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FREE TRADE AGREEMENTS
VERSUS CUSTOMS UNIONS

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ABSTRACT

Until NAFTA, analyses of preferential trading arrangements began by assuming a customs union with a common external tariff, and the differences between customs unions and free trade agreements (FTAs) have been little analyzed. This paper points to some of the differences between FTAs and customs unions, and shows that on welfare grounds a customs union is always Pareto-superior to an FTA. Moreover, the political economy of FTAs will lead to more opposition to further multilateral trade liberalization than will customs unions.

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FREE TRADE AGREEMENTS VERSUS CUSTOMS UNIONS

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Historically, preferential trading arrangements were widespread: most favored nation (MFN) practices did not become predominant until the 20th century.² After World War II, a dispute between the United States, which favored universal MFN practices, and Britain, where the preservation of Commonwealth preferences was important, led to the adoption of Article XXIV of the GATT Agreement. Under Article XXIV, countries may enter into preferential trading arrangements provided that: 1) the preference is 100 percent 2) preferences cover substantially all aspects of trade, and 3) the average tariff barrier against third countries is no higher after customs union than before.³

In the postwar years, the most visible and significant preferential trading arrangement was clearly the highly successful European Union, which under the Treaty of Rome started as a common

¹I am indebted to Donald Davis, Roderick Duncan and Ronald Wonnacott, and participants in the Harvard International Economics Seminar for helpful comments on an earlier version of this paper.

²See Taussig (1931).

³Interestingly, the United States initially opposed preferential arrangements when negotiating a postwar trade organization, but was quite willing to have the GATT articles permit customs union. When the issue of free trade agreements was raised, the United States accepted them as well, reportedly without any significant deliberation, on the grounds that Free Trade Agreements would be a first step towards customs union.

market with a common external tariff among members and free mobility of factors of production, and has since become increasingly integrated with the objective of becoming a "single market". The European Union, of course, evolved in the context of significant multilateral liberalization of trade barriers, so that external tariffs were greatly reduced even as tariffs and other trade barriers were dismantled among the members. Other efforts to form preferential trade arrangements and emulate the Europeans were mostly among developing countries, were usually free trade agreements, and generally failed.

Given the United States' commitment to MFN principles and the apparent reality that Europe was integrating, the trading system was increasingly multilateral. In the postwar years, therefore, analysis of preferential trading arrangements centered largely on customs unions.⁴

Most analyses of customs unions focussed on the effects on member countries and on the rest of the world. Analyses started with the recognition that formation of a customs union was second-best, because economic welfare could generally be improved unilaterally by moving from a tariff-ridden situation to free trade, terms of trade issues aside.

Since the early 1980s, free trade agreements - and especially the NAFTA - have emerged. According to official pronouncements, NAFTA is to be enlarged to become the Western Hemisphere FTA. The

⁴That there were also a number of moves to integrate the European economies further came as no surprise in light of the Vinerian analysis of pressures that customs union would generate for harmonization of other policies.

countries participating in APEC have announced that they will have free trade by the years 2010 for developed, and 2020 for developing countries.⁵ These developments have raised a variety of concerns, centering in part on the relationships between the multilateral trading system and MFN, on the one hand, and regional free trade arrangements (especially when countries such as the United States may belong to more than one such arrangement) on the other. Many are concerned that the emergence of trading blocs might be detrimental to the open multilateral trading system, but there is little basis in existing theory for such a concern.⁶

Surprisingly, despite the increased interest that NAFTA and other arrangements have provoked, there has been little analysis of different types of preferential arrangements, and in particular, of free trade agreements in contrast to customs unions.⁷ It is the purpose of this paper to analyze some of the salient differences.

It will be argued that there are a variety of reasons for being more skeptical about the likelihood of an FTA being welfare-improving than for a customs union, and that the political economy of FTAs is less likely to be conducive to enhanced economic efficiency of the international trading system than is that of a

⁵It is not clear from official pronouncements whether the countries in APEC are to become "free trade" countries vis-a-vis the entire world, or whether a preferential arrangement is envisaged. A timetable and concrete arrangements to achieve the free trade area have not yet been announced.

