suggests that it is dangerous to try to rely on such generalizations as if they provide reliable guides of the likely extent of net trade creation. There are no hard and fast rules and thus no substitute for a case-by-case empirical analysis.

Outsiders. Theory does suggest that trading partners who do not participate in a preferential arrangement will be hurt, even when global welfare as a whole is enhanced (Mundell, 1964). Unless the outsiders are too large (or the preferential trading area too small) for the arrangement to affect world prices, outsiders as a whole will be harmed, because their terms of trade are likely to

9. The results obtained here are sensitive to the assumptions made. Corden (1972) shows that scale economies complicates the analysis. In addition to the traditional trade creation and trade diversion there can also be trade suppression and cost redution effects. The former occurs when, as a result of access to a larger market, a producer expands and thus displaces goods which would have been imported. This is not necessarily efficient, since if it was, it would have occurred prior to the union. In addition, however, there could be cost reductions, which do raise efficiency.

10. Most theorizing about preferential trade agreements assumed that nations sought to maximize their overall welfare. Increasingly, however, more attention has been paid to the distributional effects of trade policy. Under such circumstances, Grossman and Helpman (1993) found in a median voter model, free trade areas are most likely to be supported under conditions when trade diversion outweighs trade creation. This is precisely the case when these agreements are harmful.

11. For discussion , see Krugman (1991) and Frankel, Stein and Wei (Frankel and others 1993).

deteriorate.[12] But again there could be exceptions. If the internal trade liberalization has dynamic effects which increase growth, or if there are scale economies which stimulate the demand for imports from outside the region, the income effects of liberalization could more than offset trade diversion, thereby raising outside welfare.[13]

Dynamics: Building blocks or stumbling blocks?[14] Viewed statically, in the context of border barrier removal, preferential trading arrangements are inferior to multilateral free trade. But they can also be viewed dynamically, as measures which move the world in the direction of global free trade. Indeed, over the postwar period the world has moved towards free trade, partly in a series of GATT trade rounds which have successively lowered trade barriers, and partly through preferential arrangements. One process of liberalization entails partial liberalization but full participation; the other, full liberalization but partial participation. An important question for which the answer remains uncertain, is whether the rise of preferential trading arrangements makes the achievement of full multilateral liberalization more or less likely.

The literature provides some reasons which could tilt policies towards further liberalization and others which could tilt them towards further protection.[15] As might be expected, predictions are sensitive to the manner in which the dynamics of trade liberalization are modelled, to whether the arrangements considered are customs unions or free trade areas (although there is no firm presumption that one particular type is more liberal) and to the rules of the international trading system.

There are many plausible considerations leading to opposite conclusions. Naive application of optimal tariffs, dangers of capture by protectionist interests, increased interests in protection, the diversion of political capital and dilution of political support all make multilateral liberalization less likely. On the other hand, reactions by other major players demanding accession or liberalization, the greater ease of monitoring and negotiating, the ability to adjust in stages and thus reduce protectionist interests, and the increased difficulties of capturing large arrangements—particularly customs unions—all make it more likely. The rules of the game on compensation,

12. If the intra-union terms of trade are changed, Corden gives an example in which the outsiders terms of tradecan actually improve. (Corden 1984) page 120. "If C the outsider imports 1 and 2 from the union and the relative prices of 1 and 2 change , the terms of trade measured in terms of goods 3 (C's export) might improve in terms of 1 but worsen in terms of 2. Because of intra-union terms of trade changes, C's terms of trade could thus improve".

13. See for example Baldwin (1989).

14. For a survey see Frankel (1995).

15. See Frankel (1995) for a more complete survey.

protection and accession can all be important. Again, in the end there is no substitute for seeing which of these effects dominates in practice.

In sum, theory is useful in underscoring the considerations for empirical evaluation, but it does not settle the issue. Ultimately it is the task of empirical analysis to estimate the relative importance of trade creation and trade diversion and the effects on additional liberalization.

