Rent Dissipation, Political Viability, and the Strategic Adoption of Free Trade Agreements

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Abstract

This paper studies the political viability of free trade agreements (FTAs). The key element of the analysis is the "rent dissipation" that these arrangements induce: by eliminating intra-bloc trade barriers, an FTA reduces the incentives of the local firms to lobby for higher external tariffs, thereby causing a reduction of the rents created in the lobbying process. The prospect of rent dissipation moderates the governments' willingness to participate in FTAs; they will support only arrangements that are "substantially" welfare improving, and no FTA that reduces welfare. Rent dissipation also implies that the prospects of political turnover may create strategic reasons for the formation of FTAs. Specifically, a government facing a high enough probability of losing power may want to form a trade bloc simply to "tie the hands" of its successor. An FTA can affect the likelihood of political turnover as well. If the incumbent party has a known bias toward special interests, it may want to commit to less distortionary policies in order to reduce its electoral disadvantage; the rent dissipation effect ensures that an FTA can serve as the vehicle for such a commitment. In nascent/unstable democracies, the incumbent government can use a free trade agreement also to reduce the likelihood of a dictatorial takeover and to "consolidate" democracy – a finding that is consistent with the timing of numerous accessions to and formations of preferential arrangements.

1. INTRODUCTION

Perhaps the most visible trend in the international trading system in recent years has been the proliferation of regional trade agreements. In the period 1948-1994, the GATT received 124 notifications of regional trade agreements from both large and small, developed and less developed, countries. Recently, this trend intensified with over 100 additional arrangements being notified to the WTO since its inception in 1995. Not surprisingly then a relatively large literature exists addressing these trends and evaluating their welfare consequences. However, little of this work has explored the possibility that the "economics of politics" may be at least partially responsible for this proliferation. This paper investigates how and why "politics" can matter to the willingness of a country to enter into a free trade agreement.

To do so I adopt a relatively standard and simple modeling environment. The analysis is undertaken in a partial equilibrium oligopolistic setting where markets are segmented and entry is abstracted from. The governments' decisions regarding trade policy are shaped by both national welfare concerns and industry contributions, being modeled similarly to Grossman and Helpman (1994). The analysis proceeds by evaluating the political viability of free trade areas (FTAs) under various scenarios.[1] Despite many similarities in model structure with earlier research, the results I obtain are very different. For example, in contrast to the earlier literature showing how politically motivated governments may have a penchant for welfare reducing trade arrangements, I show just the reverse. Any politically viable free trade agreement (i.e., any individually rational agreement for a contribution loving government) will also be overall welfare enhancing. Moreover, while others have argued that an FTA is likely to raise the level of lobbying for protection against the (excluded) rest of world, I show that it actually lowers lobbying for tariffs against excluded countries.

When I move to a setting with voting and political turnover, other new results arise. I show that in contrast to the common view that FTAs can play a role in solving time inconsistency problems by tying the hands of incumbent governments, FTAs now play a role in tying the hands of one's opponents in future periods. And instead of a benevolent government employing an FTA to tie its own hands in future periods, I find that a government very biased towards special interests has a strong incentive to adopt FTAs to ensure a continuation of their political rents in

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[1] Free trade areas, such as NAFTA, correspond to arrangements in which the trade barriers within the bloc are eliminated, but whose members maintain independent external trade policies. They differ from customs unions, such as the European Union, where members not only eliminate the trade barriers within the bloc, but also coordinate their external trade policies.

future periods. Finally, I demonstrate a possible role for FTAs in reducing political uncertainty and deterring dictatorship.

In these, and in the remaining results of this paper, a key driving force is what I will refer to as the "rent dissipation effect." This effect has not been identified in the existing literature; moreover, the novelty of my results follows precisely because the previous literature eliminated its workings by assumption. This paper introduces the rent dissipation effect and carries through its logical implications for the political viability of FTAs.

In order to understand the rent dissipation effect, it is helpful to start by examining how tariffs are determined. With no FTA in place, the logic of tariff determination is simple. Contributions by special interests induce the government to set the country's import tariffs above the welfare maximizing level. These higher import tariffs shift market share from foreign firms to their domestic counterparts and shift surplus from consumers to producers through the higher local price the tariff causes. As a result, profits of the domestic firm are enhanced and this is, of course, the reason why special interests are willing to pay for the protectionist policies.

An FTA eliminates tariffs between its members, enhances exports within the bloc and gives each domestic firm a greater market share in the other partner markets. Since a higher tariff against outside countries would shift market share and consumer surplus to both domestic and partner firms, the benefits of a higher tariff are now shared with the firms from the *other* FTA members. Therefore, domestic firms become less willing to compensate the government for higher external tariffs on excluded countries. The FTA then generates lower external tariffs and less lobbying, thus inducing a reduction in the volume of rents created in the lobbying process: hence the name "rent dissipation." Anticipating these effects, and recognizing that lower rents implies lower contributions, a politically motivated government will adopt only FTAs that will raise national welfare considerably.

This result is at odds with the findings of some other researchers, including Grossman and Helpman (1995) and Krishna (1998). They argue that politically motivated governments are more likely to form preferential arrangements when they *reduce* national welfare, as a result of pervasive rent-creating trade diversion. Although there are other methodological differences between those papers and this paper, the critical difference concerns their treatment of external tariffs. Both authors take these external tariffs as exogenous. But as we saw above, it is precisely the endogeneity of these external tariffs that allows for the rent dissipation effect. By disregarding this endogeneity, earlier authors essentially shut down the rent dissipation effect. In turn, this

downplays the welfare gains induced by FTAs, and distorts the relationship between the political feasibility of FTAs and their national welfare impact.[2]

Even in models with endogenous external tariffs, the impact of rent dissipation on lobbying efforts and tariff formation has been overlooked. For example, Bhagwati (1993) suggests just the opposite should happen – i.e., that a preferential trade agreement should *enhance* lobbying against the outsiders. In response to this, Panagariya and Findlay (1996) demonstrate that by making lobbying against the other members redundant, an FTA releases labor and lowers the economy's wages. Lower wages then make it cheaper to lobby against non-members. *Taking the benefits of such lobbying to be constant,* they find that an FTA induces more lobbying and more protection against the rest of the world. Hence, the Panagariya-Findlay result relies on both the assumed absence of rent dissipation effects, and the presence of general equilibrium factor market effects arising from reduced lobbying.

The rest of the paper proceeds as follows. Model details are described in Section 2. Section 3 then describes the rent dissipation effect in some detail. The real analysis begins in Section 4, where I examine the impact of rent dissipation effects on the political viability of FTAs. I assume that an incumbent government is in office permanently and consider how a given FTA affects its members' internal political equilibrium. As the governments anticipate the rent dissipation effect of FTAs, this constitutes a key element determining their viability. I show how rent dissipation makes the government more "conservative" in its decisions regarding the support of a given FTA. Thus, a government permanently in power supports only arrangements that are "substantially" welfare improving.

Since no government is in office forever, I then turn to examine the possibility of political turnover in Section 5. In order to introduce political turnover, I extend the model to a 2-period setting where the incumbent faces a fixed probability of being replaced in office. I then show how the prospect of political turnover may turn an otherwise unviable FTA into a politically viable one. This possibility arises because the incumbent government does not acquire any of the rents generated in the political process when it is out of office, but it is still harmed by the welfare consequences of protectionist policies. Accordingly, it wants to constrain the ability of future

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[2] Richardson (1993) was the first to recognize that an FTA might induce its members to lower their external tariffs. However, he does not analyze the political viability of free trade agreements, the main issue addressed in this paper. Cadot et al. (2001) do account for the changes in the external tariffs when assessing the viability of FTAs. However, their goal is only to show the existence of *an* arrangement that is simultaneously welfare improving and politically feasible.

administrations to create rents through inefficient policies. The rent dissipation effect of an FTA ensures this.

