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Economics and Political Economy of Regional Trade Agreements

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Working Paper 07/5

TRADEAG is a Specific Targeted Research Project financed by the European Commission within its VI Research Framework. Information about the Project, the partners involved and its outputs can be found at <http://www.tradeag.eu>

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Abstract

This paper provides a literature review of selected aspects of economics and political economy of regional trade agreements. From a static perspective regional trade agreements have ambiguous effects on the welfare. Assumption of welfare maximization cannot explain the proliferation of regional trade agreements as it cannot explain extensive use of trade barriers. New political economy approach endogenizes trade policy as well as decisions to form a regional trade agreement. According to major models of political economy, regional trade agreements are likely to be formed when they secure higher protection and trade diversion. Furthermore the literature mostly concludes that integration affects external tariffs.

1. Introduction

There are two different aspects of international trade policy: efficiency and distribution of income. Neoclassical economics states that free trade maximizes national as well as global welfare. From efficiency perspective, global free trade leads to efficient allocation of resources, i.e. it maximizes welfare in aggregate. Additionally, if perfect information and lump sum transfers are assumed then free trade maximizes the utility of every person in the economy as well. Therefore free trade can be Pareto efficient. This traditional neoclassical perspective on international trade policy recommends to policy makers to pursue free trade policy as the best option to maximize welfare of the society.

Neoclassical economics admits that there are, however, some grounds for the government involvement in international trade. Large country can, for example, increase its welfare by imposing an optimal tariff which equals to the inverse of the elasticity of foreign export supply. Welfare of large country imposing a tariff increases due to improvements of the country's terms of trade. There is also a possibility to improve welfare through strategic trade policy in the case of imperfect international competition. Helpman and Krugman (1989) show that a tariff increases domestic welfare under Cournot duopoly (single domestic firm and single foreign firm competing in quantities). In such a case, government policy can shift

profits from foreign to domestic firm thus raising domestic welfare. Under Bertrand competition (domestic and foreign firm compete in prices) there is an optimal tariff that increases domestic welfare if the elasticity of demand is increasing in price. If elasticity of demand is constant in price then optimal tariff is zero. Strategic trade policies therefore could lead to the increase of domestic welfare. However, the conduct of strategic trade policy requires very detailed economic information that is rarely available to the governments. Furthermore strategic trade policy as well as optimal tariff policy of a large country increase domestic welfare at the expense of foreign trade partners which invites retaliation leading to subsequent welfare decline.

Additional reason that calls for government interference with free trade includes protection of domestic infant industry. Domestic industry obtains protection that allows it to increase current production and reduce costs in the future.

The income distribution through trade policy is studied within the subject of new political economy of trade policy. New political economy of trade policy emphasizes political interaction of self-interested subjects (politicians, lobbyists, voters) in an institutional context of decisions. Trade policy is viewed as determined jointly by (i) objectives of policy makers, (ii) the influence over policy exerted by the gainers and losers from trade policy including free trade policy and (iii) the institutional setting governing the interaction between policymakers and the gainers and losers from protection (Hillman, 1989).

There are three major theories of international trade which form the framework for the analysis of the political economy of trade policy. These are Ricardian model, Heckscher-Ohlin theory, and specific factors model. When Ricardian assumptions are made all participants individually gain from international trade. This model is therefore uninteresting from the political economy perspective because it is in the interest of everybody to pursue free trade policies.

In the Heckscher-Ohlin setting, the Stolper-Samuelson theorem (Stolper and Samuelson, 1941) states that the owners of scarce resources gain from protectionism in real terms while owners of abundant resources lose. The overall welfare impact of protectionism is negative. The owners of relatively scarce resource used to produce import-competing goods are therefore motivated to increase protection through political markets. For example if the imported good is labor-intensive, workers will prefer protection while owners of capital will prefer free trade. Heckscher-Ohlin theory would therefore predict the existence of factor based political coalitions. The Stolper-Samuelson theorem is very potent for two goods, two countries case while its power declines significantly when many goods are assumed.

Specific factor model explains political coalitions based on industry lines, as it is observed in reality. The model predicts that the owners of the industry-specific factor gain from the protection of the industry and the owners of factors that are specific to non-protected industries lose. The effect of protection on the flexible (mobile) factor is ambivalent.

2. Economics of regional trade agreements

Policy-makers have a wide range of possibilities or instruments of trade policy like tariffs, export subsidies, non-tariff barriers and others. Formation of regional trade agreements (RTA) is an additional instrument that policy-makers can use to regulate international trade. There is a spectrum of RTAs (free trade area, customs union, common market and economic union). In a free trade area (FTA) member states eliminate tariffs and other trade barriers among themselves and keep separate tariffs with the third countries. Customs union (CU) is the same like FTA but members agree to have common external tariffs. A common market allows for free movement of factors of production in addition to free movement of goods within CU. In economic union member states in addition to forming common market also unify some economic policies like monetary, social or other policy.

RTAs are exception to the World Trade Organization's (WTO) ruling principle of nondiscrimination. WTO is based on Most Favored Nation (MFN) Principle which states that all trade preferences granted to one member state must also be extended to all other member states (Article I of WTO). WTO recognizes three exceptions to MFN principle. 1. Developed countries can give non-reciprocal trade preferences to developing countries within General System of Preferences (GSP). 2. Developing countries can grant partial trade preferences to each other within the so called Enabling Clause. 3. Developed countries can, according to Article XXIV, form customs unions or free trade areas if they cover substantially all the trade.