3. Traditional Experience

The postwar experience with regionalism has been mixed. Preferential trading arrangements (PTAs) have had a checkered history. To be sure, the rapid growth and liberalization achieved by European countries between 1958 and 1973 coincided with the formation of the European Community and the European Free Trade Area (EFTA). But regional arrangements were also associated with the disastrous fragmentation of the world economy into trading blocs in the 1930s, and with the ill-fated arrangements between developing countries in the 1950s and 1960s.

In particular, the agreements between developing countries, in the Middle East and elsewhere, often failed miserably.[16] This might have been expected given their motivation. They were an extension of domestic import substitution and planning policies to the regional level and were usually proposed to achieve scale economies for protectionist policies. The theory was that participating countries would become more specialized. In practice, however, given the general philosophy of trying to produce everything at home, members tended to give each other access to their markets only in those products they imported from the rest of the world. In other words, the region as a whole became more self-sufficient, but in a most inefficient manner—by maximizing trade diversion. The bilateral protocol trade arrangements in the Middle-East, in which countries selectively determine specific products and quantities to be traded, are examples of politically-driven trade that inevitably fails to yield much benefit.

Under these circumstances, it was no surprise that preferential trading agreements among developing countries often failed. It is difficult enough—many would say impossible—to manage resource allocation in a single economy. Planning for several simultaneously is impossible and inevitably becomes tangled in international politics. This was particularly the case when countries had similar patterns of specialization so that there were few opportunities for avoiding competition. However, even where there was scope for such specialization, once the extra-regional trade was

16. See for example Hazlewood (1979).

diverted, the impact of the agreements was exhausted. If one partner ran surpluses, acrimony inevitably resulted. (The East African experience is a good example.)[17]

4. The New Regionalism

Neither traditional trade theory nor this previous experience provides an adequate guide to current regional arrangements. The forces driving the current developments differ radically from those driving previous waves of regionalization in this century. Unlike the episode of the 1930s, most of the current initiatives represent efforts to facilitate their members participation in the world economy rather than their withdrawal from it. Unlike those in the 1950s and 1960s, the initiatives involving developing countries are part of a strategy to liberalize and open their economies in general, and to implement export- and foreign-investment-led policies, rather than to promote import-substitution. The current moves towards regionalization are, by and large, not responses to thwart the allocative process of the market but to strengthen its operation. They represent efforts to fill the functional needs of international trade and investment and the requirements of international governance and cooperation to which globalization gives rise. In particular, countries hope that by integrating with their regional partners, they will become more attractive export locations. Thus ,for example, firms in the United States who supported the NAFTA hoped to become more competitive internationally by sourcing some of their more labor-intensive activities in Mexico. They recognize however, that such sourcing cannot take place if tariffs, regulatory differences and other legal barriers prevent the movement of components and finished products across the border. In addition, many important regional initiatives are not developing as arrangements with exclusive memberships wherein insiders limit contact with outsiders. On the contrary, they are developing as inclusive arrangements in which members either allow outsiders to join or independently join them in developing similar arrangements. In sum, as noted in Chart 1, there are crucial differences between earlier and current regional initiatives.

Some major aspects of the new regionalism are listed in Chart 1. It is striking that recent regional agreements have been strongly supported by corporate leaders. In Europe, the initiative to establish a single market was promoted by large European firms who argued that a fragmented Europe deprived them of the scale economies they needed to be competitive. Similarly, the NAFTA was boosted by US business both large (as the Business Round Table) and small (as the US Chamber of Commerce).[18]

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17. See Langhammer (1992).

18. See Fishlow and Haggard (1992).

Chart 1. Regionalism: Old and New

Old	New
Import substitution Withdraw from world economy	Export orientation Integrate into world economy
Planned and political allocation of resources	Market allocation of resources
Led by governments	Led by private firms
Mainly industrial products	All goods, services and investment
Deal with border barriers	Deeper integration
Preferential treatment for less developed	Equal rules (different adjustment periods).

Major free trade agreement supporters in Canada were the Business Council on National Issues and the Canadian Manufacturers Association (CMA)[19] and large Mexican industrial groups strongly backed NAFTA. Private foreign investors have led the informal regional integration in Asia. In addition, in the APEC, political leaders have explicitly institutionalized the role of business by creating an advisory Pacific Business Forum, established in June 1994. Both large and small firms from the 18 member countries are represented in this forum, which is charged with providing proposals for facilitating trade and investment within the region.

