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Endogenous free trade agreements and the multilateral trading system

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Abstract

I evaluate in this paper the impact of free trade areas (FTAs) on the world trading system. I use an oligopolistic-political-economy model where the external tariffs of FTA members, as well as the decision to form FTAs, are endogenously determined. In this context, I show that FTAs are primarily beneficial to the multilateral trading system. This conclusion is based, first, upon the finding that FTAs induce their member governments to lower their external tariffs, and to do so deeply enough to enhance trade even between FTA members and non-members. While this ensures gains for the latter, in general FTA members may not gain. I show, however, that governments will endorse *only* welfare-improving arrangements, in spite of their political motivations; as a result, FTA members benefit from ratified arrangements as well. Finally, I find that FTAs, by reducing the role of special interests criteria in governments' trade regime decisions, also tend to enhance support for further liberalization at the multilateral level.

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1. Introduction

There are over 150 regional trade agreements currently in force, with most countries in the world participating in at least one of them. Policymakers often regard these trade ini-

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tiatives as a positive effect of a more “globalized” world. Within the economics profession, however, there remains significant disagreement about the consequences of “regionalism.”

The ongoing debate about regionalism has two main dimensions. One relates to the direct impact of preferential trading blocs on world trade flows and welfare, the other to their effect on the incentives for further liberalization on a non-discriminatory basis. [Bhagwati \(1993\)](#) alludes to these as the “static” and the “dynamic” time-path issues, respectively. In this paper, focusing on preferential arrangements in the form of free trade areas (FTAs)—where participating countries eliminate tariffs against each other but set tariffs against excluded countries independently¹—I adopt an oligopolistic-political-economy model to analyze both issues in a unified framework. In doing so, I treat the trade regime, as well as the trade policies (particularly the choice of external tariffs) under each trade regime, as endogenous decisions.

This is not the first attempt to analyze FTAs taking into account their endogeneity or the endogeneity of external tariffs. As I point out below, external tariffs have been addressed in previous “static” analyses of FTAs, and the endogeneity of trade agreements has been accounted for in recent analyses of their “dynamic” effects. However, the endogeneity of *both* FTAs and external tariffs in a common setting has not been considered in previous studies. The present analysis highlights the importance of taking this perspective to understand the effects of regionalism.²

Previous studies indicate that preferential liberalization affects external tariffs. [Kennan and Riezman \(1990\)](#) find that countries tend to reduce their external tariffs after entering in an FTA. [Richardson \(1993\)](#) shows that governments may lower external tariffs to lessen the negative impact on tariff revenue caused by the shift of imports from outsiders to FTA partners. [Bagwell and Staiger \(1999a\)](#) indicate that terms of trade changes constitute an extra force toward lower external tariffs.

Other authors have suggested that countries entering in free trade areas may also have reasons to raise their non-preferential tariffs. [Cadot et al. \(1999\)](#) analyze this issue in a political economy model a la [Grossman and Helpman \(1994\)](#). They find that, in the formation of a bilateral FTA, one member will necessarily reduce its external tariffs. However, if general equilibrium effects that travel through the wage rate are sufficiently strong, the other member’s external tariffs may rise. [Panagariya and Findlay \(1996\)](#), assuming that tariffs arise from the allocation of labor into lobbying activities, argue that an FTA—by making lobbying against partners innocuous—reduces the overall demand for labor, thus lowering wages and making lobbying against third countries cheaper. In that

¹ Custom unions—which are not dealt with here—constitute the other main form of preferential liberalization. Unlike free trade areas, members of customs unions adopt common external tariffs. According to the World Trade Organization, over 90% of the existing preferential agreements consist of free trade areas.

² [Grossman and Helpman \(1995, p. 669\)](#), in studying governments’ incentives to form FTAs, acknowledge the desirability of an endogenous treatment for the external tariffs: “We recognize that this assumption [of exogenous external tariffs] is not without fault. [...] A more complete analysis—which would allow for an additional stage of tariff setting after the FTA issue were resolved—would certainly be desirable but is beyond the scope of the present paper.” As I will show, this endogenization can actually reverse the main conclusions of their paper.

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