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

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An Extended Abstract

The aim of this study is to examine the role of side-payment transfers in bilateral negotiations over Preferential Trade Agreements (PTAs) based on a model for oligopolistic competition among two (small and large) countries and the rest of the world (ROW). Since Ohyama (1972) and Kemp and Wan (1976) proved that forming a Customs Union (CU) enables all members to improve their economic welfare without harming outside countries if adequate income compensation is provided within the region, previous studies have been conducted on the effect of income transfers in forming PTAs. Moreover, one of the notable features observed in recent PTAs since the 1990s is an increase in PTAs between asymmetric countries with respect to market size (Either 1998).

This study investigates how participants strategically utilize external tariffs in PTA negotiations from the perspective of strategic trade policy. When side payments are regarded as a tool for income transfers from the small country that obtains relatively more benefits from trade liberalization, it intends to reduce economic losses incurred by the partner when forming a PTA. By contrast, the large country is willing to raise the partner's economic welfare by earning substantial transfers. On the one hand, in the case of Free Trade Agreements (FTAs), in which members individually determine external tariffs, they impose tariffs on the ROW at a level that is higher than the welfare-maximizing level; therefore, the formation of an FTA brings negative

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economic effects on the ROW. On the other hand, in the case of CUs, in which a Common External Tariff (CET) is adopted, side-payment transfers enable asymmetric CU participants to harmonize external tariffs. This is because both participants have an incentive to set a CET closer to the tariff that maximizes the partner's economic welfare. Hence, forming a CU could enhance economic payoffs for all nations, including the ROW.

Here, Paragraph 4 of GATT Article XXIV specifies the prohibition of enhanced external discrimination when forming PTAs. This rule constrains CU members with sufficiently different market sizes from applying a CET at the optimal level. If the difference in market size among members is extremely large, this constraint makes a Pareto-efficient CU infeasible and discourages the formation of a CU that brings positive gains to the ROW. By contrast, if the difference in market size is intermediate, it makes a Pareto-efficient CU beneficial to the ROW.

From the above, while an FTA is preferable to a CU for the aggregate welfare of PTA partners, a CU is more beneficial to the global economy. In addition, it is shown that the prohibition of enhanced external discrimination is not necessarily efficient in CU negotiations; namely, forming a CU by applying the optimal CET can be more efficient.

Keywords: Customs Union, Free Trade Agreement, GATT Article XXIV, Side Payment, Tariff Harmonization.

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