This motivation is similar to that demonstrated in the political economy literature in macroeconomics. As shown there, political turnover can impact on the policymaking process significantly.[3] In particular, governments might act strategically to constrain the policy options available to their successors. In concert with these findings, this paper shows that an FTA might constitute a useful instrument for an incumbent government that wants to ensure that, even if it is replaced in office by a rival political group, policies would still be set in conformity with its own preferences.[4] This rationale parallels the line of analysis pursued by Maggi and Rodríguez-Clare (1998) and Mitra (2001), who also assess the value of trade agreements as a commitment device against time-inconsistent political problems. However, while these authors focus on circumstances in which governments want to constrain their own future choices, I emphasize time inconsistency created by the possibility of political turnover.

Since the implementation of an FTA may not only reflect the realities of political turnover, but also determine the likelihood of turnover, I next endogenize the incumbent's probability of remaining in office. I consider two cases. In Section 6, I assume that the country in question is a full-fledged mature democracy with a tradition of multi-party politics. Political turnover is through the ballot box, and hence I introduce a probabilistic voting mechanism to determine turnover. In Section 7, I assume the country in question is a fledgling democracy where political turnover occurs via takeover by an authoritarian group.

In the first case, I demonstrate how an FTA may be used as an instrument to steal the election platform of challengers. In particular, a party with a known bias toward special interests can credibly commit to less distortionary policies by entering an FTA. This in turn reduces the relative importance of welfare issues on the voters' decisions and raises the probability of the incumbent staying in office. The reason is, again, the rent dissipation effect: when an FTA reduces the incentives for lobbying, it reduces the electoral disadvantage of a party known to favor special interests.

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[3] See for example Persson and Svensson (1989), Alesina and Tabellini (1990) and Cukierman et al. (1992), some of the first contributions to this field, which comprises the effects of political turnover on various issues such as fiscal/debt policies, tax reforms and stabilization programs.

[4] To the best of my knowledge, McLaren (2000) is the only other study in the literature of regionalism that incorporates the possibility of political turnover. However, his emphasis is on the choice between free trade areas and customs unions, retaining thus little overlap with this paper.

This result is important because, while the intuition of Section 4 suggests that only governments weakly attached to rents may want to engage in an FTA – because they care little for the rents dissipated by these agreements –, this intuition can be reversed when electoral outcomes are endogenous. Therefore, a very much rent-seeking incumbent might adopt an FTA to benefit electorally from "tying its own hands" albeit at the cost of less rents generated in the subsequent FTA equilibrium. This result is related to those of Aghion and Bolton (1990) and Milesi-Ferretti and Spolaore (1994), who have employed similar reasoning to analyze the strategic use of debt and fiscal policies. The key difference being that here rent dissipation is the cause, and the vehicle for commitment is an FTA.

Finally, in Section 7 I consider a situation in which democracy is not yet "consolidated" in a given country, so an authoritarian group considers a takeover. I assume that the potential dictatorship is "kleptocratic," and then demonstrate how an FTA may be useful to prevent such threats to the democratic system. The reason is simple: as an FTA reduces the scope for rents, it reduces the gains from a successful coup, while leaving unaltered the costs of a failed takeover attempt. By lessening the potential gains from dictatorial incumbency without altering the costs of an attempt, an FTA can stabilize a nascent democracy.[5] This reasoning is often heard in the policy circles where democracy and trade liberalization are linked. For instance, it is consistent with the views expressed in the recent trade talks for the establishment of a free trade area of the Americas (FTAA).[6] In addition, the same logic is often invoked to explain the demand of the Eastern European countries for membership in the European Union as well.[7] The analysis in Section 7 provides the first formal analysis of these claims.

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[5] Whenever I claim that an FTA may be used to constrain the policies of future governments, democratic or not, I implicitly assume that is costly enough to reverse the arrangement. I discuss this point further in Section 5 and in Appendix III, where I show that non-reversibility may actually be regarded as an equilibrium outcome. Yet it is interesting to note that even when authoritarian regimes have gained control of a country that participates in a trade agreement, the arrangement tends to be honored, as it has happened for example with Swaziland, a member of SACU.

[6] In a recent summit congregating all potential FTAA signatories, "President Bush said striking down trade barriers was critical to sustaining democracy […] throughout the region" (*New York Times*, 4/18/2001). To the extent that can be inferred from public speeches, all of the other region's leaders appeared to share his view.

[7] As asserted in a recent *Business Week* (6/19/2000) article: "Poland, Czech Republic, […] Hungary, Estonia, and Slovenia. These and other Eastern and Central European nations lined up to join [the European Union] are eager to secure their nascent democracies."

2. THE BASIC MODEL

A. The Economic Structure

I consider a 2-sector, *N*-country model where one of the sectors is competitive (X) and the other, which is the center of the analysis, is oligopolistic (Q). Both goods are homogeneous and produced under constant returns to scale technologies: X = *L* and Q = *L/c*, where *c* > 0 is a constant and *L* denotes labor. Labor is the economy's single input, and is inelastically supplied in each country. Thus, choosing X as numeraire, any equilibrium with diversified production requires wages set to unity, with trade taking place only because of the oligopolistic behavior in sector Q.

The analysis is conducted from the perspective of a "home" country, *H*, but for notational ease, I use identifiers for the home variables only when necessary to avoid confusion. Home's population is composed by a continuum of identical consumers, whose size is normalized to one. For simplicity, I assume that there is only one oligopolistic firm in each country, and that a negligible fraction of the population owns the country's oligopolistic firm. Consumer preferences are represented by X + *u*(Q), and for convenience I assume that $u(Q) = AQ - Q^2/2$, with $A > c$. These preferences generate a demand for the oligopolistic good given by Q = $A - P$, where *P* denotes the consumer price. The demand for the competitive good is found residually, from the consumer's budget constraint: X = $L - QP(Q) = L - (AQ - Q^2)$. The representation is analogous for the other countries, though labor supply and population size may vary across countries.

Each oligopolistic firm has a marginal cost of *c* when selling in its domestic market. However, when selling abroad, their marginal costs are increased by the specific import tariffs set by those countries. That is, a firm's marginal costs from selling in foreign country *j* is given by *c* + t_j, where t_j denotes country *j*'s uniform tariff.[8] I assume that the firms engage in a Cournot competition in each of the national markets, regarding them as segmented. Thus, each firm makes its choices taking tariffs and the sales of the other firms as given.[9]

Market segmentation and constant marginal costs imply that the sales decisions of each firm are independent across markets. In an equilibrium without trade agreements, the sales of the domestic firm and of a single foreign firm in the home market can be shown to equal, respectively:

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[8] In this model, when a country selects its tariffs without constraints – i.e., when it does not participate in trade agreements –, it *chooses* not to discriminate against distinct sources of imports. This is due to the symmetry of the oligopolistic sector across countries, and implies in particular that framing the model under GATT's rules, which require nondiscrimination (in the absence of preferential trade agreements), would be inconsequential in this respect.

[9] In order to maintain the focus on tariffs, which correspond to the policy instrument typically negotiated in trade agreements, I abstract from transport costs and export subsidies in the analysis.

$$q = \frac{(A - c) + t(N - 1)}{1 + N} \qquad \text{and} \qquad q^J = \frac{(A - c) - 2t}{1 + N} , \qquad (2.1)$$

where t denotes home's tariff. One can also easily check that the profit of each firm in any market j is given simply by $\pi_j = q_j^2$. It is then straightforward from (2.1) that, while a tariff benefits the domestic firm, it hurts its foreign counterparts.

