

Trade Agreements, Political Economy and Endogenously Incomplete Contracts

Na Li PHD student

Alan Ker Professor and Chair

Department of Food Agricultural and

Resource Economics

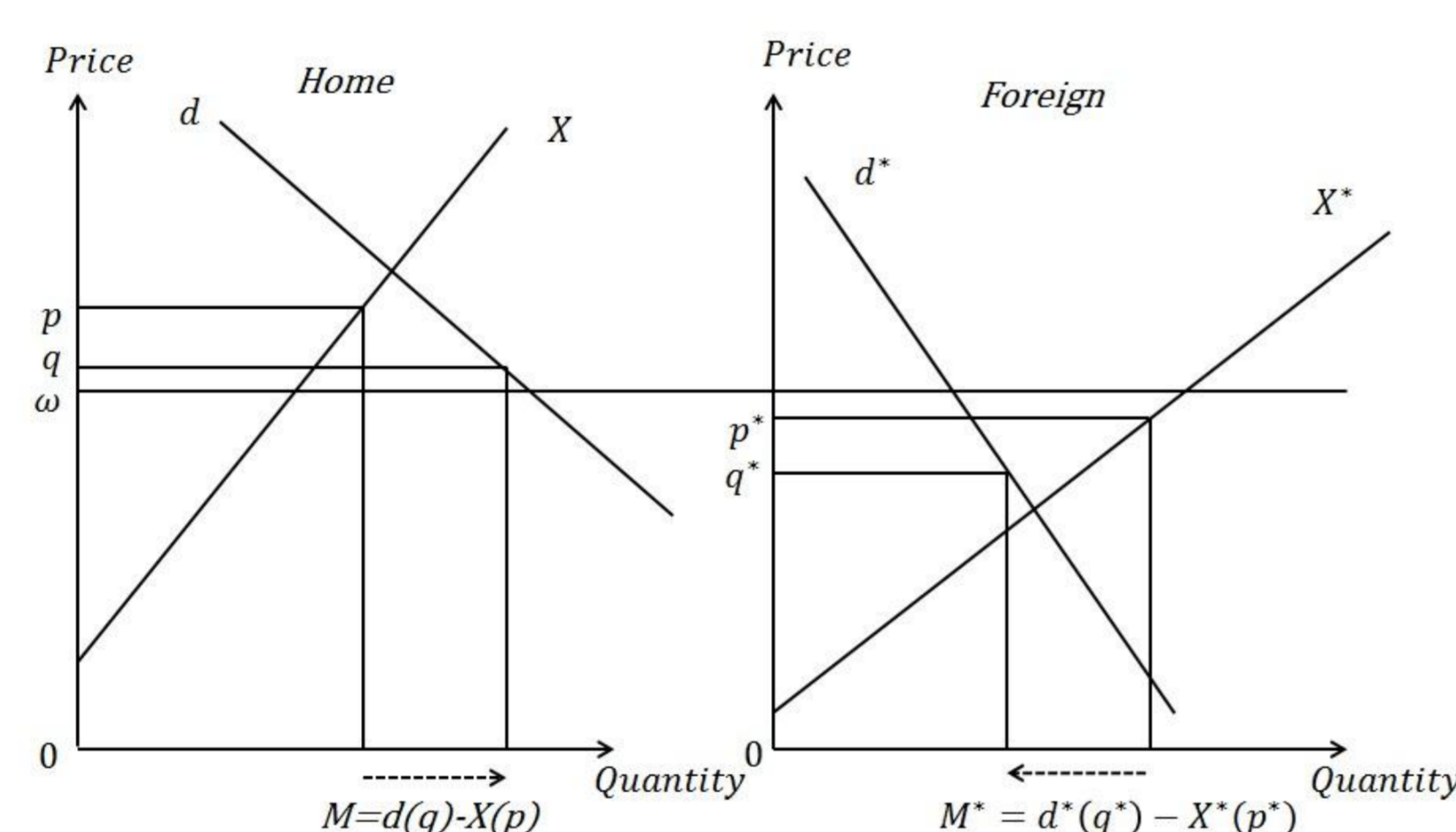


Introduction

- 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.



- $q_i \equiv \tau_i \omega_i$
- $p_i \equiv q_i + s_i$
- $q_i^* \equiv \tau_i^* \omega_i$
- $p_i^* \equiv q_i^* + s_i^*$
- $\omega_i(\tau_i \omega_i, s_i) + \omega_i^*(\tau_i^* \omega_i, s_i^*) \equiv 0$

A political economy model

- The objective of lobby group i

$$V_i = W_i(\tau, s, \omega) - C_i(\tau, s, \cdot),$$
 where $W_i(\tau_i \omega_i, s_i)$ is its gross joint welfare, $C_i(\tau_i, s_i, \cdot)$ is its contribution schedules
- The objective of Home government

$$\sum_{i \in L} C_i(\tau, s, \cdot) + aW(\tau, s, \omega)$$
 where $W(\tau, s, \omega)$ is the aggregate social welfare.
- Costless trade agreement maximizes

$$a^*G + aG^*$$

$$= a^* \sum_{i \in L} C_i(P, P^*) + a \sum_{i \in L} C_i^*(P, P^*) + aa^*[W(P, P^*) + W^*(P, P^*)],$$
 where P is the policy vector, the weight of each country's aggregate social welfare are equalized (to aa^*).

Findings

(assuming no contracting costs)

- Noncooperatively,
 - production subsidies will emerge in industries that are politically organized at the expense of those not.
 - Tariff rates depends on international market power ($1/e^*$), Johnson's optimal tariff rates.
- A costless trade agreement would lead to equal rates of tariff in one country and export subsidy in another for each industry i , a circumstance equivalent to free trade, rationale for WTO'S countervailing duty law.
- A trade agreement which only constrains production subsidies but not tariffs is not optimal.

Assumptions

(the Optimal Agreement Based on)

- Four sources of uncertainty that may leads to an incomplete contract, state variables:
 - the relative weight of aggregate social welfare,
 - the fraction of population that are represented by lobbies,
 - whether an industry organizes or dissolves its political lobby,
 - the level of import.
- Two categories of contracting costs:
 - state variables,
 - policy variables,
 e.g. τ and s and their Foreign counterparts.

Conclusions

(Implied by Incomplete Contract Theory)

- 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).

**Research Poster from the
*Canadian Agricultural Trade Policy and Competitiveness Research
Network (CATPRN)*
*Enabling Research for a Competitive Agriculture***



Abstract CATPRN-02

**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.

Growing Forward in a Volatile Environment
2nd Annual Agriculture Policy Conference
January 11-13, 2012
Ottawa, Canada