Clearly, many multinational corporations view these regional arrangements as promoting their interests. This reflects the role of these arrangements as responses to the functional demands of multinational firms in the current economic environment. In particular, it is noteworthy that these initiatives are concerned with services and foreign direct investment as well as goods trade, and focus on internal rules and regulations and institutional mechanisms to ensure implementation and enforcement as well as removing border barriers.

As global competition has intensified, market access has become increasingly important for success. Access for products is crucial because the international diffusion of innovations has become increasingly rapid. The diminished time before competitors respond to new innovations makes large global markets essential for spreading the fixed costs of innovation. But the ability to operate abroad has also become vital. Foreign investment and exports have become increasingly

19. See Doern and Tomlin (1991).

complementary activities.[20] Firms selling sophisticated products find that a significant local presence can be a prerequisite for marketing, sales and service. The ability to follow market trends, respond to customer needs, and acquire innovative smaller firms in all major markets has also become important in determining competitive success.

There has also been a dramatic rise in direct foreign investment in services industries. Indeed foreign investment in services has grown more rapidly than in goods. As manufacturing firms move abroad, other firms providing complementary inputs and services (such as banking, advertising, management consulting) often accompany them.[21] Some of the rise in services FDI can therefore be understood as complementary to the manufacturing investment. However, there are also independent reasons. Developments in information technologies have increased global integration in many services sectors that were once isolated. Moreover, in many economies in the 1980s, there was a strong trend toward financial liberalization, privatization and deregulation, which created investment opportunities in sectors such as banking, communications, utilities and transportation, where investment opportunities for foreigners were once relatively limited.[22]

Developing Countries. As they seek to attract capital and at the same time pursue programs based on export-led growth, foreign firms become increasingly attractive to developing countries. They bring knowledge about the latest technologies and ready-made access to major markets. Moreover, in many developing countries, accompanying the shift towards more open trade policies has been a reduction in the role of the state through privatization. In this context, foreign investors have become increasingly attractive as providers of capital, technology and operational skills.

The demand for foreign investment emanating from the developing countries has corresponded with an increased supply from multinational corporations. As international competition intensifies, small cost advantages may have large consequences. Particular national locations are not necessarily well suited for the complete manufacture of complex products. With improvements in communications and transportation, firms are increasingly able to produce products by sourcing from multiple locations. Raw materials might best be sourced in one country, labor-intensive processes performed in a second, and technologically sophisticated processes in a third. Multinationals from many nations are therefore expanding their foreign investments.

20. See Encarnation (1992) for a study along these lines.

21. The second half of the 1980s, in particular, were marked by a massive increase in FDI that was initially concentrated in the developed economies. According to the United Nations (UNCTC 1991;4) between 1983 and 1989 the dollar value of FDI outflows grew at an annual rate of 28.9 percent, three times as rapidly as the 9.4 percent pace of world exports and 7.8 percent rate of world GDP.

22. See O'Brien (1992).

Traditionally, foreign direct investment in developing countries occurred to gain access to raw materials. Later, in countries following protectionist import-substitution policies, it was attracted by the prospects of selling behind trade barriers in a large internal market.[23] While the motive of an attractive domestic market persists, as developing countries have lowered their trade barriers, investment has increasingly been motivated towards servicing export markets.[24] Those able to offer export platforms have become most successful in attracting FDI.[25]

Implications. The increased importance of international investment naturally shifts attention from trade to investment barriers, and focuses attention on (a) national differences in the degree of ease with which foreign firms can enter new markets through acquisition and new establishment, and (b) the effects of domestic regulations and taxes on the conditions under which such firms can operate. Similarly, firms planning to source in one country and sell in others need security about the rules and mechanisms governing trade. Such firms also prefer secure intellectual property rights and technical standards and regulations that are compatible.

