Trade agreements have never been easy to negotiate nor have they always been effectively enforced.

In endogenously Incomplete Contracts, The set of policy instruments that would be constrained and how the constraints would change are determined by the net expected global benefit they bring.

This manuscript develops a model which allows for rent-seeking pressures while accounting for uncertainty and contracting costs and explains key provisions of WTO/GATT.

### A political economy model

- 2 countries, Home and Foreign, a numeraire good 0 and n other nonnumeraire goods.

\[
\begin{align*}
q_i & \equiv \tau_i \omega_i \\
p_i & \equiv q_i + S_i \\
q_i^* & \equiv \tau_i^* \omega_i \\
p_i^* & \equiv q_i^* + S_i^* \\
\omega_i (\tau_i, \omega_i, S_i) + \omega_i (\tau_i^* \omega_i, S_i^*) & \equiv 0
\end{align*}
\]

### Conclusions

Our model also yields predictions on the form of the optimal trade agreement and how it depends on uncertainty and contracting costs.

- It is optimal to leave production subsidies to discretion
  - If production subsidies can not adequately substitute for tariffs (small \(x^*\) or large \(M^*\)).
  - Or if countries trade little (small \(M\)).

- It is optimal to leave consumption taxes to discretion in an NT-based trade agreement.
  - If consumption taxes can not adequately substitute for tariffs (small \(d^*\) or large \(M^*\)).
  - Or if countries trade little (small \(M\)).
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Trade Agreements, Political Economy, and Endogenously Incomplete Contracts

Na Li and Alan Ker

We develop a political economy model of trade agreements following along the lines of Grossman (1995) yet incorporating contracting costs, uncertainty and multiple policy instruments. We show that rent-seeking efforts do not affect tariff rates as they are offset by the substitution effect of domestic production subsidies. Similar to Horn (2010), we find the coexistence of uncertainty and contracting costs make optimal trade agreements incomplete contracts. Our model helps explain differential treatment on subsidies, countervailing duties, and the national treatment principle.