⁶See, however, Krugman (1991).

⁷Exceptions include Frenkel and Wei (19xx), Levy (1993a, 1993b), and Richardson (1993).

customs union.⁸

In particular, on welfare grounds, a free trade arrangement can yield no benefits that are not attainable under a customs union, and can generate additional welfare costs that are not incurred under customs union. Therefore, all else equal, customs union arrangements are strictly Pareto superior to free trade agreements. Moreover, for the same reasons that customs unions dominate free trade agreements in terms of welfare, the political economy of free trade agreements is likely to be less conducive to multilateral trade liberalization than is a customs union.

A starting point is necessarily the basic insights from customs union theory, and the treatment of customs union and of preferential trading arrangements under GATT. Thereafter, the ways in which an FTA differs from a customs union are examined, with a view to the additional questions these differences create for analysis. Next, questions arising from the emergence of a multiplicity of overlapping FTAs are examined. A final question concerns the political economy of various forms of preferential trading arrangements. On the basis of these considerations, the final section raises questions as to the desirability of altering GATT rules in ways that would restrict choices governing preferential trading arrangements.

Types of Preferential Arrangements

It is useful to start by restating the standard definitions.

⁸ Lal (1993) points out that "historically, FTAs have been the economic policy of the uncompetitive and the foreign policy of the weak..." P. 353.

A preferential trading arrangement is any trading arrangement which permits the importation of goods from countries signatory to the preference at lower rates of duty than are imposed on imports from third countries. A preferential arrangement may be partial (such as 50 percent duty reduction) or total with respect to the amount of duty reduction and with respect to the commodity coverage of the arrangement.⁹

A free trade agreement is a preferential arrangement in which tariff rates among members are zero, although external tariffs may be at different rates for different members of the arrangement.¹⁰

Customs union is an arrangement in which there is zero duty between members on imports of goods and services, and a common external tariff.¹¹ It is, of course, this arrangement on which the

⁹There is no obvious reason in economic theory why preferences should be 100 percent or zero, as under GATT rules. Indeed, it seems evident that one could readily construct an example in which a partial preference was welfare-superior to 100 percent preferences, even in an arrangement that increased potential welfare. There may, however, be political economy reasons for insisting upon 100 percent preferences. See the discussion below.

¹⁰Free trade arrangements may cover one or more sectors or apply to all trade in goods and services. For present purposes, however, it will simplify the discussion to use the term "FTAs" to refer to arrangements in which tariffs among members are reduced to zero for all trading transactions. When it is necessary to distinguish between sectoral and economy-wide FTAs, the term "selective FTA" will be used. The U.S.-Canada Automobile Agreement and the European Coal and Steel Community are examples of selective (sectoral) FTAs.

¹¹ It is possible for there to be a customs union that applies only to certain sectors of the economy. Some proposed enlargements of the European Union take this form, where trade in manufactures and services, but not in agricultural commodities, would be subject to customs union. Although interesting administrative issues arise in this case, analysis of it does not add any insights into issues surrounding FTAs.

classic analyses of Viner, Meade and Lipsey and subsequent work has centered.

Next in increasing order of integration, there is the common market, in which not only movement of goods and services, but also of factors of production, is relatively free among member countries. In practice, of course, an FTA might provide for some arrangements permitting greater mobility of factors of production¹², as the arrangements governing foreign investment in the NAFTA have clearly demonstrated. But a common market normally refers to an arrangement whereby of countries enter into a customs union and also permit free, or at least greatly increased, mobility of factors of production among members.

Furthest up the scale of integration is the "single market", in which all producers and consumers within the arrangement are governed by the same rules, in the sense that participants in one geographic part of the market may not be prevented from operating in another part of the market.¹³

It should be noted that there is nothing in the definition of any form of preferential trading arrangement that requires that it

¹²The Canada-U.S. FTA, for example, provided for considerably greater mobility of professionals than had earlier existed.