For developing countries, particularly those which were previously inhospitable towards foreign investment, establishing the credibility of new policies to attract investment and securing access to markets for exports becomes important. In addition, for some developing countries, it may be easier to "import" new institutions and regulatory systems than to develop them independently. While such institutions may not have the virtue of matching domestic conditions precisely, they do offer the advantages of having been pretested, and also of international compatibility. For nations in Eastern Europe for example, adopting policies which conform to EU norms is particularly attractive. Finally, entering international negotiations can tilt an internal debate in favor of one side and against another. In many cases, domestic forces interested in liberalization will find their hand strengthened if they can present their policies as part of an international liberalization agreement.[26]

Given these developments, the reasons for the distinctive character of the emerging regional arrangements becomes clearer. They are motivated by the desire to facilitate international

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23. In the 1970s, therefore, the developing countries receiving the largest foreign investment flows were Brazil (1.3 billion annual average inflow) Mexico (0.6 billion) Malaysia (0.3) Nigeria (0.3) Singapore (0.3) and Egypt (0.3) (UNCTNC 1992;317) Of these only Singapore was an open, export oriented economy.

24. See Wells (1992).

25. Between 1980 and 1990, the list of developing economies receiving the largest annual average inflows of FDIis headed by Singapore ($2.3 billion) followed by Mexico (1.9) Brazil (1.8) China (1.7) Hong Kong (1.1) and Malaysia (1.1). Of these, only Brazil has not emphasized export-oriented investment.

26. See, for example, Hagard (1995).

investment and the operations of multinational firms, as much as to promote trade. While liberalization to permit trade requires the removal of border barriers—a relatively "shallow" form of integration, the development of regional production systems and the promotion of services investment requires deeper forms of international integration of regulatory systems and policies; for example, eliminating differences in national production and product standards which make regionally integrated production costly. Investment also requires credible and secure governance mechanisms and secure access to large foreign markets, unhindered by either customs officials or domestic actions such as anti-dumping. Since much of the investment relates to the provision of services, the regulatory regimes governing establishment and operation become the focus of attention.

These developments, to be sure, have had an impact on the multilateral trade agenda. The Uruguay Round, for example, included agreements which (a) limited trade-related investment measures; (b) place disciplines on the use of standards; (c) required enforcement of intellectual property rights; (d) liberalized trade in services; (e) clarified the rules on anti-dumping and subsidies, and (f) established a more binding mechanism for the resolution of disputes. But it is not surprising that they have also been important in regional initiatives; indeed, in several cases these agreements have gone much further than the GATT.

5. Deeper Integration.

As described in Section 2, theorizing about regionalism considers these arrangements in the context of a traditional paradigm in which trade policy is characterized by changes to barriers at the border. Regional arrangements are modelled either as customs unions (in which members have free trade internally and a common external tariff), or as free trade areas (internal barriers are eliminated while external tariffs differ). Many empirical studies of these arrangements similarly construct models which focus on the effects of lowering tariff and nontariff barriers.[27]

Traditional trade theory has largely ignored the existence of different national institutions. Trade policy is generally modelled as decisions to change border barriers while other governmental policies are usually ignored. One justification is that these differences can simply be subsumed as similar to differences in technology or climate. In fact, the paradigms of traditional theory and the GATT notion of sovereign national states fit quite neatly with each other, provided that institutions (and regulations) can be taken for granted.

27. For a discussion of these methodologies as applied to the NAFTA, see Lustig and others (1992).

In traditional analysis, therefore, the dominant goal is the maximization of global welfare by multilateral free trade. Each nation exploits its distinctive features by freely trading with the rest of the world. Against this paradigm, preferential free trade arrangements are judged to be "second best".

But while the removal of internal border barriers is certainly an important feature of these arrangements, focusing only on these barriers overlooks much of what regional arrangements are about. The traditional perspective is at best incomplete, and at worst misleading.

A more comprehensive view of these emerging arrangements acknowledges that they are also about achieving deeper integration of international competition and investment. Once tariffs are removed, there remain complex problems between nations relating to different regulatory policies. The traditional approach is that these should be determined and administered at the national level, with foreign goods and firms accorded nondiscriminatory national treatment—an I approach I have termed "shallow integration". Increasingly, however, globalization has created pressures for deeper integration, to reconcile divergent national practices with common rules and policies and supranational implementation mechanisms.

