Political Viability and Tariff Complementarity of Preferential Trade Agreements

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Abstract

This paper analyzes the political viability and tariff complementarity effects of preferential trade agreements (PTAs) in a three-country oligopoly model comprising two potential PTA members and the rest of the world (ROW), incorporating asymmetric market sizes and domestic political bias. Based on how the external tariff is levied, PTAs are classified into four distinct trade regimes: Nash-equilibrium and regionwide-optimal free trade agreements (FTAs), alongside decentralized and centralized customs unions (CUs). The analytical results reveal that, in the FTA regime, the tariff complementarity effect is consistently stronger under a Nash-equilibrium FTA than under a regionwide-optimal FTA. In the CU regime, however, which type of CU generates a stronger tariff complementarity effect—and, correspondingly, higher economic welfare—depends on the relative magnitude of the member countries' political biases. Specifically, when the small country's political bias is relatively high, a centralized CU generates a stronger tariff complementarity effect and higher region-wide welfare and ROW welfare than a decentralized CU, despite failing to satisfy incentive compatibility. Conversely, when the small country's political bias is low, these results are reversed: a decentralized CU is both incentive-compatible and welfare-superior. Despite tariff complementarity, CUs consistently reduce the ROW's welfare relative to unilateral tariffs.

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