This oligopolistic framework is convenient, in particular, because it avoids some extreme results that may arise in analyses of FTAs under perfect competition. With perfect competition, differences in consumer prices in conjunction with internal free trade may, for example, induce the producers in some sectors to ship all their output to another FTA member (as e.g. in Grossman and Helpman 1995). This, in turn, may stimulate the FTA members to eliminate some of their external tariffs (see Richardson 1993). In the model used here, these extreme results do not arise – even though they would only *reinforce* the conclusions of the paper. This structure is also suitable to capture the ample body of empirical research that is supportive of the prevalence of oligopolistic behavior and market segmentation in international markets. See e.g. Goldberg and Knetter (1997) for evidence on the pervasiveness of the so-called "pricing-to-market" behavior, which requires market segmentation and oligopolistic behavior. Moreover, specifically to preferential liberalization, the empirical analysis of Winters and Chang (2000) is also in full consonance with oligopolistic behavior and market segmentation.

Now, defining notation, let the domestic firm's local and export profits be denoted by $\pi(t)$ and Π^{ROW}, respectively. Export profits do depend on the set of tariffs set elsewhere; however, I shall use this more concise representation for notational ease. The domestic firm's aggregate profits can then be expressed as $\Pi(t) = \pi(t) + \Pi^{ROW}$. National welfare, $W(t)$, is defined as the sum of consumer's surplus, tariff revenue and producer's aggregate profits. I define also *local* welfare, as the difference between national welfare and export profits: $W^l(t) \equiv W(t) - \Pi^{ROW}$.

B. The Political Structure

The preferences of the governments are defined analogously to Grossman and Helpman (1994), who assume that governments care about both "contributions," denoted here by D, and national welfare. Thus, the preferences of each government are specified as:

$$G(t, D) = W(t) + bD , \qquad (2.2)$$

where $b \geq 0$ is a constant that defines the government's "political bias:" the higher b is, the higher is the government's predilection for contributions, relative to social welfare.

This type of specification is very useful, as it incorporates in a single parameter (b) the government's political motivations. As Grossman and Helpman argue, it can be rationalized in many distinct ways.[10] In fact, I will adopt an interpretation for the objective function (2.2) that is more adequate for a scenario with political competition when I introduce it (Section 5). Nevertheless, until then I simply take this specification as given, as it is typically done in the numerous trade policies analyses that also employ it.

In this setting, the net payoff of the oligopolistic firm is given by the firm's aggregate profits minus the contributions that it gives to the local government, in exchange for extra levels of protection. That is, $V(t, D) = \Pi(t) - D$.

As in Maggi and Rodríguez-Clare (1998), the interaction between the government and the local firm is modeled as a Nash bargaining game. I define the bargaining powers of the government and the firm as α and $1 - \alpha$, respectively. The "political tariff" (t^p) that results from this interaction is such that it maximizes G subject to a given level of V (or vice-versa). Equivalently, the political tariff is such that it solves:[11]

$$t^p = \arg\max\left[W^l(t) + b\pi(t)\right]. \tag{2.3}$$

Notice that the bargaining parameter α does not affect t^p, since the tariff is set at the level that maximizes the two parties' joint surplus. However, as it will be shown below, α does affect the transfer D, which is the instrument that distributes the surplus from the lobbying process between the government and the firm.

It is also clear from (2.3) that the difference between the political tariff and the "optimal tariff" (t^*), which maximizes national welfare, is due only to the "extra weight" b posted on producer's profits. Market segmentation and constant marginal costs ensures in addition that each country's political tariff is independent of the tariffs set elsewhere – that is, the governments have "horizontal" reaction functions with respect to the selection of their preferred tariffs, despite the absence of "small-country" assumptions. This feature of the model facilitates the analysis considerably.

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[10] They model one possibility later (Grossman and Helpman 1996), showing that purely opportunistic, office-motivated political parties may behave indeed in consonance with the objective function (2.2).

[11] Using the fact that $G(t, D) = W(t) + bD$ and $V(t, D) = \Pi(t) - D$, the maximization of G subject to $V = \bar{V}$ is equivalent to maximizing $W(t) + b[\Pi(t) - \bar{V}]$. Since $\bar{V}$ is a constant, (2.3) follows.

C. The Equilibrium

Developing the expression in (2.3), the first order necessary condition (FONC) that defines the political tariff in an interior equilibrium can be written, after some manipulation, as:

$$(N-1)q^f(1-\frac{\partial P}{\partial t}) + (N-1)t\frac{\partial q^f}{\partial t} + (1+b)(P-c)\frac{\partial q}{\partial t} + bq\frac{\partial P}{\partial t} = 0. \qquad (2.4)$$

The first term in (2.4) corresponds to the terms of trade effect, while the second gives the impact of a marginally higher external tariff on the governments' fiscal revenues. Neither of them is affected by the political parameter b, but b does affect the last two terms in (2.4). In the subsequent analysis, the focus will be on how the political motivations of a government affect its willingness to form an FTA. That is, the analysis will be conducted essentially by comparing how a political motivated government differs from a benevolent social planner (i.e., a government whose political bias b is nil) with regard to the decisions to form an FTA. Since the first two elements of (2.4) are identical for both of them, they do not affect such a comparison. By contrast, the last two components of (2.4) depend on the parameter b. For this reason, they constitute the center of the following analysis.

The first of those components corresponds to the "strategic" motive for protection that is characteristic of oligopolistic markets; it represents the gain in market share that a higher tariff would give to the local firm. Since $P > c$, an expanded market share enhances the profits of the domestic producers, although at the expense of the foreign firms.[12] The last term corresponds to the "distributive" motivation for protection. As long as $b > 0$, the politically biased government benefits from a tariff also because, by raising the local price, it redistributes surplus from consumers to the domestic producer, and the latter's interests are weighted more heavily in the government's (equilibrium) payoff function.

Whenever (2.3) has an interior solution, condition (2.4) is satisfied and the political tariff is strictly increasing in b. The intuition is straightforward: the higher is the government's predilection for contributions vis-à-vis general welfare, the stronger will be the strategic and the distributive motives, and therefore the higher will be the equilibrium tariff.[13] On the other hand, if the political parameter b were too high (specifically, if $b \geq \frac{1}{2}$), the equilibrium tariff would become prohibitive.

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[12] Note that this strategic effect would exist in spite of political considerations; however, as the coefficient (1 + b) indicates, it is magnified by the government's political bias.

[13] The equilibrium tariff would, nevertheless, be strictly positive even if $b = 0$, as a result of the terms of trade and the strategic motivations.

For clarity, I shall nevertheless restrict the analysis to the more realistic case in which the equilibrium tariff is non-prohibitive, which amounts to assuming hereafter that $b < \frac{1}{2}$.

Addressing now the division of the surplus from the bargaining process between the government and the oligopolistic firm, notice first that, in the absence of lobbying, the government sets the tariff at the level that maximizes national welfare, t^*, obtaining a payoff of $W(t^*)$. Accordingly, when the government has no bargaining power ($\alpha = 0$), it gets a transfer of $[W^I(t^*) - W^I(t^p)]/b$ from the firm, which is just necessary to leave it at its reservation utility, $W(t^*)$, when it sets $t = t^p$. At the other extreme, when $\alpha = 1$, the government extracts the whole surplus from the political process, $[\pi(t^p) - \pi(t^*)]$, leaving the firm indifferent between lobbying or not. For a generic α, the equilibrium level of contributions is given by:

$$ D^e = \alpha\big[\pi(t^p) - \pi(t^*)\big] + (1-\alpha)\big[W^I(t^*) - W^I(t^p)\big]\big/b . \qquad (2.5) $$

Substituting (2.5) into the government's objective function, we then obtain:

$$ G = W^I(t^p) + \Pi^{ROW} + b\big\{\alpha\big[\pi(t^p) - \pi(t^*)\big] + (1-\alpha)\big[W^I(t^*) - W^I(t^p)\big]\big/b\big\}. \qquad (2.6) $$

This expression can be rewritten in a more meaningful way. First, I define what I call henceforth the "political rents" (*PR*) created in the lobbying process:[14]

$$ PR \equiv \frac{1}{b}\Big[\big(W^I(t^p) + b\pi(t^p)\big) - \big(W^I(t^*) + b\pi(t^*)\big)\Big]. \qquad (2.7) $$

The expression in the first parenthesis of (2.7) is the function defined in (2.3), which corresponds to the joint payoff of the government and the firm, evaluated at its maximum, i.e. when $t = t^p$. The expression in the second parenthesis of (2.7) is the same function, but evaluated at $t = t^*$, the tariff that maximizes national welfare – or equivalently, the equilibrium value of the function $W^I(t) + b\pi(t)$ in the absence of lobbying. The difference between these two expressions can be interpreted as the surplus that the political activities add to the joint payoffs of the government and the firm (the normalization by the coefficient $1/b$ is made simply for future convenience).