In a national context, the literature on fiscal federalism bears extensive theory dealing with the question of how to assign authority over different aspects of fiscal policy to different levels of government. The optimal degree of integration to maximize public welfare will reflect two factors. The first is the technology of producing public services. The benefits and costs of different public goods and externalities will be realized on a variety of spacial scales. Purely private goods should be provided through decentralized markets. Other goods generate local externalities and should be provided by local governments. In still other cases, the externalities will span larger areas. Some goods are public, in the sense that consumption is nonrival. For example, an additional individual can obtain knowledge without detracting from the knowledge of others. Such goods may be provided locally, nationally or internationally, depending on the span of publicness. The mobility of factors and consumers dramatically complicates the ability of local authorities to internalize the costs and benefits of providing public goods.

The second factor is diversity of consumer choice. If tastes vary widely, it is efficient to accommodate such variations in taste even when some advantages in production efficiency might be gained from a broad governmental authority.

No single answer seems to result from a general consideration of the factors that will affect this choice.[28] There will inevitably be tensions between realizing scale economies and internalization

28. For additional discussion, see Begg (1993).

by increasing the scope of governance, and realizing more precise matching of tastes and choices by reducing that scope. What does seem clear, however, is that the answer will not always be the nation state or the world. It is bound to differ, depending on the nature of the activity to be regulated.[29] In some cases, e.g., global warming or global financial networks, the appropriate level may be the world; in other cases, it could be the local community. The answers to this question are ambiguous and not independent of technology, history, incomes and tastes. Indeed, there is no reason, *a priori*, to assume that the provision of regulatory regimes and other public goods should be the sole responsibility of the nation state. Some goods and rules are better provided locally, while for others bilateral and plurilateral international arrangements may be more appropriate. What is critical for appraising the current regional initiatives, however, is the recognition that some emerging international regional arrangements reflect efforts to come up with solutions to this issue. This insight has both normative and positive implications. While multilateral free trade may result in an efficient allocation of international resources, a single global government is almost certainly not the ideal solution to providing all public goods. Accordingly, in principle, regional arrangements dealing with international governance need not be second best—they could be the first best. Some activities may be best carried out on a global level, others on a plurilateral level, while some may best be left to the sub-national level. For removing border barriers, regional arrangements may be second best, but for establishing governance, they may be first best.

In addition, focussing only on border barriers could miss much of the effects of a deeper regional arrangement. The EU might do nothing to change its external tariffs, but the adoption of a single European product standard, for example, could affect both intra and extra European trade flows. Given its reliance on the traditional theoretical approach, it is not surprising that economic modeling of regional arrangements has often been incomplete. Such modeling is useful in capturing the effect of incremental change on a given economic system. It is far less able to capture the effects of changes in a legal or institutional order. But these changes can be extremely significant in affecting resource allocation. Insecurity about access to foreign markets or the rights of foreign investors, for example, may act as a severe tax on the incentive to invest.

Indeed, the concerns of regional arrangements have shifted away from incremental changes, toward changes in the rules of the game: defining property rights and permissible behavior by governments and firms. But too little effort has been placed in modeling their effects. Also often neglected is the contribution that more effective enforcement mechanisms will make in ensuring adherence to the rules.

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29. See Whitman (1972) and Cooper (1974) for discussions.

First or Second Best? What is critical for appraising the current regional initiatives is the recognition that some emerging international regional arrangements reflect efforts to come up with solutions to this issue. While multilateral free trade is an optimal solution, given the institutionless setting of traditional analysis, a single global solution to deeper integration is surely not. Accordingly, in principle, regional (or plurilateral) deeper arrangements need not be second best, as some activities may be best carried out on a plurilateral or sub-national level.

Recognizing the deeper nature of these agreements provides important challenges for modeling their effects—indeed, these are not challenges which have been adequately met.[30] For example, uncertainty about property rights and market access could have a powerful impact on resource allocation and investment. A regional agreement which guaranteed domestic firms better access to large neighboring markets and foreign investors more secure control could boost investment and give rise to important dynamic gains. A key Mexican motive for the NAFTA was to ensure that policies would be credible and permanent. But modeling such a process is not easy, and it is generally easier to estimate the impact of changes in tariffs and other prices than changes in rules.

