Do trade agreements matter?

A deal that drops tariffs between members can move buying to a cheaper maker (trade creation) or to a more expensive one inside the deal (trade diversion); the WTO, the EU and USMCA; rules of origin; what the evidence says. Sandals: $12 at home, $10 in Palmera, $8 in the rest of the world.

1 Where shops buy

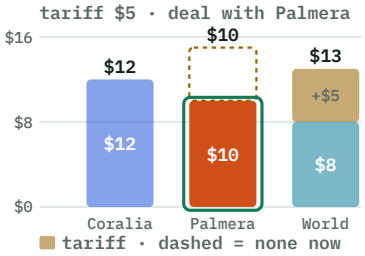
cost + tariff

- **Tariff** = tax paid when goods cross the border → shop pays `maker's cost + tariff` (none on home goods)
- Shop buys from the **lowest** price · sandals: Coralia $12 · Palmera $10 · rest of world $8
- Tariff $5 → home **$12** beats Palmera 10 + 5 = 15, world 8 + 5 = 13 → the tariff hides the cheapest maker
- Practice: bike $19 / $15 / $12 → smallest tariff ($2 steps) to keep imports out = **$8** (12 + 8 = 20 > 19; at $6: 18)

2 Trade creation

to a cheaper maker

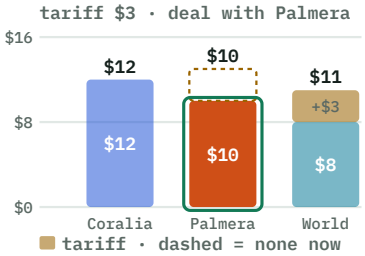
- **Free-trade agreement** = members drop tariffs on each other's goods; outsiders still pay
- **Trade creation** = buying moves from a more expensive maker to a cheaper one → real cost of making ↓ (maker's cost, tariff aside)
- Tariff $5, deal with Palmera → Palmera **$10** < home $12 → **−$2** a pair · bikes: home $19 → Palmera $15 → **−$4**



3 Trade diversion

to a costlier friend

- **Trade diversion** = buying moves from a cheaper maker **outside** to a more expensive one **inside** the deal → real cost ↑
- Tariff $3: before, world 8 + 3 = **$11** (gov. keeps $3) → deal → Palmera **$10**, though the world makes it for $8
- Bill per pair: buyers `+1` · government `−3` ⇒ net `−2` = 10 − 8, the extra cost of making
- Practice: covers $10 / $8 / $5, tariff $4 → world $9 → Palmera $8 → +1 − 4 = **−3** × 20 thousand = **−$60 thousand** a year
- Names: **Jacob Viner** (Canadian economist, 1892-1970), The Customs Union Issue, 1950



4 Sort any case

before → after

- `t` = tariff · before = lowest of `home · partner + t · far + t` → after = lowest of `home · partner · far + t`
- Seller changes to a **cheaper** maker → creation · to a **more expensive** one → diversion · same seller → **no change** (partner > far + t)

Creation	Diversion	No change
juice: home $6 → partner $4 · shoes: $30 → $22	shirts: far 9 + 4 → partner $12 · rice: 5 + 2 → $6	toys: partner $9 > 5 + 3 · pens: $3 > 1 + 1

5 Real deals

WTO · EU · USMCA

- **GATT**: 23 countries, Geneva, 1947 → **WTO** (World Trade Organization), 1 Jan **1995**, Geneva, **166** members (2024)
- **Most-favored nation** = best tariff for one member → for **all** members (no favorites) · exception: free-trade agreements covering nearly all trade

Free-trade area	Customs union
no tariffs inside · **own** tariffs on outsiders · **USMCA** (US, Mexico, Canada) replaced NAFTA (1994) on **1 July 2020**	no tariffs inside · **one common** tariff on outsiders · **EU**: customs union 1968, single market 1993

- **Rule of origin** = share of a good made inside the area to cross tariff-free · USMCA cars: **75%**
- Without it: Coralia 25%, Palmera 5% on steel → steel enters via Palmera → crosses tariff-free → Coralia's 25% collects ≈ nothing
- Car $40,000, $28,000 inside → **70%** < 75% → pays the tariff · 75% = $30,000 → **$2,000** more

6 The evidence

where from?

- **Baier & Bergstrand** (American economists, 2007): an average deal ≈ **doubles** trade between members after 10 years → creation + diversion together
- Practice: imports from partner 10 → 20 · from the rest of the world 12 → 4 · total 22 → 24 ⇒ **$2B** new, **$8B** diverted (equal tariffs before → outside makers were cheaper)
- `CASE FOR` low tariffs hard to undo, bigger markets, clear rules · `CASE FOR CAUTION` diversion, paperwork, losing industries (Lesson 2) · no verdict

Watch out: "more trade between members" ≠ the world gained → ask **where the new trade came from** · compare the **cost of making**, not just the shop price · in diversion buyers gain (+1) but the government loses more (−3) · a deal changes nothing if partner > far + tariff