Almost all countries of the world are members to some RTA (WTO, 2003). By end of 2002 year 176 RTAs were in effect and additional RTAs were under negotiation. By March 2003 only Hong-Kong, Macao, Chinese Taipei and Mongolia were not party to any RTA. RTAs are observed in all continents. In Europe regional trade is dominated by the common market in the European Union. USA used to rely on the multilateral trading system characterized by MFN principle. Recently USA became strongly involved in regional trade within North American Free Trade Agreement (NAFTA) and in negotiation to establish free trade for the Americas. Similar development is taking place in Asia and other continents. According to WTO estimates preferential world trade share within RTAs reaches in 2005 51.2 percent of all world trade. This share constitutes 67.0 percent for the Western Europe.

Historically Bhagwati (1993) recognizes two waves of creation of RTAs. The first one took place in 1960s and 1970s and did not spread beyond Western Europe, the second wave of creation of RTAs started in 1980s when US switched its trade policy from multilateral approach to liberalization of trade to regional liberalization of trade within RTAs.

On the one hand, formation of RTA can be viewed as a move towards free trade because some trade barriers are eliminated. However, RTA liberalizes trade among a subset of countries only, not globally like liberalization within WTO. From the welfare perspective,

RTAs are therefore the second best not the first best. Viner (1950) was the first one to notice that RTA can either increase the overall welfare or reduce it. As Viner concluded, RTA does not automatically increase welfare. Whether RTA has overall positive effects or negative depends on the extent of trade creation and trade diversion. Trade creation occurs when one of the members of the RTA will import from the other member which it formerly did not. Trade creation therefore occurs when production in member countries is replaced by imports from a more efficient producer in member state of RTA. When one of the members will start to import from the other member at the expense of imports from the rest of the world because of discriminatory tariff reduction then trade diversion occurs. Trade diversion therefore occurs when imports from a more efficient producer from the outside of the RTA are replaced by imports from a less efficient RTA member because of discriminatory trade barriers.

Meade (1955) introduced concepts of trade creation and trade diversion within a model with infinite supply elasticities and zero demand elasticity. In his model trade creation is associated with welfare gain and trade diversion is associated with welfare loss. The magnitude of trade creation and trade diversion is one factor that determines the magnitude of welfare change. How much the welfare changes is also affected by how much costs are reduced when trade is created and the magnitude of cost increase when trade is diverted (Meade, 1955).

Lipsey (1957) and Gehrels (1956 – 57) demonstrated that trade diversion can also lead to increase in welfare when a more realistic downward sloping demand curve is considered. Similar results are achieved when supply curve is upward sloping and has non-zero elasticity.

Bhagwati (1971) concludes that to eliminate the possibility of a trade diverting RTA leading to welfare gains, we must assume demand elasticity to be zero and supply elasticity to be infinite like in the previous Meade's case.

Figures 1 and 2 present standard textbook treatment of trade creation and trade diversion caused by RTA. When a customs union is formed with a partner who has more efficient producers than those in the outside world, the situation is depicted in figure 1. Before the formation of customs union domestic price was $P_B + t$, price in partner country plus tariff. After the formation of customs union, price declines to P_B . Imports increase from a more efficient producer from within the customs union at the expense of domestic production and due to rise of domestic consumption. Trade creation is measured by $S1S2$ plus $D1D2$. Customs union implies the following changes in welfares: welfare of consumers increases by $a+b+c+d$, while welfare of producers declines by a , and tariff revenue declines by c , the net effect is positive, $b + d$. Because the partner country (B) was a sole supplier to country A even initially there was no trade distortion when RTA was formed and there was unambiguous gain from forming RTA. This is an equivalent to unilateral trade liberalization.

