

# Tariff Coordination and the Feasibility of Efficient Preferential Trade Agreements with Side-payment Transfers

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## Abstract

This study examines the role of side-payment transfers in the preferential trade agreement (PTA) negotiations between two countries with asymmetric market sizes. An appropriate side-payment transfer enables PTA participants to coordinate tariffs at a level that maximizes their aggregate welfare. Under this coordinated tariff or the optimal tariff for the small country, a Pareto-efficient customs union (CU) is feasible unless a relatively small country's market size is extremely low. A welfare comparison indicates that PTA members prefer a CU to a free trade agreement (FTA) if the relative difference in market size among them is sufficiently small. However, a CU between nations with similar market sizes is more harmful to the rest of the world (ROW) than an FTA. Moreover, a CU is more likely to be a stumbling block for the small country than an FTA if the ROW's market size relative to those of PTA participants is intermediate.