¹³This could come about in a variety of ways. At one (liberal) extreme, the parties could agree to accept all items which satisfy regulations of partner countries, and to confer national treatment to all firms from partner countries doing business in members' markets. At the other (restrictive) end of the spectrum, members could negotiate common regulations and practices. It may be noted that if efforts to impose labor and environmental standards on members of a WHFTA succeed, that will constitute a case of common regulations and practices.

be regional in nature. Indeed, in theory and under GATT rules, any pair of countries can form a 100 percent preferential arrangement. There is nothing to suggest that the gains from preferential arrangements are more likely to be positive (and larger) among neighbors than among other groups of countries. Only if some aspect of proximity can be identified which is thought to be conducive to greater trade creation or diversion is there any presumption in theory that countries geographically proximate may in any sense differ in their prospects under preferential arrangements from those further apart. Earlier preferential trading arrangements (Commonwealth preferences, for example) did not focus heavily on neighboring countries.¹⁴

Customs Union Theory and Preferential Trading Arrangements.

The classic works by Viner (1950) and Meade (1953) became standard, with focus on trade creation and trade diversion. To be sure, exceptions and qualifications were noted,¹⁵ but this distinction remained central to analysis. Kemp and Wan (1976) added an important result, noting that if formation of a customs union nonetheless resulted in trade with the rest of the world at at

¹⁴Indeed, the first FTA formed by the United States in the 1980s - with Israel - did not feature geographic proximity.

¹⁵See Corden (1984), pp. 112-24 and Hine (1994) for surveys. The important qualification pertains to the consumption gains that arise for consumers even when there is trade diversion. If losses from trade diversion were sufficiently small, the consumer welfare gain (from lower prices after removal of tariffs) could conceivably outweigh the higher real cost of imports.

least the prior level, welfare of all parties could increase.¹⁶

In all analyses, trade creation is welfare-increasing, while trade diversion is welfare reducing subject to some qualifications. Trade creation takes place when a member country's domestic production of an item falls and is displaced by lower-cost production from a partner country because, by construction, the importation of the good is cheaper than producing at home.¹⁷ Trade diversion takes place when a member country replaces (tariff-ridden) imports from the rest of the world (which must have been the low-cost source in the absence of preferences) with imports from the higher-cost partner country.

In this paper, the trade creation - trade diversion framework will be used in assessing the differences between customs union and free trade agreements. Prior to doing that, however, a prior issue must be addressed: the impact of customs union and free trade agreements on trade relations with the rest of the world.

It has long since been recognized that the welfare effect of a customs union depends in significant part on the way in which the formation of the union affects trade barriers vis-a-vis the rest of the world. Indeed, in order to isolate the effects of customs union formation per se from the effects of changes in external trade barriers, analysts of customs union have traditionally started by

¹⁶As always, the proof is contingent upon appropriate lump-sum transfers, but gainers could always compensate losers.

¹⁷This analysis assumes the absence of any transport costs. Once the existence of transport costs is taken into account, the analysis is somewhat more nuanced.

assuming that the formation of customs union was accompanied by the maintenance of a common average external tariff with respect to the rest of the world.¹⁸ The question then posed was whether trade creation among members exceeded trade diversion, with attendant welfare gains; and whether consumption gains for consumers (due to lower prices) under trade diversion might not offset part or all of the production losses associated with it.

Subsidiary questions included the impact of the customs union on each member individually and on the rest of the world. It may be noted that a customs union (or other preferential arrangement) might result in the attainment of a Pareto-superior situation for one trading partner (due to the predominance of trade creation) and of a Pareto-inferior situation for the other trading partner, with either a Pareto-superior or inferior situation for the union (or FTA) members as a group.

It will be argued below that the question of the impact of preferences on the level or levels of external protection of members vis-a-vis the outside world is critical to the analysis of NAFTA and other preferential trading arrangements. Moreover, it is not necessarily true that the average level of protection as it

¹⁸ There is a real-world counterpart to this basic proposition, which may be important in explaining why most observers have accepted NAFTA and other FTA proposals rather uncritically as being conducive to freer trade. That is, the European Community was formed and has evolved within the context of extensive multilateral trade liberalization. Indeed, while countries in the European Communities were removing their tariff barriers vis-a-vis each other, they were also engaged in significant liberalization of their external trade barriers.

affects those making resource allocation decisions remains unaltered after entry into an FTA.¹⁹

It has been difficult to draw theoretical generalizations about the sorts of customs unions that may result in the largest positive welfare effects. But it is generally accepted that the larger the share of trade preexisting among union partners, the more likely there is to be net trade creation and the less trade diversion will normally result. Likewise, when preexisting tariffs are very high (so that there is little trade to divert) or very low (so that the costs of trade diversion are low), welfare is more likely to improve with the formation of customs union.