Figure 1. Formation of customs union with the most efficient producers

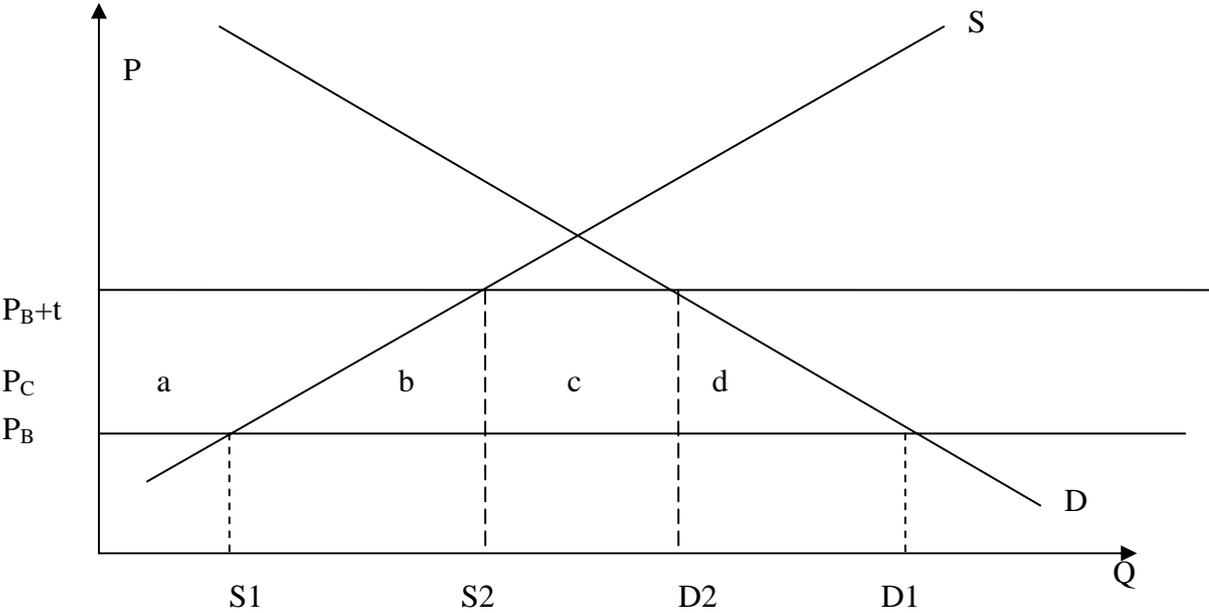
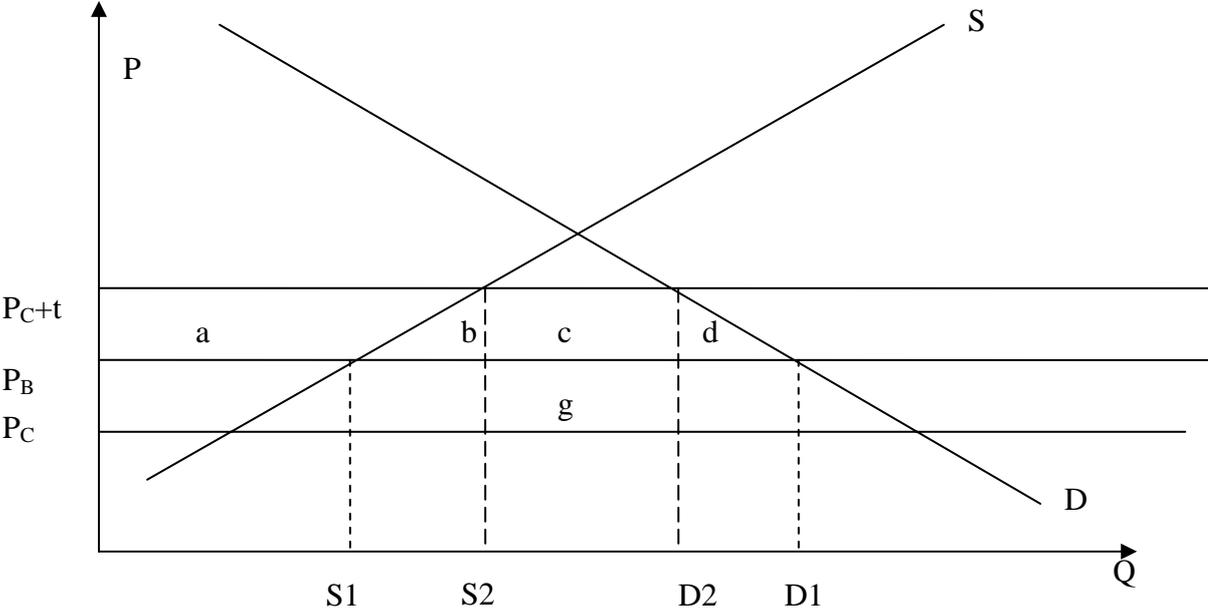


Figure 2. Formation of customs union with less efficient producers



In figure 2 P_B represents supply curve from the preferred partner with whom customs union is formed while P_C represents the world price. When customs union is formed with the preferred partner imports previously supplied by more efficient producers from outside the customs union are replaced by imports from the partner country within the customs union. D_2S_2 therefore represents trade diversion effect of the customs union. Because of the formation of customs union domestic price declines from P_{C+t} to P_B and some trade is created, namely S_1S_2 and D_2D_1 , which is the difference between D_1S_1 and D_2S_2 . The welfare implications are the following: $d + b - g$. A net welfare loss occurs when areas b and d are smaller than area g . Therefore welfare due to customs union increases: the more elastic is the demand and supply curve, the lower the difference in efficiency between partner country producers and producers in the rest of the world, the higher is pre-union tariff the lower was the imports relative to domestic consumption and production before the formation of customs union.

Pangariya (1996) also introduces finite supply elasticity on the side of suppliers (country B and C) and shows how welfare effects change.

There is an important difference between customs union and free trade area. Members of FTA can impose own tariffs on imports from third countries while members of customs union have to agree on common external tariffs. When tariffs differ in FTA then imports to the FTA will be directed through the low tariff country – trade deflection will occur. Governments try to avoid trade deflection by imposing rules of origin. Shibata (1967) and Richardson (1994) showed that rules of origin are irrelevant. If country A has lower tariff than country B and they form a FTA, then imports into the FTA will be channeled through country A. Rules of origin make sure that country A imports free of tariffs from country B only goods produced in country B, not transshipped goods from third countries. However, when country's B production is higher than imports of country A, country B will export own goods free of tariffs to country A and domestic consumption in country B will be satisfied with domestic production and imports from third countries. In such a case prices in both country A and B will be equal to price in country B which is the world price plus tariff (assuming both countries are net importers). Vousden (1990) showed that initially high tariff country will be better off when reducing tariff below the tariff rate of low tariff country in order to increase tariff revenue. A race to lower tariffs because of competition for tariff revenue between members of FTA will lead to total elimination of tariffs, FTAs are therefore not stable.

In general equilibrium context there are secondary effects of the change of tariffs. Meade (1955), Lipsey (1970) and later Bhagwati (1993) and Pangariya (1997) assume three countries, country A exports good 1 to B and C, while country B exports good 2 to countries A and C, large-country C produces all three goods. Initially country A imposes tariffs on good 1 (t_1) and on good 2 (t_2). The effect of reduction of t_2 leads to trade creation and subsequent welfare gain. In general equilibrium context discriminatory tariff reduction t_2 affects demands

for goods 1 and 3 too. If the goods are substitutes then import of good 3 decreases (trade diversion) and export of good 1 goes up (trade creation). For a small change in t_2 trade creation dominates leading to welfare gain. However if t_2 approaches zero then trade diversion might be bigger than trade creation leading to welfare loss. From Meade-Lipsey model follows that a small preferential reduction of tariff increases welfare while full liberalization has ambiguous effect.

The Meade-Lipsey general equilibrium model is a specific case. Panagariya (1999) generalizes the model and demonstrates that a RTA increases the union's joint welfare when it increases the value of the union-wide output at world prices.

