



Preferential versus multilateral trade liberalization and the role of political economy



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ABSTRACT

In this paper we analyze the effect of the freedom to pursue preferential trade liberalization, permitted by Article XXIV of the GATT, on country's incentives to participate in multilateral negotiations and on feasibility of global free trade. We present a model, in which countries choose whether to participate in preferential or multilateral trade agreements under political pressures from domestic special interest groups. We show that heterogeneity in political preferences across countries plays an important role in determining the relative merits of preferential and multilateral approaches to trade liberalization. On one hand, the opportunity to liberalize preferentially may be necessary to induce countries with strong political motivations to participate in multilateral free trade negotiations. On the other hand, when countries share similar political preferences, multilateral free trade that would have been politically supported otherwise becomes unattainable if countries can pursue preferential liberalization.

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1. Introduction

Since the establishment of the General Agreement on Tariffs and Trade (GATT), trade reforms have proceeded along three main fronts: unilaterally, preferentially with a few partners, and multilaterally within the GATT, now subsumed by the World Trade Organization (WTO). Of the three approaches, preferential trade liberalization gained the most popularity in recent years, with the number of preferential trade agreements (PTAs) increased fourfold since completion of the Uruguay round of the WTO negotiations in 1994.² In contrast, the last round of the WTO trade talks – the Doha Round – have failed to come to a fruitful conclusion despite thirteen years of intense negotiations. Although PTAs are sanctioned by the Article XXIV of the GATT in order to promote freer trade, they come into direct conflict with the main GATT/WTO principles of non-discrimination. As such, there are concerns that the spread of PTAs may hurt the multilateral trading system and serve as an alternative, rather than a complement, to multilateral trade liberalization.³

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² As of 15 June 2014, 585 notifications of PTAs had been received by the WTO. Of these notifications, 379 PTAs are already in force with others scheduled for implementation in the near future.

³ While the most favored nation (MFN) clause requires the WTO member countries to undertake trade liberalization on a non-discriminatory basis, Article XXIV of the GATT permits a group of countries to pursue PTAs under which they can grant tariff concessions to each other that they do not have to extend to other WTO members.

Diverse interests of the WTO members are often blamed for the decline in multilateralism and proliferation of PTAs. In particular, differences in political idiosyncrasies and protectionist preferences across countries may induce “similar” countries to negotiate PTAs rather than participate in large-scale multilateral deals. Therefore, the political economy factors may play an important role in the analysis of PTAs, and the goal of this paper is to study how the freedom to pursue PTAs affects countries' choice to participate in preferential versus multilateral trade agreements in the presence of cross-country heterogeneity in political preferences.

Our point of departure is a world in which all countries are the WTO members so that each one has to apply the same MFN tariff rate towards other members. A group of countries can choose to lower tariffs towards each other as long as these preferences are extended to other countries,⁴ and we call such tariff reduction arrangement a *multilateral agreement* (MA). As such, we do not impose reciprocity in multilateral negotiations and allow each country to decide whether or not to participate in multilateral tariff reductions. We next introduce the option for countries to form Free Trade Agreements (FTAs) and liberalize trade on preferential basis. The comparison of equilibria that arise with and without FTAs allows us to explore whether the freedom to liberalize trade on a preferential basis is a *necessary* condition to attain global free trade. We find that while the ability to form FTAs reduces the likelihood of global free trade when countries have symmetric political preferences, with asymmetric preferences the global free trade may become politically feasible only when countries have the freedom to pursue FTAs. These results suggest that, in order to assess the effect of Article XXIV on the prospect of global free trade, political asymmetries across countries must be taken into account in the analysis of trade agreement formation.