The basic insights from customs union theory can be augmented in a large number of ways.²⁰ If there are economies of scale, a larger market may lower costs (even of new import-substitution industries if governments will anyway protect new industries). Increased competition may stimulate searches for static or dynamic productivity gains. And, of course, if a customs union were formed among countries which collectively would produce goods and services at factor prices that would prevail at a full global free trade equilibrium, the welfare effects of customs union would be those of free trade. It is generally accepted that developing countries' comparative advantage and opportunities for gains from trade lie predominantly in the wide divergence between their factor

¹⁹This is shown below. The argument was presented in Krueger (forthcoming).

²⁰See de la Torre and Kelly (1992) for a recent survey.

endowments (skewed toward great abundance of unskilled labor relative to human and physical capital) and those of their developed countries. As such, it is arguable that customs unions between developing countries are less likely to provide welfare gains than those between developed and developing.

It should be noted that additional foreign investment may be attracted under customs union (and under FTAs). Analysis of the welfare effects of these investments follows similar lines to analysis of changes in trade flows: if the investment comes about because of a higher real rate of return arising out of trade creation (or other enhanced economic efficiencies arising out of the arrangement), it will improve welfare. If, however, investment is "diverted" from other destinations that have a higher global rate of return, welfare will decrease.

Differences between FTAs and Customs Unions

It was already noted that analysis of customs union has proceeded by assuming that the partners adopt a common external tariff which is in some sense the average of the preexisting tariff levels of the two countries. The purpose of the assumption is, naturally, to abstract from the effects of trade liberalization or restriction and isolate the essential aspects of the preferential arrangement. For free trade areas, it had been assumed that, since each country maintains its preexisting structure of external tariffs, the assumption that the average external tariff level remains unchanged is automatically satisfied.

An FTA maintains each country's individual external trade

barriers but removes barriers on trade between the member countries. This has three related consequences: first, the existence of different tariff rates on the part of different member countries implies that measures must be taken to prevent "trade deflection" -the term used to describe the situation in which each good or service enters through the member country with the lowest tariff rate and is transshipped.²¹ This results in a need for "rules of origin" to establish that goods shipped between partners in fact originate in a partner country. Second, although in a definitional sense it can be said that an FTA "automatically" preserves the pre-FTA tariff level unless deliberate changes are made in tariffs and other trade barriers, rules of origin can in effect "export protection" from one country to another. However, in terms of incentives facing producers, an FTA may "export" protection from one country to the other through the incentives created by rules of origin. Third, the fact that protection rates are different implies that producers in partner countries cannot be facing common prices of tradables (quite aside from transport costs) or of nontradables that use significant quantities of

²¹To be sure, tariff differentials might be smaller than transport costs and, if so, trade deflection might not occur. Most FTAs, however, contain undertakings whose purpose is to avoid trade deflection, thus suggesting that tariff differentials are regarded by policy makers as sufficient to make trade deflection profitable in the absence of barriers to it.

It should be noted that "trade creation" that largely replaces tariff revenue with transport costs in an FTA is likely to be welfare reducing, and measures taken that prevent such trade from increasing could increase the net gains (or reduce net losses) from an FTA.

tradables as inputs.²²

How important each of these is depends, naturally, on the structure of protection existing in members of the FTA, and the economic responses to them. Each is likely to have consequences for economic behavior and hence the impact of an FTA.

The fact that policy-makers seek to avoid trade deflection itself has consequences: unlike a customs union, border measures must be taken. In consequence, there can be no prospect of an FTA evolving into a "single market" until tariff-rate unification is undertaken at a later date. Moreover, whereas one can, at least in principle, imagine a group of contiguous countries forming a customs union and removing border-crossing procedures among themselves for their interior borders, it is not possible to imagine such freedom in an FTA, and whatever costs there are of documenting products and verifying them prior to border crossings must be a continuing part of FTA arrangements.