Using this definition, the government's equilibrium payoff can then be rewritten from (2.6) simply as:

$$ G = W^I(t^*) + \Pi^{ROW} + b\alpha PR = W(t^*) + b\alpha PR . \qquad (2.8) $$

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[14] I use the terms "rents" and "political rents" interchangeably throughout the text; both refer to the expression in (2.7).

Hence, the government obtains in equilibrium its reservation utility added by its share of the political rents, weighted in accord to its own preferences. This makes clear that the government does not internalize the welfare distortions due to its use of the political tariff. The firm's equilibrium payoff can be interpreted in an analogous fashion, being expressed as:

$$V = \pi(t^*) + \Pi^{ROW} + (1-\alpha)PR = \Pi(t^*) + (1-\alpha)PR. \tag{2.9}$$

The analysis so far has abstracted from the possibility of trade agreements, but the determination of the political equilibrium with an FTA in place is entirely analogous to the preceding analysis. The only change comes from the introduction of a constraint setting the tariffs between the FTA members to zero. However, as I show in the next section, this constraint turns out to affect the political equilibrium in very important ways.

3. FTAs AND RENT DISSIPATION

In this section, I assume that an *M*-country FTA is exogenously instituted and evaluate its impact on the internal political equilibrium of its participants. This evaluation, in addition to describing how the expected consequences of an FTA depend on the political parameters of its constituent governments, will also set the basis for the following sections, where I appraise the conditions under which an FTA is politically feasible. The definition of an FTA used here is the standard one: an arrangement that eliminates all trade barriers between its participants, which maintain independent trade policies.

I start by evaluating the effect of an FTA on the political tariff. It is important to clarify that whenever I refer to tariffs under an FTA, I will be alluding to a member's *external* tariffs on the imports from non-member countries, which remain unconstrained under the preferential arrangement. Indicating the variables under the FTA with a subscript "*M*," the FONC analogous to (2.4) under an FTA (which specializes to the no-FTA case if $M = 1$) can be expressed as:

$$\left[(N-M)q_M^f(1-\frac{\partial P_M}{\partial t_M}) - (M-1)q_M^p \frac{\partial P_M}{\partial t_M}\right] + (N-M)t_M \frac{\partial q_M^f}{\partial t_M} + (1+b)(P_M - c)\frac{\partial q_M}{\partial t_M} + bq_M \frac{\partial P_M}{\partial t_M} = 0, \tag{3.1}$$

where q_M^p indicates Home's imports from a firm in a partner country.

In a previous work (Ornelas 2000), I show that an FTA reduces the first two components of (3.1), which correspond to the terms of trade and the efficiency effects of a marginally higher

tariff.[15] Nonetheless, since those two terms are independent of the political parameter b, they are also independent of the country's political environment – and for this reason play no special role in the subsequent analysis, whose focus is on the political motivations for protection.[16]

The last two elements of (3.1), on the other hand, are scaled by the parameter b. They correspond, as indicated in the previous section, to the "strategic" and "distributive" motives for protection, respectively. As I indicate in Ornelas (2000), an FTA weakens both of these effects. The reason follows from the free access the arrangement provides to the partners' firms. By increasing competition and lowering the local price at any given external tariff (so that the local price under an FTA, P_M, becomes lower than the price with no FTA in place, P), this free access reduces the domestic firm's local mark-up from $(P - c)$ to $(P_M - c)$. As a result, under the FTA each unit of market share shifted from outside firms to the domestic firm generates less profit to the latter than it would without the FTA. The arrangement, therefore, reduces the "strategic" motive for protection.

The free access provided to the partners' firms under the FTA also has the effect of reducing the domestic firm's local sales at any given external tariff (so that $q_M < q$). For this reason, the arrangement makes any price increase brought by a higher tariff less valuable for the domestic firm, with part of the benefits from such increase now going to the partners' firms. The FTA, consequently, makes the external tariff less effective in shifting consumers' surplus to the domestic producer, thus weakening the marginal "distributive" motive for protection as well.

Hence, an FTA makes surplus redistribution from the foreign firms and from the local consumers to the domestic producer more difficult. This, in turn, reduces the impact of the political economy forces in the determination of the country's trade policies. As a result, an FTA reduces the difference between the country's "political" and "optimal" tariffs, as Proposition 1 shows.[17] This and the other propositions in this section are proved in Appendix I.

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[15] Other authors, including Richardson (1993) and Bagwell and Staiger (1999a), have noted as well that an FTA can diminish the protectionist forces against non-members. As showed in Ornelas (2000), the forces that they identify would correspond, in the model used here, to the reduction of the first two terms in (3.1).

[16] Moreover, if the analysis were framed in a framework that incorporated cooperation at the multilateral level, these effects would tend to be neutralized anyway. This is so because, as Bagwell and Staiger (1999b) show, multilateral agreements negotiated under the aegis of the GATT are designed precisely to eliminate these kind of beggar-thy-neighbor inefficiencies. However, GATT agreements cannot remove the *political* motivations for protection. In this sense, the disregard of multilateral cooperation in the evaluation of the pre- and post-FTA equilibria is innocuous in this paper.

[17] In this model, an FTA reduces its members' political external tariffs not only relatively to their optimal tariffs, but also in absolute value. This effect is discussed thoroughly in Ornelas (2000), but has no particular relevance for the results of this paper.

Proposition 1: *An FTA reduces the difference between its members' political and optimal tariffs; that is, $(t_M^p - t_M^*) < (t^p - t^*)$. This reduction is larger, the larger is the bloc (M) and the higher are the members' political bias (b).*

The proposition follows directly from the lower responsiveness, induced by the FTA, of the domestic firm's profit to tariff changes – that is, from the weakening of the strategic and distributive effects. As the arrangement constrains the gains from protection, the oligopolistic firm lobbies less intensely than it did previously to the FTA. This, in turn, shrinks the divergence between the political and the optimal tariff.

The proposition is illustrated in Figure 1. It depicts four curves, representing the FONC for a tariff with and without an FTA for both a government that is politically motivated (the solid lines) and another that is not (the dashed lines). The politically motivated government always sets higher tariffs. However, the difference between the external tariffs set by the two governments diminish with the FTA. As indicated above, this is the result of the weakening of the marginal strategic and distributive motives for protection. The former affects the politically motivated government more intensely, and the latter affects only it.
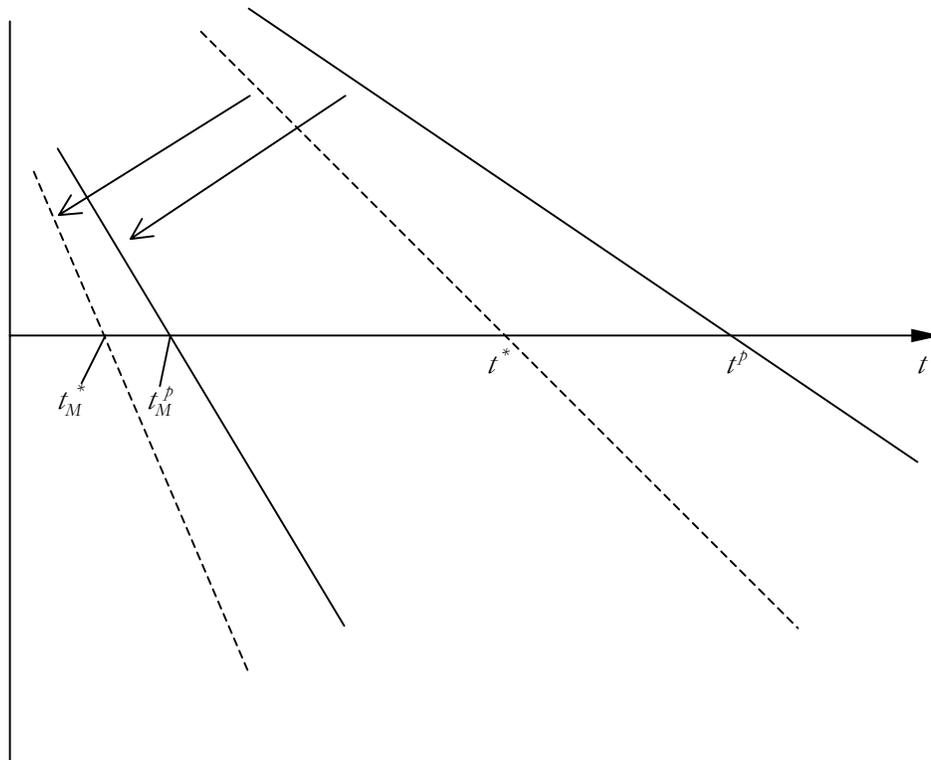