Whether the formation of RTA is welfare improving or reducing depends on the underlying parameters of the economy, like elasticities and elasticities of substitution. On the other hand, Summers (1991) and Krugman (1991) use a natural trading partner argument to find out whether trade diversion or trade creation occurs within RTA. If the initial trade volume is high (Summers) or the distance between the countries is low (Krugman) then formation of RTA is not likely to lead to trade diversion.

Mundell (1964), Vanek (1965), Kemp (1964), Caves (1974), Pearce (1970), and others studied the terms of trade effect of RTAs. If a country unilaterally reduces tariff to its trading partner while keeping tariff with the rest of the world unchanged, terms of trade for trading partner improves with respect to tariff reducing country and with respect to the rest of the world. Terms of trade effect on tariff reducing country with the rest of the world is ambiguous (Mundell, 1964). RTA improves member states terms of trade with respect to other countries outside the RTA. Because of the terms of trade, RTAs can dominate unilateral trade policies, especially for small countries which cannot affect their terms of trade in isolation but are able to do it when forming a RTA. From welfare perspective it is optimal for large customs union to set welfare maximizing tariffs which are the same as welfare maximizing tariffs in a large

country case. Similarly when there are differentiated products each country has monopoly power over products that it produces and for each country there is an optimal tariff rate.

When economy of scale is introduced, trade creation and diversion still remain relevant concepts, but have to be expanded by cost reduction and trade suppression (Corden, 1972). Formation of RTA expands the market and lowers costs; this subsequently suppresses further imports from the ROW even if ROW has more efficient producers.

If two countries form a RTA in the presence of economy of scale the effects are still ambiguous from welfare perspective. On the one hand, trade is normally diverted from the rest of the world which is a negative effect. On the other hand, economy of scale and larger market for a firm from countries forming RTA (either A or B) leads to lower average costs of production which is a positive effect.

In the presence of economy of scale and no external trade, when two countries form a RTA then they both gain. Markets expand and average cost decline which is a positive effect. Obviously there is no trade diversion as there was no external trade before the formation of RTA. Formation of RTA enables domestic firms to access bigger market and to expand trade and reduce costs when average cost curve is decreasing.

The previous theories take external tariffs of RTAs as given and when intra-RTA tariffs are reduced external trade adjusts. If external tariff is endogenous, Kemp and Wan (1976), preceded by Vanek (1965), Kemp (1964) and Ohyama (1972), showed that a subset of countries could always form a customs union in such a way that improves the welfare of members while leaving the welfare of non-members unchanged, thus increasing the world welfare. This can be achieved by keeping external trade with non-members and subsequently their welfare unchanged and eliminating internal barriers within the customs-union. The result also requires inter-country transfers of income within the customs union such that no member will be worse off due to customs union formation. Kemp and Wan actually showed that a

customs union can always be formed in a way that improves the overall welfare. Kemp and Wan concluded that we do not observe a process of continual enlargement of customs union because of institutional constraints (international restrictions on formation of RTAs), imperfect information and by political economy reasons (non-economic motives). Berglas (1979), however, showed that anything that members of RTA gain can be gained also by unilateral reduction of trade barriers.

Non-reciprocal preferences

In addition to reciprocal regional trading agreements characterized by mutual reduction or elimination of trade barriers by trading partners there are also non-reciprocal preferential arrangements. Non-reciprocal preferential arrangement exists when one country (donor) provides other countries (beneficiaries) with better than MFN access to its own market without requesting reciprocal market access to their markets. Non-reciprocal trading arrangements are best known for General System of Preferences (GSP). The GSP is a system under which developed countries grant preferential tariff treatment to imports of certain products from certain developing countries. The granted preferences are almost unilateral, i.e. the policy does not require the developing countries to grant similar access to their markets by the developed countries. GSP by developed countries to developing countries were introduced between 1971 and 1976. This was an outcome of two conferences of United Nations Conference on Trade and Development (UNCTAD) that took place in 1964 and 1968. At its inception GSP was opposed by protectionist forces in the donor countries and from supporters of MFN principle (Pomfret, 2001) as well as by proponents of multilateral trading system. GSP as promoted by UNCTAD and also by the World Bank is non-discriminatory for countries at the same level of development, i.e. it does not recommend discrimination between developing countries. In practice developed countries adopted non-reciprocal trade arrangements on a selective basis, favoring mostly their colonies or some specific regions etc.

The purpose of non-reciprocal preferences was to assist developing countries. The assistance is to be provided through trade. Developed countries granted free access to their markets to selective developing countries for selective products. In donor countries producers are worse off, tariff revenue declines but consumers are better off due to decline of domestic prices. The overall effect is ambiguous and depends on the levels of trade creation and trade diversion.

The net impact of non-reciprocal preferences on beneficiary countries is positive (WTO, 2004). The higher the preference margins (difference between MFN tariff and GSP tariff) the higher exports from those countries to developed countries leading to higher economic growth and welfare. On the other hand, because of granting preferential access not to all products but rather to a subset of products selected by donor countries the pattern of exports from developing countries is strongly influenced by political economy of granting of preferences in developed countries rather than by comparative advantages of beneficiary countries.

The value of preference margins for beneficiary countries depends positively on supply elasticity in beneficiary countries and on elasticity of substitution in developed countries.

On the other hand the higher preference margins the more negative impact on the non-beneficiary countries. Non-beneficiary countries are more discriminated against and their welfare declines relative to non-existence of non-reciprocal preferences.

There is a literature comparing GSP and MFN tariff cuts from developing countries perspective. Baldwin and Murray (1977) use a differentiated product model to conclude that developing countries gain more from MFN tariff cut than from GSP preferential tariff margins erosion. MFN tariff cuts are preferable because a) not all developing countries nor all products are covered by GSP while MFN tariff cut would cover more products and be

applicable to more countries, b) preference schemes embody quantitative limits on exports while MFN not.

