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On necessarily welfare-enhancing free trade areas

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Abstract

The well-known Kemp–Vanek–Ohyama–Wan proposition establishes that if two or more countries form a customs union (CU) by freezing their net external trade vector through a *common* external tariff and eliminating internal trade barriers, the union as a whole and the rest of the world cannot be worse off than before. Owing to the fact that a Free Trade Area (whose member countries impose country specific external tariff vectors) does not equalize marginal rates of substitution across its member countries (in contrast to a CU), the literature has been unable to provide a parallel demonstration regarding welfare improving Free Trade Areas (FTAs). The present paper eliminates this gap. In extending the result to the case with intermediate inputs, the paper also sheds new light on the rules of origin required to support such necessarily welfare enhancing FTAs. We show here that provided no trade deflection is permitted, all that is required by way of rules of origin is that the goods produced within the union – whether final or intermediate – be allowed to be traded freely. The proportion of domestic value added in final goods does not enter as a criterion in the rules of origin. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

The literature on preferential trade areas (PTAs), being concerned essentially

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with 'second-best' contexts,[1] rarely offers clear-cut answers with respect to the question of the welfare impact of the formation of trading blocks between nations. A singular exception is the well-known result relating to customs unions (CUs)[2], stated independently by Kemp (1964) and Vanek (1965) and proved subsequently by Ohyama (1972) and Kemp and Wan (1976), that if two or more countries freeze their net external trade vector with the rest of the world through a set of common external tariffs (CET) and eliminate the barriers to internal trade, the welfare of the union as a whole necessarily improves and that of the rest of the world does not fall.[3]

The logic behind the Kemp–Vanek–Ohyama–Wan theorem is as follows: By fixing the combined, net extra-union trade vector of member countries at its pre-union level, we can guarantee non-members their original level of welfare. Moreover, taking the extra-union trade vector as an endowment, the joint welfare of the union is maximized by equating the marginal rate of substitution and marginal rate of transformation for each pair of commodities to each other and across all agents in the union. This implies the elimination of all internal distortions. The PTA thus constructed has a common internal price vector implying further a *common* external tariff; it is therefore a Customs Union.

More than three decades have passed since the publication of the original statement of the Kemp–Vanek–Ohyama–Wan theorem. However, progress in the literature on this subject has been minimal. In particular, we still lack a parallel result on Free Trade Areas (FTAs) where members could use *member-specific* external tariff vectors rather than the common external tariff vector required by CUs. The purpose of the present paper is to fill this gap in the literature – a major gap, in our judgment, given the relative popularity of FTAs over CUs in practice.

It should be straightforward to see that a demonstration regarding welfare-improving FTAs is substantially more complex than that for CUs: In the case of an FTA, member-specific tariff vectors imply that the domestic-price vectors differ across member countries. This, in turn, implies that an FTA (as opposed to a CU) generally fails to equalize marginal rates of substitution across union members.[4] It is this difficulty which accounts for why the Kemp–Vanek–Ohyama–Wan result has not been extended to FTAs to-date.

In this paper, we demonstrate that as long as goods produced within the union move free of duty across member-country borders, a welfare-enhancing FTA can

[1]On some general results concerning policy intervention in the presence of second best distortions and a unification of such results in the international trade literature, see Krishna and Panagariya (2000).

[2]To get the basic definitions out of the way: A Customs Union (CU) is a preferential trade agreement in which member countries maintain a common external tariff vector against non-members. In contrast, in a Free Trade Area (FTA), member countries may maintain member-specific external tariff vectors. For a recent, comprehensive survey of the literature on preferential trading, see Panagariya (2000).

[3]Panagariya (1997) offers a detailed history of this result.

[4]It should be readily evident that this non-equalization of the marginal rates of substitution across agents within the FTA implies that the Kemp–Wan proof methodology cannot be directly applied here.

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