Figure 1: Changes in the FONC for a Tariff due to an FTA

Hence, an FTA not only shuts down the possibility of lobbying for protection against the FTA partners, but it also reduces the incentives for lobbying against the non-members. Moreover, it does so more prominently precisely when the member governments are more biased toward special interests. This indicates that the external tariffs of the most protectionist administrations should be the most affected by FTAs.

This result is suggestive that an FTA might also diminish the rents generated in the political interaction between the government and the oligopolistic firm. After all, since an FTA makes the enhancement of the firm's local profit through higher external tariffs more difficult, it is reasonable that it should also diminish the volume of rents created in the political process. The next proposition confirms this intuition.

Proposition 2: *An FTA reduces the volume of rents generated in the political process; that is, $PR_M < PR$. This reduction is larger, the larger is the bloc (M) and the higher are the members' political bias (b).*

Proposition 2 will prove critical for the subsequent analysis. It will also help us understand the welfare consequences of FTAs, to which I turn now.

Perhaps the most typical finding in the literature of regionalism regards its ambiguous welfare results. Such ambiguity is present in the context of this model too. Here, the elimination of the internal trade barriers and the reduction of the external ones induced by an FTA would surely increase consumer surplus, but it would reduce tariff revenues. Moreover, while the enhanced competition would surely reduce the domestic firm's earnings in the local market, the free access to the other members' markets would indisputably increase its export profits.

Despite such ambiguity, the "rent dissipation" identified in Proposition 2 allows us to evaluate the role of the country's political structure in the determination of the welfare consequences of an FTA. Essentially, by dissipating rents created by policies derived from criteria opposed to national welfare, the arrangement's welfare impact tends to vary in proportion to the volume of rents that it destroys. Since Proposition 2 establishes that FTAs dissipate rents more effectively precisely when political considerations are more far-reaching, the result below follows.

Proposition 3: *Everything else constant, an FTA improves the welfare of a participating country by more (or reduces it by less), the higher is the government's political bias (b).*

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This result indicates that, everything else constant, the countries that are likely to obtain the largest welfare gains from an FTA are precisely those most affected by special interests politics. It implies, in addition, that the welfare impact of an FTA for a specific country depends on the characteristics of its ruling government. For instance, it may be negative during an administration lightly influenced by special interests, but become positive if a strongly politically motivated group gains control over the country's trade policies.

This section establishes, hence, that a free trade agreement diminishes the role of lobbying in the trade policy outcomes. Three related consequences result from that. First, an FTA induces a reduction in the divergence between the "political" and the "optimal" tariffs (Proposition 1). Second, the arrangement decreases the volume of rents created in the political process (Proposition 2). And third, it generates an element of welfare gain in addition to the ones usually considered in the literature (Proposition 3).

These results contrast with those of Panagariya and Findlay (1996), who claim that the formation of an FTA would tend to enhance lobbying against non-members. As I note in the Introduction, the Panagariya-Findlay result relies on two assumptions. First, it depends on the presence of general equilibrium factor market effects arising from reduced lobbying. This requires lobbying activities to be large enough to affect market wages. Moreover, and more importantly, they also model the benefits from lobbying for protection against foreign imports as a constant, unaltered by the presence of an FTA. However, as an FTA allows the partner countries' firms to share the gains from the domestic firm's lobbying efforts, it will typically reduce the latter's gains, as shown here.

It is also interesting to note how the rent dissipation effect relates with the contributions of Maggi and Rodríguez-Clare (1998) and Mitra (2001). Those authors show that governments may use a trade agreement to neutralize inefficiencies that lobbying activities generate on the economy, but for which they are not compensated. Maggi and Rodríguez-Clare and Mitra suggest that this motivation may help explain the recent propagation of international trade agreements. However, as they work with 2-country settings, they do not model discriminatory liberalization. Nonetheless, since the rent dissipation effect ensures that an FTA is indeed a legitimate instrument toward the foreclosure of lobbying activities, it is indicative that the applicability of the Maggi–Rodríguez-Clare–Mitra rationale might extend to preferential forms of liberalization as well.

4. FTAs with Governments Permanently in Office

In the previous section, I evaluated the consequences of an FTA on the political equilibrium of one of its members. I now begin to analyze the circumstances under which a government would *choose* to form an FTA. In this section, I assume that the incumbent government remains in command forever. This assumption, adopted by most authors, is evidently restrictive. Nevertheless, it is inconsequential once it is also assumed that governments behave as "social (welfare-maximizer) planner," as was common in the earlier trade policy literature.

Under the more recent political economy perspective, however, that assumption becomes indeed highly restrictive whenever the policies of the current policymakers can affect the actions of its successors. Nonetheless, treating the government as permanently in office offers a useful benchmark, and it highlights forces that will be at work whenever an FTA is considered. In the next sections, however, I move to situations where there is potential alternation of power.

I assume henceforth that the opportunity to participate in an FTA with $M - 1$ other countries becomes exogenously available to the home government, which decides whether or not to implement it.[18] As in Maggi and Rodríguez-Clare (1998), but distinctly from Grossman and Helpman (1995), I assume that the government makes this decision without explicit interference of the private sector. That is, although I allow the firms to lobby for protection under any trade regime, I rule out lobbying for or against the institution of an FTA. I show in Appendix II that the incorporation of the latter is qualitatively inessential here. Thus, in order to avoid additional structure and keep the focus of the paper clear, I rule that possibility out in the main text, focusing instead on how an FTA alters the lobbying equilibrium of its members.

Suppose then that the government remains in power forever. In that case, it endorses the FTA if and only if the arrangement improves upon its no-FTA equilibrium payoff, $G = W^I(t^*) + b\alpha PR + \Pi^{ROW}$. If the government enters in the FTA, its payoff can be analogously specified as:

$$G_M = W_M^I(t_M^*) + b\alpha PR_M + \Pi_M^{ROW}.$$ (4.1)

Hence, the government will be willing to create the FTA iff $G_M > G$.

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[18] This choice can be seen from two distinct perspectives. In one, the home government is critical to launch the free trade agreement in question, so the arrangement is formed if and only if the government agrees so. An example of this would be the U.S. in the establishment of NAFTA. In the other view, the government chooses only its participation in an existing arrangement. An example of this case would be the accessions to the European Free Trade Association. In the context of the present model, the only formal distinction between these two perspectives concerns the level of the country's export profits when it stays out of the agreement (Π^{ROW}). Yet the analysis is qualitatively identical for both cases. For this reason I adopt the two views interchangeably throughout the text.