Recognizing the deeper nature of these agreements also provides challenges for appraising their effects on welfare. The nature of policy changes under these arrangements suggests that the normal presumptions about trade creation and diversion may not hold. It is generally presumed, for example, that preferential trading arrangements will reduce exports from outside the region. However, deeper internal agreements could actually stimulate such trade. For example, if members agree on tougher pollution controls or labor standards, their imports of products from nations with more lenient standards could rise. Similarly, the adoption of a common standard in the regional arrangement may make it less costly, not only for domestic producers, but also for producers outside the region to sell their products. Likewise, the adoption of constraints on national state aids would provide benefits for both internal and external producers who compete with firms that might once have received such subsidies, and tougher anti-trust enforcement could provide improved market access for both internal and external producers.

In empirical studies, a reduction in external trade is generally an indication of trade diversion—i.e., that a member of an agreement is buying products from a less efficient internal source. However, deeper agreements could actually make regional firms more efficient. This might lead to a reduction of external trade, but it would not represent trade diversion that reduced welfare. For example, changes in domestic regulations could give internal firms cost advantages over outsiders, resulting both in fewer imports from outside the region and in lower internal costs. This has

30. For additional discussion, see Lustig and others (1992).

important implications for proposals that outsiders should be compensated for their loss of trading opportunities when preferential trading arrangements are formed.

It is also possible however, that even without raising border barriers, or increasing internal trade, deeper regional agreements could become more closed to outsiders. One example would be the adoption of a common standard which discriminated against external imports and raised internal costs. Another might be the adoption of common cartel-like industrial policies in the region as a whole, to limit external producer access.

As these examples indicate, from an efficiency standpoint, deeper international agreements could be better or worse than the domestic policies they replace or discipline. *Deeper does not necessarily mean better or more efficient.* First, the choice of the level of government is a matter of judgment and balancing the costs and benefits of more centralized government. Mistakes could be made, and policies implemented by international agreement could violate the principle of subsidiarity. Second, much depends on the specific policies that are adopted. It could be much worse to harmonize on the wrong policy than to retain national policies which are not linked.

The European example is illustrative of the argument that deep integration, i.e., the achievement of harmonized regional policies, could lead either to more or less protection depending on the specific nature of the policies. In particular, the EC's choice of trying to thwart market pressures in sectors such as agriculture, steel and coal led to a Europe that was more protectionist to the outside world. In addition, the efforts by the Community to wrest control of external VRA policies away from individual countries has probably also led to more protection for the Community as a whole. Similarly, the availability of anti-dumping rules has permitted producers one-stop shopping for protection that might have been more difficult to achieve in markets that were more fragmented. There is thus ample evidence of contamination. On the other hand, market-conforming measures have had the opposite effect, leading to increased trade opportunities both internally and externally. European disciplines on state aids and other measures which favor domestic producers provide benefits for all who compete within Europe. Similarly, the achievement of common standards reduces costs for all who wish to sell in the market.

In sum, while traditional trade theory provides us with interesting insights into both the benefits and costs of regional arrangements and their dynamics, the deeper aspects of these agreements suggest they need to be viewed through more than the narrow prism of conventional trade theory.

6. Implications

The traditional view of regional arrangements focuses on the impact of tariff and nontariff liberalization. This view leads to an ambivalent verdict on such arrangements, since they both divert and create trade. This perspective also provides an ambiguous verdict on whether the proliferation of these arrangements undermines or increases the chances of achieving multilateral liberalization. There are numerous arguments in both directions.

An alternative view of the emerging preferential agreements acknowledges that some of these are both broader and deeper than the coverage of the WTO. On the one hand, they may provide more extensive liberalization of investment and services; on the other, they may also involve efforts to adopt rules and governance in areas of domestic policy that affect trade and investment. Once tariffs are removed, there remain complex problems relating to different levels of subsidies and other industrial and regulatory policies. The traditional approach is to assume these should be determined at the national level. Increasingly, however, globalization has created pressures to reconcile divergent national practices through international agreement and governance. Indeed, there is no reason, a priori, to assume that all public goods should be delivered at the level of the nation-state. In some cases, the best outcome may be for such goods to be provided by groups of countries, either permanently, or until a broader multilateral arrangement can be concluded. In principle, some regional arrangements may well be first best.

