



# Trade policy of a free trade agreement in the presence of foreign lobbying<sup>☆</sup>

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## ABSTRACT

This paper studies the effect of foreign lobbies on trade policy of a country which is a member of a Free Trade Agreement (FTA). It uses a monopolistically competitive political economy model in which the government determines external tariffs endogenously. The effect of foreign lobbying under the FTA is examined empirically using Canadian industry-level trade data that allow differentiating of lobby groups by the country of origin. The analysis suggests that the presence of foreign lobbying has a significant effect on the domestic trade policy. The heterogeneity of foreign lobbies is also important: the presence of an organized lobbying group in an FTA partner country tends to raise trade barriers while an organized lobbying group of exporters from outside of the FTA is associated with less protection.

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## 1. Introduction

In the political economy literature a growing number of studies view trade policy as an endogenous outcome of lobbying activity by special interest groups. Several authors (Goldberg and Maggi, 1999, Gawande and Bandyopadhyay, 2000) have confirmed that lobbying intensity by domestic firms is one of the main determinants of the cross-industry pattern of protection. More recently, Gawande et al. (2006) also find that lobbying by foreign firms for trade barriers reduction has a significant effect on the structure of tariffs across industries. However, if a country is a member of a regional free trade agreement (FTA) and foreign firms can affect the government's decision regarding trade policy, it becomes necessary to distinguish foreign lobbying from within and outside of the FTA. Organized foreign interests with preferential market access will lobby for more protection against other foreign firms, and the trade agreement may become more protectionist with a strong lobby group in a prospective FTA partner country. Active foreign lobbying under the preferential

trade agreement may not only lead to an increase in trade barriers, but also make welfare-reducing trade agreements politically feasible.

In this paper I analyze the effect of foreign lobbying on domestic trade policy when the country is a member of a preferential trade agreement using Canadian post-NAFTA trade data. This analysis reveals two main results. First, the activity of foreign lobbyists in Canada is a significant determinant of the Canadian trade policy, and sectors in which foreign firms without preferential market access are politically organized tend to receive less protection. This result supports the previous finding by Gawande et al. (2006) for the US. Second, NAFTA has an important effect on the structure of foreign lobbies. The data confirm that foreign firms with preferential market access lobby for more protection just as domestic firms do. This result has important implications for the effect of an FTA on a country's trade policy. It implies that prior to NAFTA, US firms lobbied for Canadian trade barriers reduction like all other foreign firms, but once NAFTA was signed, they switch to lobbying for trade barriers increase. As a result, an FTA with a large and politically strong partner country may raise trade barriers and increase trade distortions, making trade policy of regional trading blocks more protectionist.<sup>1</sup>

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<sup>1</sup> Two considerations should be taken into account when partner country lobbying for more protection is considered. First, the WTO tariff binding constrains the lobbying opportunities by the partner country firms; however, they may still play an important role in the future and impede multilateral trade liberalization in those sectors. Second, the WTO precludes countries from raising their tariffs once the FTA is signed. Yet foreign lobbies may oppose further tariff reduction as described above and use anti-dumping and countervailing measures to gain protection.

This paper is the first one that analyzes from theoretical and empirical points of view the effect of foreign lobbying on domestic trade policy in the presence of an FTA. The political economy model presented in this paper incorporates a monopolistically competitive market structure into the Grossman and Helpman (1994) 'protection for sale' setup (henceforth GH) to analyze the role of foreign lobbying in the making of national trade policy. The framework is further extended by allowing for two types of foreign interest groups, namely, lobbying groups formed by firms from an FTA partner country and by firms from countries outside of the FTA, aggregated into the rest of the world (ROW). This differentiation of foreign lobbies by market access is important in the presence of an FTA. When two countries join a regional trade agreement, granting zero import tariffs to each other, firms from countries with preferential market access will lobby for more protection under the FTA to lock it from competition from the ROW firms, while firms from outside of the FTA will continue to lobby for trade liberalization. This differentiation of foreign lobbying objectives, that follows from the presence of the FTA, implies that in a world where almost every country is a part of at least one regional trade agreement, a complete theory of the effect of foreign lobbying on the national trade system should take this differentiation into account.

The model of foreign lobbying in the presence of the FTA is tested using Canadian post-NAFTA trade data. The empirical analysis suggests a strong and statistically significant effect of domestic and foreign lobbying on Canadian trade policy, and points to the importance of distinguishing partner country lobbying from ROW lobbying. Using data on lobbying intensity by sector and by country of origin, this paper verifies that the main predictions of the model are consistent with the data. First, the importance of both partner country and ROW foreign lobbying under the FTA is confirmed in the Canadian data: while the presence of an organized domestic lobbying group raises industry import tariffs by 3–5% relative to an unorganized industry, organized partner-country lobbying would raise it by 1–2%, and foreign lobbying from the ROW would lower it by 2–3%. These results are economically meaningful and confirm the main prediction of the model that foreign firms with preferential market access behave just as domestic firms do, which introduces an additional distortion in the policy making process.