Second, as already mentioned, the rules of origin adopted to avoid trade deflection can provide incentives for producers in one partner country to purchase higher cost inputs from another country (despite the existence of lower-priced inputs from the rest of the world given their tariff structure) in order to satisfy rules of origin requirements and thus export the end product to the partner country duty-free. Thus, a Mexican producer may find it profitable

²²This statement must be qualified insofar as transport costs would in any event lead to different prices in partner countries. The essential point is that when the same good is imported in partners at different prices, there is bound to be an uneconomic use of the good in question.

to import a part from a higher-cost U.S. source rather than from his former Japanese supplier in order to export to the U.S. without paying duty. This could happen whenever the tariff protection in the U.S. gave net effective protection to the Mexican producer provided that he met the ROO.²³ It could also happen that a foreign producer found it profitable to invest in Mexico in order to satisfy ROOs, even though a Mexican facility was higher-cost than landed costs from a third-country market. This is the sense in which external protection can increase as a result of a free trade arrangement.

Third, the fact that ROOs must be established under an FTA provides domestic producers with an opportunity to lobby for protection in a relatively straightforward, and hardly transparent, way.²⁴ Whereas negotiations for customs union must somehow reconcile the divergent interests of producers in the higher-tariff and lower-tariff countries, there may be no such constraints on bargaining in the context of an FTA: U.S. producers can insist on sufficiently high ROOs to assure that they will not be subjected to greater competition (given their knowledge of Mexican costs) while

²³See Krueger (1992) and Krishna and Krueger (1993) for an elaboration of this analysis.

²⁴It is by now well known that ROOs are set forth in about 200 pages of the NAFTA agreement. These cover such items as automobiles (where the content rules for assembly were contentious and one of the final items settled in the NAFTA agreement) and textiles and apparel (where the "triple transformation test" assures that the yarn, cloth, and garment must all be manufactured within the FTA in order to confer origin). ROOs can be highly restrictive, as evidenced by the case cited by Palmeter, where tomato sauce is deemed to have origin within NAFTA unless it contains any tomato paste!

Mexican producers are "compensated" by their ability to receive a higher (net of tariff) price in the U.S. market. I return to this point when considering the political economy of FTAs and customs unions below.

Obtaining the necessary documents to prove origin itself entails costs, which have been variously estimated in the context of EFTA at 3-5 percent of f.o.b. price.²⁵ It is reported that Canadian producers have on occasion chosen to pay the relevant duties rather than incur the costs of proving origin. To be sure, the higher the nominal tariff protecting imports of the item in question in the importing country, the greater will be the willingness of producers to provide the necessary documentation.

This result yields the critical proposition from the viewpoint of the welfare economics in comparisons of FTAs and customs unions: an FTA cannot lead to any more trade creation than can a customs union and, when ROOs export any protection, an FTA leads to more trade diversion than does a customs union.

The proof is straightforward. All that needs to be assumed is that the customs union adopts a common tariff for each commodity at a level somewhere between that prevailing pre-union in the higher-tariff country and the lower-tariff country, that the common external tariff be such that effective rates of protection are not increased under customs union²⁶, there is no "water" in either

²⁵See Herin (1986).

²⁶ I am indebted to Donald Davis for pointing out that countries might have tariff structures such that averaging of tariff rates resulted in higher effective protection levels under

country's tariff schedule, and that cost curves are either constant or upward sloping.

Note first the fact that ROOs can generate trade diversion and not trade creation has already been established. All that remains is the second part: that an FTA cannot be more welfare-increasing or less welfare-reducing than a customs union. A starting point is to note that tariffs between partners in either case are zero and, hence, that whenever production takes place within an either FTA or CU, it will be in the country where costs are lower.