The emerging regional arrangements are moving to deal with measures that have not been dealt with by the GATT. Some opponents of these regional arrangements actually see the "deeper" integrative aspects of these arrangements as pernicious and undesirable. They view these as mechanisms for foisting inappropriate rules and restraints on weaker, smaller, and in particular, developing countries.

Jagdish Bhagwati, a free-trade advocate and opponent of regional arrangements, views them as "a process by which a hegemonic power seeks (and often manages) to satisfy its multiple trade-unrelated demands on other, weaker trading nations more easily than through multilateralism". Free trade arrangements seriously damage the multilateral trade liberalization process by facilitating its capture by extraneous demands that aim, not to reduce trade barriers, but to increase them (as when market access is sought to be denied on grounds such as "eco-dumping" and "social-dumping").[31]

It is indeed likely that in negotiations between countries with differing market sizes, an asymmetrical power relationship will exist. However, this does not mean that poor small countries will lose in these associations. Indeed, the power asymmetries reflect the fact that the gains, particularly those from realizing scale economies, are likely to be relatively larger for the smaller

31. See for example Bhagwati and Krueger (1995), and Perroni and Whalley (1994).

country. Similarly, economic integration generally leads to convergence, with poorer economies growing more rapidly than richer economies. Moreover, small countries join these agreements voluntarily.

Indeed, if the NAFTA or US-Canada Agreement had been seen as US initiatives, they would have been doomed politically from the start. In both cases, the governments and firms of these countries saw these agreements as in their own interests, and not simply because they feared American protectionism. The same is true of the Eastern European nations that are voluntarily seeking to join the EU, and those in Latin America seeking a hemispheric arrangement with the United States. Finally, particularly in agreements with the European Union, aid has been made part of the package.

Moreover, while countries seeking to join these arrangements may have to make "concessions" by adopting some rules and institutions that may not suit their needs perfectly, they also enjoy benefits from adopting institutions without having to go through the costs of developing them. Just as several European countries have sought to import the credibility in fighting inflation enjoyed by the Bundesbank by pegging their exchange rate to the German Mark, so countries can make their regulatory policies more credible through international cooperation.

I have noted the strong role played by corporations in promoting regional integration. Recognizing this role provides insight into both the promise of and the problems with the current regional initiatives. The promise is represented by moves toward deeper economic integration than is currently feasible under the GATT. Regional agreements can make progress in harmonizing domestic policies and providing more credible and more effective supra-national governance mechanisms than the WTO. On the other hand, there is the concern of regulatory capture: that under the influence of companies, new systems of rules will be set to help insiders and hurt outsiders. Skeptics, such as Anne Kreuger, Bernard Hoekman and Raymond Vernon, are particularly concerned that while masquerading as free trade agreements, the new arrangements have been severely compromised by intricate rules of origin and other loopholes that may actually represent a retreat from freer trade, rather than a movement towards it.[32]

In addition to the traditional problem of trade diversion, therefore there are two other major risks with regional agreements. The first is that they could implement new forms of protection, not by erecting new tariffs but by implementing rules of origin and administering anti-dumping and countervailing duties which have protectionist effects. The second is that some countries may join regional arrangements even where the rules they provide are inappropriate.

32. See Hoekman (1992), Kreuger (1993), Vernon (1994).

7. The MENA Agreements

It is instructive, in the light of this discussion, to briefly consider the agreement between Tunisia and the EU, since the agreement with Egypt is likely to be similar. The traditional view looks at what the agreement does to border barriers.[33] Tunisia already has duty-free access for most of its exports of manufactured goods to the EU.[34] The agreement requires liberalization of Tunisian manufactured imports from the EU over a twelve year period. It also requires the adoption of basic competition policy rules insofar as these affect trade with the EU. In return, the EU will provide increased financial and technical assistance. However, the agreement provides little in improved access for agricultural products, requires no liberalization of government procurement, does not ensure free movement of capital, makes no commitments to liberalize services and retains the anti-dumping rules.

