

The effects of free trade areas on non-members: Modelling Kemp–Vanek admissibility

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Abstract

A multi-sector multi-country Numerical General Equilibrium model is used to endogenously determine the trade taxes that FTA members need to charge on non-member trade so that after the FTA is formed, FTA-member trade volumes with non-members remain at their pre-FTA level. We apply the notion of Kemp–Vanek admissibility in McMillan [McMillan, J. (1993), Does regional integration foster open trade? Economic theory and GATT's Article XXIV" In Anderson, K. & R. Blackhurst (Eds.), *Regional Integration and the Global Trading System*. London: Harvester-Wheatsheaf] to construct an FTA which does not make non-members of the FTA worse off, ensuring that the FTA is necessarily a building block and not a stumbling block to global free trade. We implement the path-independent welfare decomposition in Harrison et al. [Harrison, G., Rutherford, T. & Wooton, I. (1993). An alternative welfare decomposition for customs unions. *Canadian Journal of Economics*, 26(4), 961–68]. Results of such experiments are relevant to the current debate under the WTO's Doha Round of trade negotiations over GATT (1994) Article XXIV which evaluates the consistency of FTAs with the WTO.

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1. Introduction

While there has been and continues to be substantial liberalization of trade under the auspices of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO),

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more and more countries are pursuing policies of trade liberalization through Preferential Trade Agreements (PTAs). There continues to be serious debate over the issue of whether such PTAs promote deeper liberalization of trade than would be possible through the GATT/WTO and are therefore beneficial, or whether such PTAs generate welfare gains for PTA members at the expense of non-members.

In evaluating whether PTAs are welfare-improving or welfare reducing, theoretical and applied models typically use the notions of trade creation and trade diversion described in [Viner \(1950\)](#). Detailed and disaggregated measures of trade creation and diversion are routinely used to evaluate whether PTA members benefit by joining a proposed PTA. But when it comes to the effects of a PTA on non-members, many studies either ignore the impact of a PTA on non-members, or only present aggregate effects of a PTA on non-members. The objective of this paper is to describe a method of evaluating the effects of PTAs which focuses particularly on non-members, and to implement a method of constructing PTAs which does not harm non-members, consistent with many theoretical studies in the trade literature on the formation of PTAs. We demonstrate how such a method of constructing PTAs could be implemented in a Numerical General Equilibrium (NGE) model of PTA formation, and apply the notion of Kemp–Vanek admissibility described in [McMillan \(1993\)](#) to our measures of the effects of PTA formation on non-members.

There are three principal contributions made by this paper. First, we demonstrate how to construct a PTA which is Kemp–Vanek admissible, building on the large body of theoretical work of PTA formation begun by [Kemp \(1964\)](#), [Vanek \(1965\)](#), and [Kemp and Wan \(1976\)](#), by constructing a PTA which ensures that trade volumes between PTA members and non-members do not change after formation of the PTA. An important benefit is that such a Kemp–Vanek admissible PTA will always be a stepping stone on the path to global free trade, since non-members of PTAs are never made worse off due to the formation of the PTA, and there always exists a way to ensure that all PTA members benefit from membership in the PTA. While such Kemp–Vanek admissible PTAs have received considerable attention in the theoretical literature, with existence of such PTAs demonstrated for Free Trade Areas and Customs Unions, assuming either competitive or imperfectly competitive market structures, there have as yet been no studies which numerically illustrated the characteristics of such PTAs. This paper aims to fill this gap, allowing us to numerically demonstrate how a Kemp–Vanek admissible PTA differs from a simple PTA which does not consider the effects of the PTA on non-members.

Second, we build on recent contributions by [Srinivasan \(1997\)](#), [Bond, Syropoulos, and Winters \(2001\)](#) and [Wong \(2006\)](#) which consider the question of how PTA members need to adjust their external tariff on trade with non-members of the PTA to hold constant imports from non-members into the PTA. While these are all theoretical papers which describe situations in which PTA members may need to raise or lower tariffs on non-member trade for a PTA to be Kemp–Vanek admissible, our NGE model allows us to explicitly solve for the external tariffs charged by PTA members on non-member trade which ensure that non-members are not harmed by the PTA. The ability to show how tariffs need to be changed to keep non-members from being made worse off due to the formation of a PTA should be useful in evaluating the admissibility of a PTA under Art.XXIV of the GATT/WTO.

For our purposes it will be important to demonstrate aggregate and disaggregate measures of the welfare effects of PTA formation. Many studies have noted that the commonly applied notions of trade creation and trade diversion are not well suited to this task. For example, [Lipsey \(1957\)](#) writes that while “the distinction between trade creation and trade diversion is fundamental for classifying the changes in production consequent on the formation of a customs union, it is not one on which welfare conclusions can be based”, and [Harrison, Rutherford, and Wooton \(1993\)](#)

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