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Trade diversion and declining tariffs: evidence from Mercosur

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Abstract

This paper empirically examines the alternative posed by Richardson [J. Intern. Econ. 34 (1993) 39] to the traditional view that trade integration may exacerbate inefficiencies. Richardson's hypothesis boldly predicts that trade diversion (and trade creation) may actually cause tariffs to decline! The hypothesis is fundamentally attributable to the presence of a political component in the governments' objective functions. A cross-sectionally rich data set on trade and tariffs from the Mercosur-pact countries, primarily Argentina, is used. The evidence yields surprising conclusions about the validity of endogenous tariff determination in models of trade integration.

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1. Introduction

The objective of this paper is to test hypotheses from the emerging literature on endogenous tariff determination in models of free trade agreements (FTAs). Introducing political economy into the traditional analysis of trade agreements has enriched such models by imparting a real world flavor. This paper examines a model of

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endogenous tariffs due to [Richardson \(1993\)](#) that challenges the classical view that trade integration generally isolates the trade bloc from the rest of the world. The idea behind the theory is simple. If the level of tariff protection in an industry is due in part to the political power wielded by the industry, then as the political power of the industry diminishes with trade integration so will the level of protection afforded to the industry.

While Richardson's model is specific to industries which experience trade diversion, even industries in which there is trade creation are candidates for endogenous tariff diminution. In the case of trade diversion, supply from the (less inefficient) FTA-partner country replaces imports that previously originated in the (most efficient) rest of the world. Hence, such industries experience a reduction in their political power as tariff-free imports from a possibly large FTA-partner country shrink their domestic output. In the case of trade creation, supply from the (less inefficient) FTA-partner country replaces output that previously originated in the (most inefficient) home country. These industries are therefore likely to see a reduction in tariffs on their imports from the rest of the world, as their political power is reduced. Eventually, these industries may experience true free trade as their external tariffs go to zero. Formation of the trade bloc thus promotes broader free trade.

In the area of trade integration there has been little empirical work on the relevance of models of endogenous tariff. [Olarreaga and Soloaga's \(1998\)](#) and [Calfat et al., \(2000\)](#) examination of the [Grossman and Helpman \(1995\)](#) model of the formations of FTAs is a notable exception. Since political economy is increasingly featured in the trade integration literature (e.g. [Grossman and Helpman, 1995](#); [Krishna, 1998](#); [Maggi and Rodriguez-Clare, 1998](#)) a detailed empirical examination of the validity of this class of models is warranted. To this end, this paper investigates the counter-intuitive prediction from [Richardson \(1993\)](#) about trade diversion and declining tariffs under a free-trade agreement. The paper proceeds with an investigation of the hypothesis in the presence of no specific alternative, in the spirit of first-generation empirical work on the political economy of trade integration. The ambitious task of comparing political economy models with their more traditional counterparts is left to second-generation studies.

A detailed cross-industry data set on intra-union and extra-union trade and tariffs from Mercosur over the period 1991–1996 is used in this study. The Mercosur free trade pact formed in 1991 among Argentina, Brazil, Paraguay and Uruguay is well suited for the purpose of examining Richardson's hypothesis. This study employs data on Argentinian tariffs before and after the trade agreement. Being the smaller of the two leading Mercosur countries (Brazil being the other), many of its industries faced the possibility of decline due to free trade with Brazil, a country twice its size in total output. This setting is apt for an examination of whether industries that declined due to the free trade agreement, experienced increased or lowered protection.

The paper proceeds as follows. Section 2 provides specific information pertaining to the nature of trade liberalization in the Mercosur partner countries before and after the formation of the trade agreement. In Section 3, two hypotheses from Richardson's model are derived, and the method of testing them is developed. In Section 4 the data are described and empirical results are analyzed in light of the theory. Section 5 makes concluding observations.

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