The debate about the effect of PTAs on the trade system centers around the terms *building* and *stumbling blocks*, introduced by Bhagwati (1991). The standard view in the existing literature is that PTAs are building (stumbling) blocks to global free trade if the process of preferential trade liberalization eventually converges (fails to converge) to global free trade.⁵ However, this view can be misleading if global free trade obtains regardless of whether the formation of PTAs is allowed or not. In this paper, we take an alternative view that PTAs are building blocks to global free trade if the freedom to pursue PTAs is *necessary* in order for global free trade to be achieved.⁶ Our approach to trade agreement formation follows that of Saggi and Yildiz (2010) under which both preferential and multilateral agreements emerge endogenously. Applying this approach to a political economy context, we take the building vs. stumbling blocks debate one step further. Specifically, we show that under certain conditions, the freedom to pursue FTAs (Article XXIV) is necessary to attain global free trade. In such a case, FTAs act as a *strong building block*. We also find that FTAs may act as a *strong stumbling block*, i.e. the freedom to pursue FTAs prevents attainment of global free trade that would arise if countries were to follow trade liberalization on an MFN basis only. To the best of our knowledge, this paper is the first attempt to address the role of “politics” in a model where the formation of trade agreements, both preferential and MFN-based, is endogenous.

Our theoretical framework is based on a three-country model of trade with oligopolistic markets where countries optimally choose tariff rates and membership in trade agreements.⁷ As in Grossman and Helpman (1995), policymakers in all countries are politically biased and balance social welfare with industrial interests. Our analysis draws on a comparison of equilibrium outcomes under *bilateralism*, when countries have a freedom to form FTAs, and *multilateralism*, when only non-discriminating MAs are allowed. We employ a three-stage game under both bilateralism and multilateralism. In the first stage of each game, equilibrium trade agreements are formed between countries. In the second stage, countries choose import tariffs under a given trade policy regime and contribution schedules from the domestic firms, and in the third stage firms compete in a Cournot fashion. Using the concept of coalition-proof Nash equilibrium (CPNE), we identify the consequences of the exception to non-discrimination principle incorporated in the GATT Article XXIV by comparing the sets of CPNE agreements under bilateralism and multilateralism.

As a starting point, our optimal tariff discussion under FTA confirms the findings by Ornelas (2005a, 2005b) about the effect of political economy forces on trade policy: an FTA induces each member to reduce external tariffs against non-members, and the reduction is deeper for more politically motivated governments. We complement Ornelas' results by showing that the same result obtains under an MA. More importantly, the comparison of external tariffs of member countries under FTA and MA reveals that the degree of trade liberalization undertaken by member countries is lower when they sign an MA, and the difference is bigger when member countries are more politically motivated. This difference determines the payoff of the non-member country under these two alternative trade agreements and hence the country's incentives to participate in one or the other.

⁴ We do not consider unilateral trade liberalization since in our model all countries have unilateral incentives to extract tariff rent and such liberalization is not in any country's interest.

⁵ Earlier literature on the building versus stumbling bloc discussion has taken trade agreements exogenously and focused on the incentives of countries to participate in multilateral free trade (see Grossman and Helpman, 1995; Krishna, 1998; Ornelas, 2005a,b). More recent studies, including Goyal and Joshi (2006), Aghion et al. (2007), Furusawa and Konishi (2007), Seidmann (2009), and Stoyanov (2014) use endogenous formation of PTAs but ignore the possibility of trade liberalization on an MFN basis, and view PTAs as building blocs so long as their pursuit eventually leads to global free trade.

⁶ Similarly, we argue that PTAs are stumbling blocs if the freedom to pursue bilateral FTAs hampers multilateral free trade that would have been obtained if countries were to pursue trade liberalization only multilaterally.

⁷ Using the same market structure, Krishna (1998) demonstrates that, for exogenously given tariffs, formation of an FTA between two countries reduces their incentives to liberalize trade with respect to the third country. With endogenous tariffs, Ornelas (2005a,b) shows that an FTA induces member countries to lower tariffs on non-member countries. In contrast to our paper, Krishna (1998) and Ornelas (2005a,b) do not develop an equilibrium theory of FTAs and only consider the effects of an exogenously given FTA.

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