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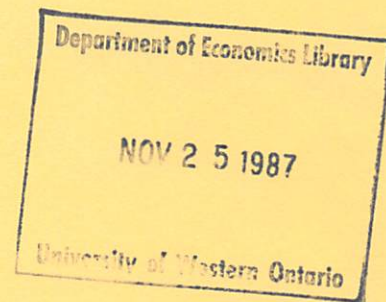
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SEARCH FOR A GENERAL PRINCIPLE

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This paper contains preliminary findings from research work still in progress and should not be quoted without prior approval of the author.

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**UNILATERAL FREE TRADE VS. A CUSTOM'S UNION: THE FURTHER SEARCH
FOR A GENERAL PRINCIPLE**

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For decades the CU literature has been heavily influenced by the principle that, under certain assumptions, unilateral tariff reduction (UTR) dominates a customs union (CU). (Unless specified otherwise, "dominates" means "weakly dominates".) However, the assumptions were so restrictive that the principle applied only over a very narrow domain and therefore had little policy content (although this did not prevent it from being invoked in policy debate). In our 1981 article (in particular Figure 2) we showed that even over its very restricted domain, this principle does not hold in general.

In this paper, we shall go one step further, to demonstrate that the traditional claim that UTR dominates a CU is essentially 180° wrong, especially when the term "CU" is used, as is common in this literature, to represent either a free trade area (FTA) or a customs union proper (CU*). Instead, UTR is dominated by an appropriately designed CU*, which in turn is dominated by an appropriately designed FTA. Moreover, this conclusion holds over a wider domain of assumptions. Our demonstration requires 4 steps:

1. If the union countries have no influence over their terms of trade, a CU* with a zero external tariff, $(CU_{t=0}^*)$ dominates a CU* with a non-zero tariff; that is,

$$CU_{t=0}^* \geq CU_{t=0}^* \quad (1)$$

(All tariffs of a CU* or FTA in this paper of course refer to tariffs on imports from third countries). (1) is true for two or more countries making up a CU* for exactly the same reason that it is true for n provinces or states

making up a nation. In this latter case, the principle is a familiar one: for a nation without terms of trade influence, a zero tariff dominates a non-zero tariff.¹

[Incidentally, a $CU_{t=0}^*$ is exactly the same as "mutual unilateral tariff reduction" which we have heard recommended as being preferred to a $CU_{t=0}^*$. We, of course, agree with this, although not with the implication that is frequently made that this somehow resurrects the principle that UTR dominates a customs union. Mutual UTR is not a unilateral policy. As is evident from our 1981 Figure 2, the dominant outcome E is possible only if a CU is formed or both countries agree to go to UTR. In either case, a bilateral agreement is necessary. E cannot be reached by either country taking unilateral action. To avoid the contradiction in terms involved in the "mutual unilateral tariff reduction" name, we prefer the equivalent $CU_{t=0}$ to emphasize that this policy must be bilaterally negotiated.]

$$2. \quad A \quad CU_{t=0}^* \geq UTR \quad (2)$$

The reason is that a $CU_{t=0}$ involves none of the diversion costs that may make a $CU_{t=0}^* < UTR$; in other words, a $CU_{t=0}^*$ provides all the benefits of UTR in trade with third countries. At the same time, it provides a possible benefit not available under UTR--namely, getting rid of partner country's tariff on its exports.

¹ Assuming domestic distortions do not upset this conclusion. (This assumption may be more difficult to make for a CU^* than for a nation.)

Despite (1), an ϵ may still be selected small enough to deduce from (2) that

$$a \text{ CU}_{t=\epsilon}^* \geq \text{UTR} \quad (3)$$

Note how this reverses the traditional theorem that UTR dominates a customs union, on precisely its own domain of assumptions. But this reversal in (3) also holds over a wider domain. In particular, we can relax the fixed terms of trade assumption, to allow for the case where the CU* has some terms of trade influence in its trade with third countries. Then ϵ may be set at the optimal tariff level, which need no longer be arbitrarily small. In short, if the CU* tariff is set at anything between zero and the optimal level, then a CU* dominates UTR.

The problem, of course, is that this doesn't mean that any CU* necessarily dominates UTR. The reason is that the partner country may insist on a higher-than-optimal common external tariff.

3. However, that problem applies to a CU*, but not to an FTA. While both are typically included in the CU, or "preferential trading club" literature, a distinction should be made between the two. Country A in an FTA may set its own external tariff at zero, or, if partner B objects to this obvious elimination of its preferences, A can set its tariff above zero and then let it gradually erode. In this case A gets the available gains from trade with third countries. If its partner follows suit, then the resulting $\text{FTA}_{t=0}$ is identical to $\text{CU}_{t=0}^*$, with all the same attractive characteristics. But country A can do even better, if its partner B retains a non-zero tariff, say β , and thus provides A with preference in B's market.

(Unlike own tariff that provides A with a producer gain that is exceeded by a consumer loss, partner's tariff in an FTA is unambiguously beneficial because it offers a producer gain to A's exporters, who are better able to compete with third countries in B because of the preferences they receive there. At the same time, there is no consumer loss in A, the only consumers who lose are in tariff-ridden B.)

[Incidentally, the economic interest of each country in reducing its own tariff in an FTA means that an FTA contains an inherent tendency towards free trade with third countries that a CU does not. However, this conclusion is weakened to the degree that any CU participant is likely to resist reductions in partner's tariff.]

4. If small country A is limited to unilateral policies, or negotiated policies with only B, it follows from (2) that

$$FTA_{t=0,0} \equiv CU_{t=0}^* \geq UTR \quad (4)$$

where $FTA_{t=x,y}$ refers to a free trade area in which home country A's tariff is x, while partner's tariff is y. A can do even better, if B's tariff is β , rather than zero. Then, noting (4):

$$FTA_{t=0,\beta} \geq FTA_{t=0,0} \geq UTR \quad (5)$$

Moreover, if A does have terms of trade influence and can benefit by setting its tariff at ∞ , it can realize an additional benefit, with the conclusion (5) then strengthened by this relaxation of one of the rigid terms of trade assumptions. While this raises a whole host of complications, (5) or even (4) is sufficient to turn the traditional dominance of UTR on its head.

Incidentally, in its 1975 "Looking Outward" the Economic Council of Canada recommended an industrial FTA with the U.S., and a concurrent reduction in Canada's own tariff. Thus it was moving towards FTA_{t=0,β}, a move well justified by (5). However, at the time it was justified in another way, by the hope that this would reduce the "double adjustment" cost, that is, the cost of rationalizing for increased world competition following future MTNs that would follow the initial cost of rationalizing for competition with the U.S. in the proposed FTA.

Conclusion

Provided that a country can set its own external tariff at the economically most beneficial level, then economic considerations lead to the conclusion that an FTA dominates a CU*,² which in turn dominates UFT. (Compare that with the traditional theorem that UFT dominates a customs union over a narrower domain of assumptions, a theorem that has, by counterexample in W&W 1981 Figure 2, been proved not to hold in general even over that extremely narrow domain. (To the best of our knowledge, critics of that article agree, although there is still a difference of opinion on the breadth and significance of our counterexample.)

Whereas an "appropriately designed" FTA will dominate UFT, it doesn't follow that any FTA will, since there is such wide opportunity for an FTA participant to design its own tariff in an inappropriate way in response to political pressures.

²Assuming partner's third-country tariff is the same in either case.

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