Baldwin and Murray (1977) do not estimate the elasticity of substitution but tie its value to that of donor country parameters. This assumption guarantee estimated trade creation to be several times larger than estimated trade diversion which leads to the conclusion that MFN tariff cut is preferable to GSP for developing countries (Pomfret, 2001). Baldwin and Murray underestimate trade diversion relative to trade creation. When true elasticities of substitution between goods from developed and developing countries are used or the model takes into consideration true export supply elasticities, trade diversion prevails over trade creation. GSP is therefore better than MFN tariff cut from beneficiaries perspective.

From the above analysis it therefore follows that formation of RTA has ambiguous impact on welfare. Moreover, unilateral reduction of tariff increases welfare more than the formation of a customs union. Government maximizing overall welfare would prefer unilateral tariff reduction rather than the formation of a customs union. The formation of customs union could be the first best option, only if a given country has an explicit objective to trade with a given country or become independent from trade from a given country (El Agra and Jones, 1981). Therefore assuming welfare maximizing government does not explain imposition of tariffs in the first place and by analogy it does not help us to explain the formation of customs union either. A customs union that improves the welfare creates trade while the one that diverts trade also reduces welfare. But if a country accepts welfare improving customs union as desirable, why does not move to the free trade? (Cooper and Massell, 1965). That is the formation of customs union must be explained by political economy reasons rather than by welfare maximization behavior of the government (Johnson, 1965, Cooper and Massell, 1965).

From the above it follows that RTAs are formed because of political reasons. There are two approaches to explain the politics of RTA: 1. Traditional approach of welfare maximizing, 2. new political economy approach.

3. Political economy of regional trade agreements

3.1. Welfare maximizing approach

Welfare maximizing approach stresses that trade policy including formation of RTAs can be best explained by government's concern for the welfare of certain social and economic groups (distribution) and by its desire to promote various national and international goals (Baldwin, 1989). This approach therefore assumes that politicians make decisions based on motives of social justice, social welfare, or social insurance (Hillman, 1989). According to this approach trade policy is used to maximize overall welfare through redistribution in the presence of risk and non-existence of risk markets. Corden (1974) uses this approach and formulates conservative social welfare function, i.e. no group in the economy should suffer significant reduction of utility due to the shift in comparative advantages. The citizens agree with this approach because of uncertainty with regard to future development of comparative advantages. Nobody knows who will suffer from the reduction of welfare in the future as the development of relative prices is unpredictable. Protectionism can result as a consensus among risk averse citizens. Cheh (1974) and Lavergne (1983) explain protectionist policies as an attempt of the government to minimize adjustment costs resultant from relative price change or exogenous policy change. Similarly Constantopoulos (1974) and Fieleke (1976) conclude that the government through protectionist trade policy supports incomes of low income groups. Low skilled labor tends to get higher protection.

Welfare maximizing approach also includes foreign policy motives. Through trade policy countries attempt to achieve various international objectives like increasing their international hegemony, reduction of other countries protection against own imports etc.

Approach of welfare maximizing explains the existence of RTAs by: utilization of monopsony power of large country through discrimination, tariff revenue motive, protection of domestic producers, support to exporters, bargaining power, political motives including strengthening of foreign policy, securing inputs, security, project cooperation and locking-in reforms.

Pomfret (1997) states four reasons for the existence of discriminatory trade policies like formation of RTA. First, the same reasons that apply to non-discriminatory trade policies also apply to discriminatory policies. Second, discriminatory trade policies provide means for supporting exporters. Third, discriminatory trade policies are used as bargaining tools to obtain better treatment of domestic producers. Fourth, discriminatory trade policies are used to further foreign policy objectives.

Traditional reason for protection is that large importing country can exploit its monopsony power to improve its terms of trade and thus to increase its welfare can be extended to RTAs. When discrimination is possible among trade partners the large importing country can set several different tariffs rather than a uniform tariff. Discriminating large country importer can gain more than large country importer that uses uniform tariff. Pomfret (1997) considers this reason for protection currently as unlikely.

By the same token discriminating large country importer can gain more revenue than the one with uniform tariff. However, as tariff revenue share in state budget declines with economic development the revenue motive behind the RTA is becoming irrelevant.

A major reason for trade barriers is protection of domestic producers. Discriminatory trade barriers can protect domestic producers only if there are no substitutes from other

countries. Discriminatory trade policies therefore lose their power of protection because other countries can replace exporters from countries that are discriminated against. However, discriminatory trade policies like forming RTAs emerge as a consequence of the institutional WTO framework based on MFN principle. This framework allows formation of RTAs. Therefore, protectionist countries rather than reducing all tariffs on MFN principle create RTA, i.e. reduce tariffs only for a subset of countries. Bilateral trading arrangements are examples of such protectionism. Bilateral trading arrangements like voluntary export restraints between an importer and exporter can protect domestic producers without breaching WTO rules. The harmed exporter is compensated by quota rent.

Infant industry argument for protection can be extended to RTAs. When the small size of national market prevents industrialization via import substitution formation of RTA among several states can solve the problem. On the other hand the argument for infant industry protection within RTA is often impaired by bargaining over the division of the “benefits” of the protection between the involved states. The bargaining often centers on the location of the protected industries.

Additional reason for formation of RTA is to secure reliable supplies of strategic commodities.

Preferred exporters are main beneficiaries of the formation of RTA. There can be unilateral reduction of barriers, i.e. certain countries obtain preferential access to domestic markets. This is the case of many preferential trading arrangements of developed countries with developing countries. Exporters from developing countries are unequivocal beneficiaries of such arrangements. On the other hand, reciprocal preferential trade arrangements help to improve terms of trade relative to non-members.