In order to facilitate notation, I define the change in any variable due to the FTA by a subscript "ΔM" (so that, e.g., $Z_{\Delta M} \equiv Z_M - Z$ for a generic variable Z). Moreover, I will use the government's political parameter (b) as the argument for the change in local welfare, $W^I_{\Delta M}$. In particular, $W^I_{\Delta M}(b)$ will denote the *actual* change in welfare due to the FTA, while $W^I_{\Delta M}(b=0)$ shall represent the effect that the FTA would have on local welfare if the government had no political motivations. With this notation, the condition $G_M > G$ becomes simply $G_{\Delta M} > 0$, or equivalently:

$$W^I_{\Delta M}(b=0) + b\alpha PR_{\Delta M} + \Pi^{ROW}_{\Delta M} > 0 . \qquad (4.2)$$

This condition may hold or not, depending on the number and the specific characteristics of the countries involved in the arrangement. However, we know that $\Pi^{ROW}_{\Delta M} > 0$, as the FTA increases the export profits in the partners' markets without altering them in the non-members' markets. On the other hand, $PR_{\Delta M} < 0$ from Proposition 2.

The condition under which the FTA is welfare-improving, in contrast with (4.2), is given by:

$$W^I_{\Delta M}(b) + \Pi^{ROW}_{\Delta M} > 0 . \qquad (4.3)$$

Since the government is moved not only by welfare considerations when deciding whether to support FTAs, conditions (4.2) and (4.3) differ. The issue here is to assess the relationship between the two conditions. For instance, do governments tend to evaluate FTAs more optimistically than a welfare-maximizer entity would, or should the opposite be true? Propositions 2 and 3, by showing how the impact of an FTA on the political rents and on welfare depends on the government's political bias, provide the elements necessary to evaluate these questions. They lead to Proposition 4, which shows that the political distortions will make a government more "conservative" in its decisions regarding the support of a given FTA. This ensures, in particular, that it will not support welfare-reducing arrangements.

Proposition 4: *A politically motivated government that expects to remain permanently in office may obstruct a welfare-improving FTA; the set of parameters under which this may happen is larger, the larger is the government's political bias (b) and bargaining power (α). The government will, however, never endorse a welfare-reducing FTA.*

Proof: Proposition 3 asserts that, for any $\bar{b}$ and $\underline{b}$ such that $\bar{b} > \underline{b}$,

$$W^I_{\Delta M}(\bar{b}) + \Pi^{ROW}_{\Delta M} > W^I_{\Delta M}(\underline{b}) + \Pi^{ROW}_{\Delta M} . \qquad (4.4)$$

Thus, in particular, for any $b > 0$,

$$W_{\Delta M}^{l}(b) + \Pi_{\Delta M}^{ROW} > W_{\Delta M}^{l}(b=0) + \Pi_{\Delta M}^{ROW}. \qquad (4.5)$$

Proposition 2, on the other hand, establishes that $PR_{\Delta M} < 0$, so adding $(\alpha b PR_{\Delta M})$ to the right-hand-side of (4.5) does not alter the inequality:

$$W_{\Delta M}^{l}(b) + \Pi_{\Delta M}^{ROW} > W_{\Delta M}^{l}(b=0) + b\alpha PR_{\Delta M} + \Pi_{\Delta M}^{ROW}. \qquad (4.6)$$

Expression (4.6) shows that the left-hand-side of (4.3) is necessarily greater than the left-hand-side of (4.2), so (4.2) implies (4.3). Hence, since a government that does not expect to leave office enters in the FTA whenever condition (4.2) holds, but the FTA is welfare-improving only if condition (4.3) is satisfied, the government will never support welfare-reducing FTAs. On the other hand, (4.6) is compatible with an FTA such that:

$$W_{\Delta M}^{l}(b) + \Pi_{\Delta M}^{ROW} < 0 < W_{\Delta M}^{l}(b=0) + b\alpha PR_{\Delta M} + \Pi_{\Delta M}^{ROW}, \qquad (4.7)$$

in which case the FTA is welfare-enhancing but is not supported by the government.

Note, in addition, that $\partial(b\alpha PR_{\Delta M})/\partial b = \alpha[b(\partial PR_{\Delta M}/\partial b) + PR_{\Delta M}]$ and $\partial(b\alpha PR_{\Delta M})/\partial\alpha = bPR_{\Delta M}$ are both negative from Proposition 2. Therefore, the right-hand-side of (4.7) is decreasing in both b and α. In contrast, Proposition 3 asserts that the left-hand-side of (4.7), which is independent of α, is increasing in b. Thus, either a higher b or a higher α enlarges the set of parameters that satisfy (4.7). ∎

The proposition may be better understood once we divide the welfare effects of an FTA into two distinct components, one relative to its "regular" welfare impact $[W_{\Delta M}^{l}(b=0) + \Pi_{\Delta M}^{ROW}]$, which disregards the rent dissipation effect, and another due only to such effect $[W_{\Delta M}^{l}(b) - W_{\Delta M}^{l}(b=0)]$. The government accounts for the former, but not for the latter, which is positive because of Proposition 3. Moreover, the political rents received by the government shrinks with the FTA – i.e., $PR_{\Delta M} < 0$ (Proposition 2). For these two reasons, the government appraises the FTA inevitably more pessimistically than a welfare-maximizer entity would, sponsoring only arrangements that "substantially" improve national welfare – that is, those that improve it by at least $[W_{\Delta M}^{l}(b) - W_{\Delta M}^{l}(b=0)] - b\alpha PR_{\Delta M}$. Hence, there may occur a situation in which condition (4.7) holds, so the FTA is welfare-improving but not politically supported. On the other hand, the political economy distortions will never raise support for a welfare-reducing preferential arrangement.

The proposition indicates, in addition, that the bias in the support of FTAs is particularly relevant for governments that are highly politically motivated and for those that have strong bargaining positions vis-à-vis the private sector in the division of the political rents. Nevertheless, it

is worth noting that even if all political rents accrued to the firms ($\alpha = 0$), so that the government would be indifferent to the reduction in the political rents, it could still deny its support to a welfare-enhancing arrangement. This is so because, even in such a case, the government would still not internalize the welfare gains due to the rent dissipation, $[W^l_{\Delta M}(b) - W^l_{\Delta M}(b=0)]$. Hence, the proposition implies, in essence, that the political economy forces, by creating distortions that are diminished by FTAs but that are not internalized by the governments, limit the viability of these arrangements to fewer circumstances than would be socially optimal.

I should also underline the contrast between these results and the findings of Grossman and Helpman (1995) and Krishna (1998). This distinction, as indicated in the outset, is due essentially to their exogenous treatment of the external tariffs, which shuts down the rent dissipation effect and therefore neglects its consequences on the political viability of FTAs.

5. FTAs WITH POLITICAL TURNOVER

In this section I begin to analyze the political feasibility of free trade agreements under the possibility of political turnover. Thus far, I have worked with the government's preferences, as specified in expression (2.2), without providing an explicit rationalization for it. I now introduce a rationale that harmonizes those preferences with a political environment marked by political competition, adopting it henceforth.

As in Grossman and Helpman (1994), in this paper the private sector makes transfers to the government only in order to influence policies. Accordingly, I consider that those transfers are specific to incumbency, so if a political group/party leaves office, it loses them as well. That is, there are *rents for holding office*.

This perspective differs from the approach that interprets transfers as campaign contributions that are not beneficial *per se*, but rather because they enhance the electoral prospects of politicians, as e.g. in Grossman and Helpman (1996). In that case, while each candidate's only goal is to hold office, their gains from being elected correspond to intangible benefits that have no relationship with the contributions received. In that instance, the possibility to obtain contributions from the private sector is unrelated with incumbency. By contrast, while recognizing the importance of campaign financing, other authors acknowledge that in practice those in office, in a position to actually enact policies, usually obtain additional benefits from their interaction with

lobbyists. A recent paper that takes this view and finds "office rents" as the equilibrium result of the interaction between policymakers and lobbies is Besley and Coate (2001).

