Trade diversion occurs when lower cost imports from non-members of a regional trade agreement are replaced by higher cost imports from a member economy. This occurs because the elimination of a tariff within the RTA lowers the cost of importing products from member economies below the cost of importing from the source outside the union which is still subject to tariffs. Trade diversion has a negative impact on welfare because it shifts production from a more efficient, lower cost producer outside the union to a less efficient producer inside the union.

Thus, a customs union can result in trade creation and trade diversion, and the net world welfare effect depends upon the relative weights of these two effects. The welfare of non-member economies will unambiguously decline if trade resulting from efficient production has been diverted away from them. So, although welfare may increase in the union, it might decrease in the rest of the world and only the relative magnitudes of these two effects will determine whether there is net welfare loss or gain.

Whether the trade diverting or creating effect dominates depends on many factors. Generally, trade creation and increased welfare is more likely to dominate the higher the preunion trade barriers, the lower the union's barriers with the rest of the world, the greater the number of and larger the size of countries forming the union, the more competitive (rather than complementary) the countries, the closer the countries are geographically, and the greater the preunion trade and economic relationship among potential members. In theory, the European Economic Community was an ideal candidate to be a trade creating, rather than trade diverting, customs union because the original member countries fulfilled almost all the above criteria. The case is less clear when applying the theoretical criteria to the NAFTA, since, for example, Mexico is more of a complementary country of a smaller size and the number of member countries is small.

- The Dynamic Benefits

As stated earlier, trade diversion and trade creation are only static, partial equilibrium effects. Important dynamic effects can also result from RTAs. These include increased competition, the exploitation of economies of scale, stimulus to investment and the more efficient utilization of economic resources[15].

The reduction in trade barriers between member economies can increase competition in industries that may have grown "fat" or non-competitive behind the

[15] *Ibid.*, p. 240.