

The overall impact on the Rest of the World is also positive, slightly larger than the USA, but considerably smaller than in Canada as whole.

In *scenario 1b*, aggregate tariff reduction on goods imported to Canada is larger, leading to a further deterioration in the terms of trade of all Canadian regions. As a result, the gains in real revenue and real consumer spending are smaller than in *scenario 1a*.

As the external tariff towards U.S. imports from the Rest of the World declines, USA terms of trade deteriorate in this scenario, leading to a slight decrease in its real revenue and real consumer spending. The reduction in tariffs imposed on exports of the Rest of the World region to the U.S. lead to a further improvement in the terms of trade of the ROW region and a further improvement in its real revenue and real consumer spending.

Scenario 2: The Elimination of Unobserved Trade Costs

Given the long history of Canada-U.S. trade, the huge bilateral trade volume boosted by a free trade agreement and significantly reduced transportation and communication costs, economists expected that the Canada-USA border would no longer be an important determinant of geographic trade patterns. Accordingly, John McCallum's (1995) finding that, after controlling for distance, trading partner sizes and a small number of other factors, trade between two individual Canadian provinces was on average 22 times larger than trade between Canadian provinces and USA states, became one of the most puzzling empirical findings in the recent international trade literature. Subsequent research challenged both the measurement and theoretical underpinnings of the McCallum estimates. Though more recent estimates have reduced the "border" effect to more than half the size estimated by McCallum, they nevertheless have confirmed the existence of a sizable "border" effect in Canada-USA merchandise trade.

While the existence of a "border effect" in Canada-USA trade has now become generally accepted, its interpretation is still a matter of debate. Two popular interpretations have competing policy implications: (a) the border effect could be due to differing national preferences: i.e., consumers prefer to buy from domestic producers; or (b) the border effect could be due to unobserved trade costs (UTCs), such as costs due to customs controls and administrative formalities, costs that arise out of national differences in technical standards and regulation, transactions costs related to currency exchange and hedging of currency risks, and costs associated with developing trade relations in different cultural and legal environments.

The first interpretation would imply that further integration between Canada and the USA would not provide any further economic advantages to either of the two countries. The second implies, however, that co-ordination of regulatory, monetary and transportation policies to lower or remove these implicit costs of trade could facilitate cross-border exchange.

Efforts to empirically test the alternative hypotheses in the Canada-USA context and more generally have been hampered by two factors.⁴⁰ First, the lack

⁴⁰ See Head and Ries (1999) for a demonstration of the linkages and attempt to separate the two factors on the border effect.