Although politicians benefit from the acquirement of these rents, they are obtainable only through the introduction of distortions into the economy. But governments also care about national welfare. As in the literature of strategic debt issuance, I consider that the governments' concerns for national welfare reflect the links between political parties and their "constituencies." In the present model, each party's constituency can be understood simply as a fraction of the population. Specifying the relative weight attached to social welfare in the government's objective function as a strictly increasing function of this share, a given distorting policy would then be more costly for the government the larger is its constituency. Thus, a broader representation will induce the government to internalize a larger part of the distortions created by its policies.[19]

This interpretation of formulation (2.2), while inconsequential for the results obtained so far, is useful in a framework with political competition. It implies that the welfare concerns of a party are unrelated with incumbency, since they stem only from the party's link with its constituency. By contrast, the transfers obtained through the interaction with the import-competing sector are specific to incumbents.

Adopting this interpretation, I show in this section that the prospects of political turnover may turn an otherwise politically unviable FTA into a politically viable one. This is possible because the incumbent government would benefit from a decline in the volume of welfare-reducing political rents when out of power. In that instance, while it still cares about its constituency, it does not receive any of the rents from lobbying. Since the rent dissipation effect indicates that an FTA would help constrain the welfare-distorting political activities of the succeeding ruling party, the government might then be willing to establish an arrangement if it expects to leave office in the near future – even if it would not support the FTA were it able to keep power permanently.

This is shown with a simple 2-period, 2-party extension of the previous framework. In this section, I assume that there is a fixed probability of reelection, given by the parameter $\rho \in [0, 1]$. If

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[19] More specifically, denoting the share of the population representing the government's constituency by $s \leq 1$, let there be a function $f(s)$ satisfying $f'(.) > 0$, $\lim f(s \to 0) = 0$ and $\lim f(s \to 1) = \infty$. The specific form of this function would depend both on the degree of leniency of the institutional constraints against making "protection for sale" and on the level of frictions existing in the negotiations with the import-competing firms. The government's objective function could then be specified as $G(t, D) = W(t) + D/f(s)$ – that is, just as in (2.2), but with b defined as $b \equiv 1/f(s)$.

the incumbent party loses power, its rival party takes office. For simplicity, I assume that the incumbent has the option to engage the country in an FTA at the end of its term, although the analysis would be entirely analogous if it could form the arrangement at any other point of its term.

Naturally, an FTA may be used to restrict future rent-seeking activities only if its reversal is costly enough to inhibit future governments from withdrawing the country from the arrangement. I present in Appendix III a simple extension of the model in which I show that irreversibility might be regarded as an equilibrium result. The new element in that extension, which is modeled similarly to McLaren (1999), is the introduction of "negotiating costs" necessary to get the arrangement implemented or undone. I show that this extension would not alter the rationale presented in this section in any significant way. Nevertheless, in order to concentrate on the paper's main arguments, I abstract from issues regarding the endogeneity of the irreversibility of FTAs in the main text, simply taking it as given.[20] It is interesting to note that irreversibility is coherent with history as well, as arrangements de facto implemented are rarely turned down later on.[21]

Focusing on the strategic motivations for the adoption of an FTA, I consider hereafter only arrangements that are not ordinarily beneficial for the incumbent government. Hence, the latter may want to implement them only if it is for "strategic" reasons – i.e., only to moderate the incentives of future governments to enact policies that contrast with its own interests. This restriction corresponds to having the following condition satisfied:

$$\textbf{A1:} \qquad G_{\Delta M}^{A} \equiv [W_{\Delta M}^{I}(b=0) + b_A \alpha_A PR_{\Delta M}^{A} + \Pi_{\Delta M}^{ROW}] < 0 \,, \qquad (5.1)$$

where the identifier A is used henceforth to identify the incumbent government. [By contrast, the rival party will be identified as party B.]

In this setup with fixed probability of political turnover, one more condition needs to be satisfied for "strategically supported FTAs" to make sense: the FTA must be welfare-improving when party B rules the country, but party B must be unwilling to implement it. The former is required because here the motivation leading the incumbent party to put the FTA into practice is precisely to ensure a higher welfare for its constituency, if it loses power. Moreover, this rationale

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[20] The role of irreversibility parallels that of the outstanding debt in the literature of the strategic role of public debt. In that line of research, it is typically assumed that future governments will have to honor the country's outstanding debt, which behaves as a state variable. Here, the state variable is instead the presence (or not) of an FTA, and I assume accordingly that the next government cannot overturn it.

[21] The only exceptions to this rule seem to be in Central America (CACM) and in the Caribbean (CARIFTA/CARICOM). After effective implementation during the 1960's, these arrangements were disrupted during the debt crisis of the 1980's. Nevertheless, both were fully reactivated in the early 1990's.

makes sense only if party B does not want to implement the arrangement itself, so the latter condition must hold as well. These conditions correspond to assuming that:

$$\textbf{A2:} \qquad G_{\Delta M}^{B} < 0 < W_{\Delta M}^{B} \equiv [W_{\Delta M}^{I}(b_{B}) + \Pi_{\Delta M}^{ROW}] \qquad\qquad (5.2)$$

Under assumptions A1-A2, party A uses the FTA to "tie the hands" of its successor if, weighted with the corresponding probabilities, the gains of party A with the FTA when it loses power ($W_{\Delta M}^{B}$) overcome its losses when it keeps power ($G_{\Delta M}^{A}$). That is, it enters in the FTA if:

$$\textbf{SC:} \qquad \rho G_{\Delta M}^{A} + (1-\rho)W_{\Delta M}^{B} > 0. \qquad\qquad (5.3)$$

It is straightforward to see that a lower ρ makes the condition more likely to hold, so the lower are the incumbent's chances of holding office, the more important becomes its strategic reasoning for adopting the FTA. Hence, sufficiently high "political instability" may compel a government to pursue agreements that it would not seek otherwise.[22]

A higher parameter b_{B}, by increasing $W_{\Delta M}^{B}$, tends to make condition SC hold more easily as well. The reason is that a party B more biased toward special interests creates a prospect of larger distortions. This, in turn, makes the incumbent more inclined to use the FTA to limit the rent-seeking activities of its potential successor and protect the expected welfare of its constituency.

Conversely, if the incumbent government is itself very sensitive to the politically generated rents, or else if its bargaining power vis-à-vis the private sector in the division of those rents is large, it would be less willing to forgo the possibility to obtain rents only to prevent future welfare distortions. This can be seen by noting that both α_{A} and b_{A} affect $G_{\Delta M}^{A}$ only through its component $b_{A}\alpha_{A}PR_{\Delta M}^{A}(b_{A})$. Since $PR_{\Delta M}^{A} < 0$ (from Proposition 2), a higher α_{A} clearly reduces $G_{\Delta M}^{A}$. The effect of b_{A} is not as clear-cut, but it is shown in the proof of Proposition 4 that $(b\alpha PR_{\Delta M})$ is indeed altogether decreasing in b. Therefore, either a higher b_{A} or a higher α_{A} make the current government more sensitive to reductions in the political rents, and thus less prone to promote the FTA (since a lower $G_{\Delta M}^{A}$ makes SC less likely to hold).

An important implication of the strategically supported FTAs studied in this section is that, as those endorsed for non-strategic reasons (analyzed in the previous section), they too enhance expected national welfare. In order to see that, note that the expected welfare impact of an FTA in this context is positive iff:

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[22] Consistent with governments implementing FTAs only to reduce the ability of future policymakers to gain from inefficient policies, Nalin and Torstensson (1995) find, in a cross-section empirical evaluation, that frequent regime changes tend indeed to reduce the distortions due to trade barriers.

$$\rho W_{\Delta M}^{A} + (1-\rho)W_{\Delta M}^{B} > 0. \tag{5.4}$$

The left-hand-side of this expression differs from that of SC only because $W_{\Delta M}^{A}$ replaces $G_{\Delta M}^{A}$. But since we already know that $W_{\Delta M} \geq G_{\Delta M}$, if SC is satisfied, condition (5.4) must hold as well, and the FTA will enhance expected national welfare.[23]

The next proposition summarizes the above discussion.