In terms of the traditional analysis of free trade agreements described above, therefore, the agreement will both create and divert trade. Tunisian consumers will benefit from duty-free access to European products. But there will also be trade diversion. On the one hand, the large market share of EU goods in Tunisian imports suggests trade diversion will be small. On the other hand, the high protection that will remain on other countries suggests it could be large. A particularly troubling feature is the positioning of the EU as a hub, with the Med countries as spokes. This implies that diversion could come at the expense of regional trade—thereby undermining the goal of increased regional integration. This would particularly inhibit growth in exports of industrial products to the region, particularly from Israel and Turkey, but also from other Middle Eastern manufacturers. All told therefore, a key issue is how the loss due to trade diversion compares with the gains from trade creation and additional financial and technical assistance. Simulations undertaken by Rutherford, Rutstrom and Tarr at the World Bank suggest the net effect would be positive—and even without taking account of the financial aid—the agreement would raise welfare by 1.7 percent. Estimates by Brown et. al, (1996), however, suggest welfare could actually be damaged. Clearly this is an issue needing serious investigation.

There are however, more dynamic implications of trade diversion which could actually be more positive. In particular, precisely because external barriers are high in MENA countries, non-European nations such as the United States are bound to object to the preferential treatment to be conferred on their European competitors. In response, they may find it necessary to offer MENA

33. See Hoekman for a more extensive analysis reaching similar conclusions.

34. A notable exception being quotas on textiles which will be liberalized, but only as called for by the Uruguay Round agreement on the Multifiber Arrangement.

countries improved access to their markets in order to be given similar access. This force could therefore impel additional liberalization.

What about measures for deeper integration? These are important, because if the Euro-Med agreements are to succeed they must help change the general environment for entrepreneurship. They should help make the Med countries more attractive locations for both foreign and domestic producers to serve the European market, and make the economies more globally competitive by enhancing domestic competition and encouraging them to open to the rest of the world. At the margin, however, the contribution made by the agreement signed by Tunisia in these respects does not appear to be large, particularly for manufactured goods exporters.[35] Producers of manufactured goods already have duty-free access to the EU. The technical assistance in bringing up Tunisian standards to the point where mutual recognition by Europe will be possible would bring benefits—but only in the long run. The adoption of competition policy rules will bring relief from countervailing duty actions, but exporters will still have to be concerned about anti-dumping actions. Foreign investors, in particular, will be struck by the lack of commitments to liberalize services and to grant rights of establishment. Likewise, those investing in services will find it gives them no additional security. Producers of agricultural goods are also given very little. All told, therefore, the agreement is unlikely to provide a boon to new investment in export industries. On the other hand, the impacts on import-competing sectors will be larger because the liberalization commitments will be more credible, since they are backed by conditional financial aid. In addition, it can be hoped that once the trade regime changes for goods from the EU, once producers understand their government is restricted in providing them with protection, it will curtail their rent-seeking activities.

Nonetheless, the political economy of the agreement remains troublesome. Liberalizing with respect to a few trading partners can be beneficial if it strengthens the sectors which are globally competitive and reduces the size of those which are not. But there is a distinct danger that while these agreements will succeed in reducing the size of the import-competing sector, they will do too little to stimulate exports and foreign investment. While the agreement will make some contribution towards upgrading standards and policies, its impact is unlikely to have the dramatic impact on foreign investment that was achieved, for example, by the much deeper agreement on NAFTA.

In the long run, of course, the MENA countries will have to adjust to their increased imports by exporting more or by receiving more aid. Even if they do not benefit by the impact of the

35. To be sure, there may be fears today about whether these benefits could be repealed, which the agreement allays.

agreements, exporters could eventually benefit as the adjustment process operates. Ironically, however, the more generous the aid, the smaller and slower these benefits may be. Nonetheless, it would serve Egypt well to try to surpass what Tunisia achieved in its negotiations. In particular, Egypt could seek additional concessions from Europe in two areas: first, additional entry in textiles and agriculture, and second, exemption from European anti-dumping rules, in return for adopting its competition policy rules. In addition, it should also try to surpass the commitments made by Tunisia with respect to liberalizing services and foreign investment. These measures would help take advantage of the greater benefits which the new regional agreements can afford.

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