

Abstract

This study examines the tariff setting behavior of preferential trade agreement (PTA) members in a three-country model with heterogeneous firms and variable markups. In this study, PTA members choose the optimal internal tariffs to maximize the sum of the welfare of PTA members and independently choose the optimal external tariffs to maximize its own welfare. I show that if two countries entering into the PTA adopt symmetric internal tariff, the optimal internal tariff is positive when the introduction of a small symmetric internal tariff sufficiently improves a within-sector misallocation. In many cases, requiring PTA members to eliminate internal tariff induces them to lower their external tariffs, which increases the welfare level of the non-member country.