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Politics of free trade areas: tariffs versus quotas

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Abstract

In this paper we compare and contrast the political viability of bilateral Free Trade Area (FTA) Agreements in the presence of tariffs and quotas. Assuming that the government maximizes a weighted sum of welfare and producer profits, we show that the political viability of FTAs varies according to whether trade restrictions take the form of tariffs or quotas. A key result is that whereas an FTA is unambiguously rejected by one of the countries under a tariff, it may be endorsed by both trading partners under a voluntary export quota or import quota that provides equal protection as the tariff.

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1. Introduction

A key issue in the recent literature on preferential trading, surveyed systematically in Panagariya (1999), concerns the conditions under which free trade

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areas (FTAs) are likely to be endorsed by potential members.¹ In an important paper, Grossman and Helpman (1995) address the question in a small-union model in which production activity is characterized by perfect competition. Relying on the political-economy model developed in Grossman and Helpman (1994), they conclude that a bilateral free trade area (FTA) is more likely to be endorsed by both partners when trade between them is approximately balanced, tariff levels are similar and the arrangement is trade diverting.² Krishna (1998) uses an imperfect-competition model and also finds that trade diverting FTAs are more likely to be endorsed. Duttagupta and Panagariya (2000) introduce an intermediate input into the Grossman and Helpman (1995) model and show that the rules of origin can make initially infeasible FTAs become feasible, although the FTAs that are supported by the rules of origin can be welfare reducing.

To-date, the issue of the viability of FTAs has been analyzed exclusively in the presence of tariffs. In this paper, we ask whether the presence of quantitative trade restrictions rather than tariffs in certain sectors may make FTAs politically more acceptable.³ We find this to be indeed true when the quantitative restrictions take the form of voluntary export quotas. Specifically, for a given level of initial protection, an FTA that is rejected in the presence of a tariff may be accepted in the presence of a voluntary export quota that restricts imports by equal amount.

From a theoretical standpoint, our paper may be viewed as a contribution to the vast body of the literature on tariffs versus quotas, stimulated by Bhagwati (1965). From the policy standpoint, our analysis contributes to a more complete understanding of the politics of FTAs. For instance, the Multifibre Arrangement (MFA) was in existence at the time the North American Free Trade Agreement (NAFTA) was negotiated.⁴ Similarly, many of the European association agreements have

¹Several of the political-economy theoretic questions on preferential trading were initially raised and discussed in Bhagwati (1993), Richardson (1993), Levy (1997), Panagariya and Findlay (1996) and Cadot et al. (1999) analyze formally some of the theoretical issues raised by Bhagwati. Among recent surveys of the literature on preferential trading are Bhagwati and Panagariya (1996), Bhagwati et al. (1998), Fernandez and Portes (1998), Panagariya (1999) and Winters (1996). Many of the important contributions to the theory of preferential trading, both old and new, have been brought together in a recent volume edited by Bhagwati et al. (1999).

²The political support function underlying the Grossman and Helpman (1994, 1995) analyses can be traced back to at least Baldwin (1987).

³To our knowledge, the only contribution to consider the role of MFA-type restrictions in a political economy model of preferential trade arrangements (PTAs) is the as yet unpublished paper by Cadot et al. (1998). The focus of these authors is on the optimal choice of the voluntary export quotas on outside countries in response to an exogenous decision to form the FTA, however.

⁴Even though the NAFTA members expected MFA to be dismantled under the Uruguay Round Agreement, its role in the negotiations cannot be ignored altogether for three reasons. First, at the time the NAFTA negotiations concluded, the UR Agreement was not a certainty. Second, under the Agreement on Textiles and Clothing (ATC), the MFA removal is heavily back loaded such that much of the liberalization will take place on January 1, 2005. Therefore, it provides continued protection for at least the first 10 years of NAFTA. Finally, many policy analysts have also expressed skepticism towards effective implementation of the ATC, arguing that anti-dumping will likely replace it.

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