Whenever there is trade creation under customs union, it seems evident that it will also occur under an FTA, and there is no mechanism by which there might be more under an FTA.²⁷ The question is, then, whether in any way a customs union might entail more trade diversion through the realignment of tariffs. At first sight, it would appear that this might happen in the case in which the higher tariff country produced prior to customs union, and that the lower-tariff country imported prior to union. However, if a common external tariff is set below the level in the high cost country,

customs union than under an FTA, and that this could result in greater trade diversion under a customs union than under an FTA. Although it seems improbable that third countries would countenance the formation of such a union under WTO, and the likelihood that the producing country would have the higher tariff on the intermediate good pre-union seems small, it does seem possible that the union of two countries with very different tariff structures might increase effective protection for some commodities.

²⁷This follows because the existence of a higher tariff in one partner than the other is irrelevant when producers can relocate to the lower cost country. Therefore, whether there is a common external tariff or not does not affect trade creation once there are zero tariffs between partners.

its production level must be reduced under customs union,²⁸ which is trade-creating whereas since production would be sustained under an FTA, there would be less trade creation. In all other instances, it is evident that a customs union cannot generate more trade diversion than an FTA. Combining the proposition that ROOs can result in trade diversion under an FTA that will not occur under customs union, while a customs union can never result in more trade diversion than an FTA because of tariff changes, it follows automatically that there can be more trade diversion under an FTA than there can be under a customs union.²⁹

Thus, since there can be no more trade creation and there can be more trade diversion under an FTA than under a customs union, it follows that the potential welfare effects of an FTA must be inferior to those of a trade-creating customs union.

Complications from Multiple FTAs

As if the greater complexity of ROOs were not enough, an FTA

²⁸This follows because either the supply curve was perfectly elastic at the former tariff level, or it was upward sloping. If perfectly elastic, production must go to zero under a common external tariff; if upward sloping, the common tariff must lower the price in the producing country, and hence the level of output will be reduced.

²⁹It is tempting to try to broaden the statement. Insofar as protection in each member country is conferred to intermediate inputs, different tariff structures between the countries must imply that the marginal rates of transformation between traded inputs and other factors of production differ between the partners. That cannot happen under a common external tariff. The difficulty with attempting to conclude that this divergence might constitute another source of welfare loss arises immediately from the second-best aspect of the analysis: alignment of all external tariff rates might result in more trade diversion than would the maintenance of separate external tariffs.

entails complications that are absent under customs union when consideration is given to adding a new member or members. When, as in Europe, there is already a sizeable economic body of members with no tariffs between themselves, accession of any additional member will take place by that member's acceptance of the common external tariff. There is no room for a new member to bargain vis-a-vis the common external tariff.³⁰ With an FTA, by contrast, bargaining must take place for each new entrant as the differing tariff structure of the applicant provides a basis on which ROOs will be reconsidered. Since each new entrant may have a different set of industries with potential comparative advantage, opportunities for lobbying for ROOs which increase trade diversion are likely to be greater than under customs union.

A first point follows immediately: the bureaucratic paperwork required to establish and enforce separate ROOs for each "spoke" of overlapping FTAs can be expected itself to be costly.

Some observers, noting the increasing resort to the use of voluntary export restraints on the part of the United States, have pointed out that FTAs may result in "trade diversion" through administered protection. That is, if Mexican exports of a particular item should increase rapidly in competition with products from, say, Taiwan, the American response after FTA might well be to use the administered protection remedies of anti-dumping or countervailing duty relief against non-partner countries, in

³⁰Bargaining may take place over the duration of a "transition" period during which tariffs are adjusted to the common external tariff.

this case Taiwan.

It has been widely noted that the entry of new members into an FTA can reasonably be expected to "dilute" the value of concessions obtained by existing members. As such, there is a presumption that the terms on which each new entrant may gain admission will be less and less favorable.³¹ For that reason, there is some basis on which to anticipate that those already in an FTA might be reluctant to witness the admission of further new entrants. This seems already to have been a concern with respect to the Caribbean Basin countries (who feared that Mexican entry into NAFTA and the formation of WHFTA would erode the value of their preferences) and perhaps other Latin American countries.³²

In the case of the CBI, resistance to NAFTA came, as might be expected, from those who had already invested in the Caribbean countries in order to take advantages of preferences. The "investment diversion" involved in yet another preferential arrangement was opposed by those having taken advantage of the earlier agreement. If and when other countries negotiate to join the WHFTA, it will be of interest to observe both the extent of opposition from foreign investors in existing NAFTA countries and any patterns of relocation that may emerge as preferences are extended to additional countries.