The formation of RTA can lead to inflow of foreign direct investment. Even countries limited by small size of their markets can attract significant FDI when they form a RTA with other countries.

Additional reason for the creation of RTA is increasing of bargaining power (World Bank, 2000, WTO, 2003). Larger groups of countries have a stronger bargaining position in multilateral or broader regional negotiations if they are able to arrive at common position. An example is EEC (EU). Milward (1984, 1992), Whalley (1996) state that the purpose of establishing EEC was also to increase the bargaining power of its members relative to the USA. The effectiveness of bargaining depends on the market access that can be granted to exporting countries (Pomfret, 1997). The larger the domestic market the higher the bargaining power, which is the main reason for the formation of RTAs.

Many regional integration endeavors were based on the belief that increasing trade reduces the risk of conflict. Linkages between states make conflicts more costly and favor cross-border cooperation (WTO, 2003). According to Milward (1984) this was the belief of the founding fathers of the EU.

Some integration arrangements however reduce security. International tensions are built if members of the RTA find distribution of income unfair. Non-members might also feel alienated and international political and military conflicts can follow the suit.

Some countries are motivated to join integration agreement in order to increase their extraregional security, an example is the endeavor of CEECs to join the EU which was partly a reaction to perceived threat from Russian Federation.

Participation in the RTA helps to built trust that can be used to solve various international problems and alleviates international project cooperation. Regional integration arrangements can also be used to lock in domestic trade reforms as commitment mechanisms. Regional agreement reduces the probability of reversing the trade reforms because renegeing

on the commitment invites retaliation by trade partners. However, WTO can serve as a good commitment mechanism too. Membership in regional trade agreement can serve as a better commitment mechanism if the RTA provides a deeper integration and therefore deeper commitment to pursue certain policies (WTO, 2003). Membership in a regional grouping restricts members in pursuing various policy options (World Bank, 2000).

3.2. New political economy approach to international trade and regional trade agreements

Theories of international trade recognize that the government policies can increase welfare at home at the expense of other countries. The scope for the welfare improvement by using trade policies is however in practice very limited. Therefore political economy factors are the main drivers of trade policies. New political economy approach¹ to international trade emphasized that trade policy is the outcome of the interaction between politicians and citizens. Citizens can be organized into lobby groups.

Mayer (1984) assumes that trade policy is formed by majority vote within Heckscher-Ohlin framework. From Stolper-Samuelson theorem it follows that each individual has his/her optimum tariff rate which depends on his/her relative endowments of resources. Individual's optimum tariff rate maximizes individual's utility. It is assumed that preferences for tariff rates are single peaked and there are no voting costs. An equilibrium tariff rate for the economy is then described by median voter theorem (Black, 1948). The tariff preference of the median voter is selected as equilibrium tariff. The median voter is determined by the distribution of factor ownership and voting eligibility rules.

The import tariff is positive for people who are relatively well endowed with the import good's intensively used factor. The greater the difference between individual and

¹ Several contributions paved the way to the current state of the new political economy. These contributions include among others Downs (1957), Olson (1965), Becker (1983), Stigler (1971), Peltzman (1976).

national endowment ratios, the greater the deviation of individually optimal tariff rate from free-trade policy. The optimal tariff rate is zero for each person whose personal capital/labor ownership ratio equals the national capital labor ratio (Mayer, 1984).

Alesina and Rodrik (1994) compute capital/labor ratios for a median voter and for the whole economy. They find out that capital/labor ratio for the median voter is always lower than capital/labor ratio for the whole economy in each country considered. That is capital/labor ratio for median voter relative to capital/labor ratio for the whole country is in all cases lower than one.

Mayer (1984) predicts that the import tariff is positive when the import good is labor intensive and import tariff is negative when the import good is capital intensive. That is, import tariffs are positive in capital abundant countries and negative in labor abundant countries.

However, empirical observations do not confirm the theoretical predictions for negative import tariffs in developing countries. Fernandez and Rodrik (1991) provide explanation for this. Individuals have imperfect information. They know what are the aggregate gains and losses for the economy but they do not know whether they personally will be included among gainers or losers. In such a case individuals prefer certain status quo characterized by tariffs against import competition to uncertain prospects of elimination of tariffs or provision of import subsidies.

Dutt and Mitra (2002) extend Mayer's model. From their extension it follows that the higher income inequality (capital labor ratio of median voter being further away from the overall capital labor ratio for the economy) leads to more protectionist trade policies in capital abundant (industrial) countries and to more liberal trade policies in labor abundant (developing) countries. This prediction is confirmed empirically.

If lump-sum transfers are not prohibitively costly capitalists preferring free trade are able to compensate workers for the lost income and thus to preserve free trade. The outcome therefore depends on the transaction costs of income redistribution. This argument can be stated in a different way – using lobbying models. Consumers have difficulties to organize because of the free-rider problem while producer's groups tend to be privileged. Consumers are therefore unable to prevent trade barriers. Destler and Odell (1987) argue that firms in other sectors (like downstream firms) might lobby for free trade if they are negatively affected by trade barriers that for example increase the price of their inputs. According to Olson (1965) those industries that have small number of firms and that are highly concentrated are able to secure the highest protection.

From the lobbying models it follows that the producers tend to dominate the political scene. Policymaking is shaped by different demands of various lobbies. Some interest groups have more influence than the others. Lobbying scene is dominated by producers' groups rather than by consumers. Because of the political market policies tend to transfer funds from many to few beneficiaries. Furthermore, producers competing against imports are more powerful than exporters. From a status quo with trade barriers, importers are already in business while export sectors might be small and underdeveloped (Hillman, 1989).