Second, the empirical evidence shows that even politically unorganized sectors receive a positive level of protection from the government of 2–4% import tariff, providing support for the imperfectly competitive structure of the model. Additionally, an important contribution of this work to the political economy literature of trade is its determination of more plausible values for the government's valuation of political contributions. In this paper, the government is estimated to value political contributions more than national welfare, which is in sharp contrast with previous tests of the benchmark GH specification in which governments were found to have stronger preferences for welfare (Goldberg and Maggi, 1999; Gawande and Bandyopadhyay, 2000). This result explains why relatively small political contributions may have strong policy effects.

My empirical results provide a new perspective on the effect of regional trade blocks on trade policies of member countries. Most of the literature on endogenous trade policy concludes that a country is more likely to reduce its external tariff when it enters an FTA. Richardson (1993), Bagwell and Staiger (1997), and Bohara et al. (2004), Bond et al. (2004) show that a welfare-maximizing government will lower external import tariffs once an FTA is formed. By doing this, the government restores part of the tariff revenue lost due to the shift in import demand from the ROW to the partner country firms.

Ornelas (2005a,b) examined the political economy of an FTA without foreign lobbying using an oligopolistic market structure in the GH model. He shows that FTA formation weakens the lobbying power of domestic firms because the elimination of tariffs between FTA member countries shifts part of the tariff rent from domestic firms

towards firms from a partner country. The model in this paper, however, allows for cross-border lobbying activity, which lessens the effect introduced by Ornelas (2005a,b) since the reduction in political activity by domestic firms is coupled with an increase in contributions for protection by the FTA partner country firms. As a result, in the presence of foreign lobbying a country's government may in fact want to raise external tariffs under the FTA when strong lobbying by an FTA partner country puts extra pressure on the government for higher trade barriers.

Activities of foreign interest groups in national policy-making have received a growing attention in the political economy literature. Many scholars have evaluated the intensity of foreign lobbying in the US and argue that it has high potential for policy influence. Mitchell (1995) found that foreign affiliates in the US contributed 5.6% of total corporate political contributions in 1987–88, and 42% of them hired professional lobbyists to promote their interests in Washington. Hansen and Mitchell (2000) claim that, although foreign corporations make lower political contributions than domestic ones due to the existing legal restrictions, they are just as intensive as domestic corporations with respect to lobbying activity and lobbying expenditures.

While it has been argued that foreign corporations are quite influential in US politics, very little research has been done on their effect on trade policy outcomes. In their pioneering work, Gawande et al. (2006) demonstrate that foreign agents lobbying expenditure in the US is even greater than political contributions by domestic corporations, and that the elasticity of the US import tariff with respect to foreign lobbying is almost as big as with respect to the domestic one. Their paper was the first to show that foreign lobbying is an important factor in the formation of national trade policy and argue that foreign lobbying may be beneficial to the country's trade policy as a counter-pressure to domestic interests, helping to reduce distortional trade barriers. In contrast, my paper suggests that the above argument is invalid in the presence of preferential trade agreements, when firms from a partner country prefer to maintain high discriminatory tariffs for third-country imports. Since most of the countries are members of at least one preferential trade agreement, this paper demonstrates that cross-border lobbying may stimulate more protectionist trade policies of FTAs and disrupt multilateral trade liberalization.

The paper is structured as follows. Section 2 provides some evidence on the lobbying activities of foreign firms in Canada. Section 3 introduces the modified GH version of the model that allows imperfectly competitive market structure and two groups of foreign lobbies, and motivates the empirical methodology. Section 4 describes the data. Estimation results are presented in Sections 5 and 6 concludes.

## 2. The role of foreign lobbies in Canada

The first law that regulates the activity of domestic and foreign lobbyists in Canada is the Canada Elections Act, introduced in 1960. This law regulates the amount of political contributions by Canadian nationals to political parties and explicitly bans the use of political contributions from foreigners.<sup>2</sup>

However, this law suffered from a lack of transparency in the lobbying process and on September 30, 1989, a Lobbying Registration Act (LRA) came into force. This piece of legislation introduced a definition of a lobbyist and a requirement for lobbyists to register with the Lobbyists Registrar. But more importantly, it requires lobbyists to provide information about the name and business address of the organization "that has a direct interest in the outcome of the lobbyists' activities on behalf of the client," all of its subsidiaries and corporate

<sup>2</sup> "No person or party shall accept or use contributions from a person who is not a Canadian citizen..., corporation or association that does not carry on business in Canada, foreign political party, or foreign government," (S.217).

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