³¹See, for example, the discussion by Snape (1989) p. 194, of the difficulties that might result for the Caribbean Basin Initiative countries and Canada were Australia to negotiate an FTA with the United States involving sugar and beef.

³²Fidler (1994), and Chapter 7 of Krueger (1993).

Several analysts have pointed out that multiple FTAs entered into by the United States could result in a "hub-and-spoke" system, under which the U.S. could have zero tariffs vis-a-vis each country with whom it had an FTA, while the "spokes" could have free trade only with a few of those countries. If that circumstance did eventuate, it is evident that producers in the "hub" would have a cost advantage relative to producers in the "spokes", in that they could obtain more of their desired inputs at lower prices.³³ It is also true, however, that any FTA member believing itself disadvantaged by being a "spoke" could offset that disadvantage by unilaterally lowering its own external tariffs.

Political Economy of FTAs.

It was already stated that a major difficulty confronting analysts of customs union was the problem of analyzing "second best": free trade would normally be a superior solution. One question which can legitimately be asked, therefore, is whether preferential trading arrangements are more likely to be conducive to further moves toward free trade or are likely to result in additional political opposition to free trade and thus make further trade liberalization more difficult.

However, once the possibility of a choice in form of preference between an FTA and a customs union is taken into account, there are two questions instead of one. The first concerns the reasons for formation of a preferential trading arrangement

³³ This notion was first introduced as the "star" system by Park and Yoo (1989), but has come to be termed the "hub and spoke" system.

instead of moving toward multilateral trade liberalization. It is a question which has been addressed in the literature without a really satisfactory answer, and one on which no additional insight can be provided here.

The second question is perhaps the more straightforward to answer. That is: when it is decided to enter into a preferential trading arrangement, what determines whether that arrangement will be customs union or a free trade agreement? And, if an FTA is chosen, does that increase or reduce the likelihood that momentum for further multilateral liberalization will be enhanced?

From a political economy standpoint, there are several insights which can prove helpful in addressing this question. First, entering into negotiations with trading partners can alter the domestic political balance by inducing exporters (and potential exporters) to weigh in on a side presumably closer to free trade and thus support an agreement whereas they might not support a unilateral move to free trade. This, of course, has been the classic defense of the political economy of GATT: countries are "conceding" measures which are in fact good for them, and in return "receive" "concessions" from their negotiating partners (which, in turn, are good for the trading partners). While the underlying political economy of this apparent irrationality may be open to numerous interpretations, there seems little doubt that there is a supremacy of producer over consumer interests entailed in it.

Second, it seems evident that "trade creation" will normally be viewed as being at the "expense" of domestic producers and thus

incite opposition, whereas "trade diversion" will generally not arouse domestic interests. This is because "trade creation" in the classic customs union case comes about as domestic producers lose markets to producers located elsewhere within the preferential trading area. By contrast, trade diversion is normally at the expense of producers external to the members of the preferential area and thus, there is likely to be less producer opposition to a trade arrangement than in the case of trade creation.

These basic insights offer some tentative hypotheses as to the political economy of negotiations for FTAs and customs unions, as contrasted with negotiations for multilateral tariff reduction. First, insofar as exporters tend to have global interests and their political resources are diverted toward support of a preferential arrangement, the existence of preferential arrangements must inherently weaken support for future moves closer to global free trade.³⁴

Second, once trade diversion has taken place, the newly-established firms producing for the partner country's market will constitute additional opposition to any moves away from preferential arrangements and toward globally freer trade. Indeed, the fact that trade diversion by its nature is uneconomic and would

³⁴Consider, for example, a producer who manufactures and sells widgets worldwide. His support for politically costly measures to achieve greater global free trade will presumably increase as the potential gains to him from free trade increase. When there is already a preferential agreement in place covering some of the producer's export markets, the gains from further trade liberalization will be smaller, and therefore the support for a multilateral process less, than it would be in the absence of the preferential arrangement.

not exist in a free trade equilibrium is sufficient to demonstrate that additional opposition to global free trade will emerge.