The most prominent model of political economy of trade policy is Grossman and Helpman (1994) model. This model is based on previous writings of Magee, Brock and Young (1989) as well as on Peltzman (1976), Stigler (1971), and Hillman (1989). Grossman-Helpman model considers trade policy making as an interaction of policy makers and lobby groups. Incumbent politicians set the trade policy. Lobby groups who represent factor owners with stakes in certain industries try to influence politicians. Lobby groups present policy makers contribution schedules (implicit rather than explicit contracts) conditioned on passing different trade policies. The size of the contribution is set to maximize aggregate welfare of

lobby group members given the action of other lobbies. Policy makers are rewarded with donations if and only if they choose policies that are preferred by interest groups. Policy makers choose the trade policy (vector of trade taxes and subsidies) that balances contributions with deadweight cost caused by protection. The chosen trade policy maximizes welfare of politicians. The policy makers' objective function is linear in campaign contribution and social welfare. The objective function of policy makers reflects their desire for reelection and the probability of reelection increases linearly with campaign contribution and with utilities of voters. Additionally policy makers value donations because donations are used to retire campaign debts, to deter competition from challengers or as means to increase candidate's reputation as a useful quality fund-raiser. The interaction between politicians and special interests is akin to principal agent problem whereby politicians are agents and special interests are principals.

Grossman-Helpman model concludes that the government chooses trade taxes and subsidies in a way that benefits organized industries at expense of unorganized industries. Organized industries are those that make contributions to politicians. Additionally tariffs and subsidies are related to export supply and import demand elasticities. The more inelastic there is import demand, the higher import tariff. Furthermore, Grossman-Helpman model predicts that within organized industries, protection is higher in industries with lower share of imports on domestic production while for unorganized industries protection is positively related to the share of imports on domestic production.

Mitra (1999) extends the Grossman and Helpman model by considering endogenous formation of lobby groups. From Mitra's model it follows that free trade is a likely outcome when government places a heavy weight on social welfare in its objective function. Moreover, free trade can also result when government is highly responsive to special interests demands.

This outcome occurs because many special groups are formed and through the competition on political market they cancel out their impact on the government.

Bagwell and Staiger (2002) incorporate into the Mayer's (1984) and Grossman and Helpman (1994) models the terms of trade effect, i.e. they consider a large country case. Terms of trade effect provides an extra motivation for the government to impose tariff. Bagwell and Staiger consider the interaction of two large countries within Mayer's or Grossman and Helpman model. The Nash equilibrium outcome of such an interaction is not efficient; it makes both countries worse off relative to the politically optimal tariff without the terms of trade effect. Bagwell and Staiger (2002) conclude that WTO's rule of reciprocity improves on the efficiency of the outcome of mutual negotiation.

Goldberg and Maggi (1999) empirically test Grossman-Helpman model and find evidence in support of theoretical model's predictions. In addition to standard Grossman-Helpman model's variables Goldberg and Maggi add additional variables that were used in other studies on political economy of trade protection. These variables include employment size, sectoral unemployment rate, measures of unionization, changes in import penetration, buyer and seller concentration, etc. They find that none of the additional variables significantly improve the predictive power of Grossman-Helpman model. Goldber and Maggi estimate structural parameters of the model and find that the weight of welfare is around 95 percent while the weight of contributions around 2 percent.

Gawande and Bandyopadhyay (2000) also test the Grossman-Helpman model using NTB for cross-sectional US data. They conclude that the model is consistent with the data.

Devault (2005) tests the Grossman-Helpman political economy model of trade protection within a context of granting unilateral trade preferences to developing countries under the U.S. Generalized System of Preferences (GSP). The GSP is a system under which developed countries grant preferential tariff treatment to imports of certain products from

certain developing countries. The granted preferences are almost unilateral, i.e. the policy does not require the developing countries to grant similar access to their markets by the USA. Moreover, this context avoids the problems of hidden protection by nontariff barriers.

Devault's econometric model leads to the following conclusions:

- U.S. is less likely to grant preferences to imports that are either competitive or come from beneficiaries who limit the access they grant to U.S. exports
- Higher levels of trade creation are associated with higher tariffs.

Gawande and Krishna (2005) investigate empirically the Grossman-Helpman model in the presence of lobbying by upstream and downstream industries. He finds that protection is lower when downstream industries that use inputs from protected industry are well-organized. Gawande, Krishna and Robbins (2004) investigate the role of foreign lobbies in determination of domestic trade policy. Their empirical investigation is done within Grossman-Helpman model. They conclude that "foreign lobbying has a statistically and economically significant impact on trade policy". Foreign lobbying lowers trade barriers.

Political economy of RTAs

Grossman and Helpman (1995) identify the economic and political conditions that would lead to the formation of FTA between two countries. The model is based on Grossman and Helpman (1994) model which determines endogenously the set of initial trade taxes and subsidies. Then countries are allowed to form a FTA. Countries have to make decision whether to form a FTA or not. The free trade agreement arises as an equilibrium outcome of a negotiation between two governments taking into consideration contributions from lobbies and the utility of the average voter in two ways: a. FTA generates substantial welfare gains for average voter and negatively affected pressure groups fail to coordinate their actions and b. FTA generates substantial gains for actual or potential exporters in excess of the losses suffered by import-competing industries and political costs of reducing the welfare of an

average voter. The formation of FTA is politically most viable when there is a balanced trade between the countries and when FTA affords higher protection and trade diversion. Furthermore, exclusion of some sectors from FTA makes FTA more feasible than without exclusion. Politically viable FTA includes trade diversion and reduction of welfare.

