new dataset. Using the new set of preference parameters, and the original benchmark data, tariff equivalents of the unobserved trade costs that are consistent with the demand and supply equations are calibrated.

Scenario 1: A "Basic Customs Unions"

In scenario 1, we model a "Basic Customs Union" - A common external tariff and abolition of all remaining tariff protection in Canada-U.S. trade.

Common external tariff harmonization implies reconciliation of Canadian and U.S. MFN rates, of general preferential rates extended to developing countries, and of preferential tariffs facing countries with which either Canada, or the U.S., or both has/have a bilateral FTA or other preferential arrangement[32]. With few exceptions[33], there are significant similarities between Canadian and USA lists of actual and expected preferential trade agreements; accordingly, the latter task would not be exceptionally difficult.

In economic terms, the impact of regional trade agreements (RTAs) is measured in terms of their welfare-enhancing effects. Generally speaking, a positive global welfare result obtains if the trade creation effects of an RTA are greater than its trade diversion effects. If trade diversion is greater, welfare losses can exceed the welfare gains for the members of the RTA. In the latter case, lower-cost production in the Rest of the World might well be displaced by higher-cost producers within the RTA who gain an expanded market within the RTA zone under the protection of MFN tariffs applied to third parties. Empirical evidence suggests that the trade created by CUSFTA/NAFTA exceeded the amount of trade diverted; that being said, the amount of trade diverted by CUSFTA/NAFTA was not insignificant—studies suggest that as much as 35 percent of the increased Canadian and Mexican exports to the USA following CUSFTA/NAFTA was due to trade diversion[34].

Insofar as moving to a common external tariff decreases average tariff rates, a "basic" customs union would be expected to reduce the trade diversion effects generated by the CUSFTA and NAFTA.

Indeed, this is likely the case for two reasons:

1) Most Canadian and USA MFN rates are "bound" under GATT/WTO agreements; accordingly, any increase in rates requires negotiated compensation to other trading partners. Harmonizing tariff rates within a customs union by lowering the higher rate is thus much less complicated than by raising the lower rate. While the tariff rates of one or the other

[32] They would also have to reconcile rates on Mexican agricultural exports because the agricultural provisions of NAFTA were not negotiated trilaterally. In principle, a customs union would also involve eliminating tariffs between Canada and the U.S. on agriculture, which did not occur under NAFTA.

[33] For example, the U.S. has a current bilateral agreement with Jordan, is pursuing FTAs with Morocco and the South African customs union, and has initiated discussions with Bahrain. In the case of Chile, though both Canada and the U.S. have bilateral agreements, the Canada-Chile agreement applies to fewer categories. For a list of similarities and differences, see Goldfarb (2003), Table 2, page 14.

[34] See John Romalis. (January 2004), Kimberly A. Clausing (2001).