One can go further, however, and evaluate FTAs, as contrasted with customs unions. Two key points may be made. First, since ROOs provide an additional opportunity for trade diversion with FTAs that does not arise under customs union, that would suggest that FTAs are, on political economy grounds, less desirable than customs unions because they will increase opposition to global trade liberalization even more than would a customs union arrangement. Second, since there are more opportunities for lobbying under FTA arrangements (with each new entrant for rules of origin) than under customs union, and since those lobbying efforts are likely to result in a higher political economy equilibrium level of trade diversion, that will build in even more opposition to further trade liberalization.

Thus, political forces are likely in general to be more supportive of (or less in opposition to) changes which are welfare-reducing than of moves which are welfare increasing. Since FTAs have no more potential for trade creation and more for trade diversion than customs union, it seems evident that they are less likely to be opposed in formation. Once in place, the producers "protected" in their sales to firms in partner countries by virtue of ROOs are likely to oppose multilateral liberalization because it would erode their benefits.

Conclusions

Five years ago, Martin Wolf presciently noted that "the shift

in U.S. thinking toward FTAs, and more generally toward bilateralism as a principle, rather than a shamefaced expedient, is momentous. As the progenitor and most enthusiastic upholder of the unconditional MFN principle, the US may well doom the GATT system in its present form by this defection". (Wolf, 1989, P. 93)

Focus here has been on those dimensions of FTAs which provide portents for the evolution of the open multilateral trading system.³⁵ There are a number of reasons for fearing that FTAs will push the world more toward trading blocs than toward furtherance of a multilateral system. Two have been the focus of this paper. First, FTAs between any given pair of countries are inherently more trade-diverting than are customs unions. Second, the political economy of FTAs suggests that their creation weakens the support of those otherwise favoring the open multilateral system, while simultaneously creating new interest groups opposing further multilateral liberalization. Insofar as trade diversion does take place under FTAs, either of goods and services trade or of foreign investment, there are new interests that will oppose further liberalization.

There are other considerations, as well. The attention given

³⁵ There are other factors which may be equally ominous, but have not been discussed here. Most notable among these are the labor and environmental standards that were appended to the U.S. agreement with Mexico on the formation of NAFTA. Their significance is twofold: first, it is evident that "labor standards" and costly environmental understandings that impact only the environment of the partner have the potential for depriving poor countries of their comparative advantage; and second, once those standards were introduced into the NAFTA agreement, the American-French attempt to extend them to other trading partners appeared to be a logical next step.

by U.S. and other trade officials to regional trading arrangements has inevitably constituted a distraction of attention of policy makers from the multilateral system when FTAs are under discussion or negotiation. Given limited resources, more attention to new FTA arrangements inevitably leaves policy makers less time for focus on the global system.³⁶

There may also be political economy considerations that favor the formation of FTAs that have not been considered here. For example, it has been argued that the Canada-US FTA increased pressure on Canadian policy makers to lower their tariffs toward U.S. levels and as such, the CUSFTA was trade-liberalizing. Moreover, there may be circumstances in which a trade-creating customs union is politically infeasible, but that an FTA is feasible and would come close to achieving the same welfare gains.³⁷ Finally, it has been argued that an FTA may overcome irrational political opposition to increasing global integration, and as such increase political support for the open multilateral system.

Each of all of these arguments in support of FTAs may have merit. Nonetheless, the complexities of rules of origin, with their attendant implications for levels of protection post-FTA and

³⁶There is also the risk that trade disputes between regions are more likely to flare into grievous misunderstandings if members of regional arrangements believe that those arrangements provide them with a satisfactory alternative to the open multilateral system.

³⁷These arguments were made orally by Richard Lipsey in a seminar at Stanford.

therefore for trade diversion, should be taken seriously. Even if the welfare costs of rules of origins are judged to be sufficiently low to be acceptable, a second judgment is necessary regarding the shift in political support for the multilateral system that will result.

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