Krishna's (1998) political economy model is based on Brander-Krugman (1983) Cournot model of international trade. Oligopolistic competition in segmented markets where firms produce goods that are perfect substitutes is considered. The agenda-setting government has to decide on bilateral or multilateral tariff reductions. Firms lobby for proposed trade regime changes if it helps them increase profits or against the change if it reduces firms' profits. Governments form decisions based on profits of domestic firms. Trade regime change is implemented when it increases profits of the relevant producers in both countries. Krishna concludes that preferential arrangements that divert trade are politically more likely to be supported. The logic is the following. By forming a RTA domestic firms gain because of preferential access to partner's country market. They also lose because domestic country grants similar access at home market to foreign firms. However, if domestic firms gain market share of firms from outside the RTA then there is a net benefit. The second conclusion is that preferential arrangements reduce incentives for multilateral liberalization.

Both Grossman and Helpman (1995) and Krishna (1998) conclude that politically viable Free Trade Arrangements generate substantial trade diversion and are therefore socially undesirable. Both models treat external tariffs as exogenous. There are several papers that consider the impact of the formation of RTA on external tariffs. Cadot, Melo, and Orlarreaga (1999) investigate how tariffs against nonmembers of RTA change after the formation of RTA. Using Grossman Helpman (1995) political economy model Cadot et al. conclude that the competition for tariff revenue drives external tariffs of members of free trade area down to free trade levels. The situation is different for customs union where the cooperation of lobbies

leads to increased protection relative to pre customs union time. The deeper the integration the better there are conditions for increasing protection. In the deepest form of integration external tariffs can be higher than equilibrium tariffs of all individual members. FTA dominates CU from welfare perspective. Panagaryia and Findlay (1996) also conclude that the formation of RTA rises external tariffs. They argue that lobbying against imports from member state became less effective and therefore extra lobbying effort is put into the lobbying against nonmembers imports.

A similar conclusion is achieved in the non-reciprocal setting. From dynamic point of view non-reciprocal preferences delay market liberalization in beneficiary countries and slow multilateral reductions of trade barriers. Beneficiaries are not motivated to open their own markets and are opposed together with protectionist forces in developed countries to reductions of MFN tariffs as this move would reduce the value of preference margins (WTO, 2004).

Ornelas (2005) uses an oligopolistic-political-economy model where both decision to form FTAs as well as external tariffs are endogenously determined. Ornelas concludes that FTAs are primarily beneficial to multilateral trading system. The reason is that FTAs induce governments to lower external tariffs. Furthermore, Ornelas concludes that FTAs tend to enhance support for further liberalization at the multilateral level.

Baldwin (1995) advances a domino theory of regionalism that explains the spread of RTAs. Baldwin observes rapid increase of membership of RTA and contrasts it with slow progress of trade liberalization under General Agreement for Trade and Tariffs. The cumbersome GATT negotiations are not at fault for this. Rather the creation of US – Mexico free trade and the Single Market in the EC started a domino effect that led to new waves of integration. US – Mexico free trade are as well as the Single Market were formed because of geopolitical, ideological or philosophical rather than commercial reasons. These integration

schemes locked out exporters from third countries outside. These exporters felt threaten and urged their governments to negotiate accession to those two regional blocs. The political economy forces driving domino effect are strengthened by a tendency of special interest groups to fight harder to avoid losses than to secure gains. Baldwin explains this asymmetry by sunk costs that create quasi rents. New export opportunities lead to attraction of new firms and extra profit dissipates. On the other in case of threat of shutting out the export markets firms are willing to invest into lobbying large amount of money to reverse this development.

Bhagwati (1993) divides the interplay between the formation of regional trade agreements and global liberalization within WTO into two distinct questions:

1. What is the impact of successive trade agreements on world welfare?
2. Does the existence of an option to form RTA have an impact on the multilateral trade negotiations within WTO?

Krugman (1991) analyzes what happens to the world welfare as the number of RTAs changes. He assumes that all countries belong to RTAs and the move towards free trade happens if the number of RTAs is reduced from many to one. If we start with many RTAs and then reduce them there are two effects: positive effect because more trade is conducted with no tariffs and negative effect due to higher level of trade diversion. Negative effect is reinforced by higher optimal tariffs of bigger RTAs. Krugman (1991) observes a U shaped world welfare when number of RTAs is progressively reduced towards one. A fall of number of RTAs from very large number to smaller number will reduce welfare. If there are many RTAs there is little trade diversion and optimal tariff for a single small RTA is low. On the other hand, the highest world welfare is achieved under global free trade when there is a single RTA encompassing the entire world. Krugman's model considers two parameters: number of RTAs and elasticity of substitution between the products of any two countries (provinces). For a wide range of elasticities of substitution the world's welfare is minimized

when the number of RTAs is three, which is the number of trading blocs observed in reality (Europe, North America, East Asia).

Levy (1997) addresses the second question. He assumes that initially there are two countries in autarky. In the first stage these countries decide whether to form RTA. RTA is formed when median voters in each country prefer RTA to autarky. In the second stage they decide whether to liberalize trade multilaterally, i.e. whether to move from RTA to global trading system. Each member of the RTA has a veto power in this decision. It is also assumed that median voters in both countries prefer global free trade to autarky. However, median voters do not have to prefer global free trade to RTA.

If both countries agree to form RTA and then to move towards global free trade then the existence of the option to form RTA has no impact on multilateral trading system. The same outcome occurs when at least one country rejects the formation of RTA and then both countries move to global free trade. There is some interaction between RTA and global trading system when both countries agree to form RTA and then they both reject global free trade and when both countries agree to form RTA and then one country blocks the move to global trade. Levy (1997) states that the last possibility can be assumed away. A home country would not like to form a RTA with a partner if the home country had an expectation that the partner country would block its later move towards free trade that benefits the home country.

Levy demonstrates that under Heckscher-Ohlin setting the possibility that both countries benefit from the formation of RTA and then they do not benefit from the move towards global free trade cannot occur. In such a case RTA is not a stumbling bloc of multilateral trade liberalization. However, under the monopolistic competition the formation of RTA can block multilateral trade liberalization.

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