Proposition 5: *Given assumptions A1-A2, the incumbent party A adopts the proposed FTA if and only if condition SC is satisfied. The set of parameters under which condition SC is satisfied is larger, the higher is b_B and the lower are ρ, α_A and b_A. If the arrangement is adopted, it enhances expected national welfare.*

As indicated in the outset, the idea that governments can manipulate state variables to constrain their successors' choices is not novel. Prominent examples are the pioneering contributions of Alesina and Tabellini (1990) and Persson and Svensson (1989), who employ such a rationale to study the politics of debt issuance. One of the key insights from that line of research is that political competition may induce a government to take measures that would increase the cost of policies that its successor might want to pursue, but which the incumbent would like to prevent. Here, a similar reasoning is employed to show that a government faced with the prospect of being replaced might want to reduce the gains of its successor from the lobbying interactions with the oligopolistic industry. An FTA is shown to be an effective tool towards such foreclosure, so an incumbent government faced with the opportunity to implement an FTA might consider doing so even if only to limit the ability of its successor to create rents.

It should be noted, however, that although my perspective is broadly consistent with the approach pursued in the macroeconomic political economics literature, there are also important differences. For instance, whereas heterogeneous preferences for the competing political groups/parties are typically central for the results in that line of research,[24] I do not require any

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[23] Note, however, that the arrangement may still reduce *realized* national welfare. In order to see this, suppose that, for the FTA in question, there is a $b_{\overline{w}}$ such that the proposed arrangement would be neutral in terms of welfare under a government with political bias $b_{\overline{w}}$ – that is, $b_{\overline{w}}$ satisfies $W_{\Delta M}^{I}(b_{\overline{w}}) + \Pi_{\Delta M}^{ROW} = 0$. A2 presumes that $b_B - b_{\overline{w}} > 0$, but implies nothing about $b_A - b_{\overline{w}}$, so we may have condition SC holding while $b_A < b_{\overline{w}}$, in which case the arrangement would reduce period 2's national welfare if the incumbent keeps power.

[24] Alesina and Tabellini, for example, assume that the competing political parties differ with respect to their preferences over the composition of public expenditure, while Persson and Svensson assume that they differ in terms of their preferred level of public expenditure.

heterogeneity between the preferences of the political groups.[25] Instead, what is necessary to create a strategic motive for the establishment of an FTA is the existence of "office rents." These rents make an incumbent party that expects to leave power shortly less responsive to special interests, since when not in office the party benefits only from higher national welfare.

There is also a fundamental distinction between the welfare consequences of "binding the successor's hands" here and in that literature. The typical finding is that political competition tends to introduce "strategic inefficiencies" in the policymaking process, because political competition would prevent governments from fully internalizing the welfare impact of their policies.[26] In this paper, by contrast, political competition generates "strategic efficiencies," as it *compels* governments to internalize the welfare consequences of a trade agreement, thus being helpful from a social standpoint.

6. FTAS WITH ENDOGENOUS PROBABILITY OF REELECTION

As suggested in the Introduction, the implementation of an FTA may also influence the likelihood of turnover. In this section, I consider the case of a mature democracy where political turnover is determined through periodical elections. To analyze this situation, I add a probabilistic voting mechanism to the previous setting.

Specifically, let the incumbent party A have a constituency made up of a fraction $s_A < \frac{1}{2}$ of the electorate, while its rival, party B, is supported by a larger fraction $s_B \in (s_A, \frac{1}{2})$ of the electorate. The constituency of each party corresponds to their share of "loyal" voters. Following Milesi-Ferretti and Spolaore (1994), I assume that there is also a fraction $(1 - s_A - s_B) > 0$ of voters that are "unattached" to political parties, and need to be persuaded before each election. As discussed in the previous section (see in particular footnote 19), b_j can be regarded as an inverse function of s_j, so the party with broader representation (B) selects a policy more in conformity with the interests of the population at large than the more narrowly represented party (A).

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[25] I actually allow the two political parties to have distinct preferences, as the potentially distinct bargaining powers and political biases indicate. But while this provides additional flexibility to the model, it is not required for Proposition 5.

[26] In Alesina and Tabellini (1990) and Persson and Svensson (1989), e.g., the incumbent government would tend to overaccumulate debt (relative to the socially optimal level) in order to raise the cost of the funds necessary to finance the successor's preferred public spending policy. Similarly, Cukierman et al. (1992) use this rationale to explain why governments avoid/postpone welfare-improving tax reforms.

All voters are rational and know the positions taken by the two parties on all matters. The loyal voters have objectives identical to the parties that they support. The unattached voters, on the other hand, base their choices on two dimensions: (1) welfare prospects, which depend on the welfare impact of the policies to be enacted by the elected government (here represented simply by the choice of the import tariff); and (2) "other issues," representing exogenous or non-economic aspects of public policy that are relevant to these voters. They have heterogeneous preferences with respect to these "non-economic issues," and for this reason do not vote homogeneously.

Specifically, let each unattached voter i cast his vote for party A if and only if:

$$\mu_i + \eta > W^B - W^A, \tag{6.1}$$

where η denotes the relative popularity of party A in terms of the non-economic issues; μ_i is an idiosyncratic parameter representing the bias of elector i toward party A; and W^j is the level of welfare that would be realized if party j were elected. The two parties observe neither η nor μ_i, but know their distributions. The distribution of η, denoted by $F(\eta)$, is assumed to be non-constant in the neighborhood of the initial equilibrium. For concreteness, I assume that the subject-specific parameter μ_i is uniformly distributed in the range $[\frac{-1}{2\phi}, \frac{1}{2\phi}]$.

Provided that not all unattached electors vote for the same party, we can define a "swing voter," i^*, as a voter whose parameter μ_{i*} is such that:

$$\mu_{i*} = W^B - W^A - \eta. \tag{6.2}$$

All voters with subject-specific parameter $\mu_i > \mu_{i*}$ vote for A, whereas those with subject-specific parameter $\mu_i \leq \mu_{i*}$ vote for B. Thus, the fraction of unattached voters who choose A is given by:

$$\int_{\mu_{i*}}^{1/2\phi} \phi \, dv = \phi\left[\frac{1}{2\phi} - \mu_{i*}\right] = \frac{1}{2} - \phi\left[W^B - W^A - \eta\right]. \tag{6.3}$$

Party A's reelection prospects can now be determined. Defining $\Delta \equiv (W^B - W^A)$, the total fraction of voters supporting party A corresponds to:

$$v^A = s_A + (1 - s_A - s_B)\left[\frac{1}{2} - \phi(\Delta - \eta)\right], \tag{6.4}$$

whereas the share of voters captured by party B is $v^B = 1 - v^A$. Hence, the probability that party A is reelected is given by $p^A \equiv \text{prob}\{v^A \geq 1 - v^A\} = \text{prob}\{v^A \geq \frac{1}{2}\}$. This probability can be rewritten after some rearranging as:

$$p^A = \text{prob}\left\{\eta > \Delta + \frac{(s_B - s_A)}{2\phi(1 - s_A - s_B)}\right\} = 1 - F\left(\Delta + \frac{(s_B - s_A)}{2\phi(1 - s_A - s_B)}\right). \tag{6.5}$$

Because of party *B*'s larger constituency, the argument of *F*(.) in (6.5) is always positive. Consequently, party *A* can be reelected only if it is sufficiently more popular than party *B* in the "non-economic" issues – that is, only if η is positive and sufficiently large.

Expression (6.5) makes clear which are the factors that improve the reelection prospects of party *A*: a smaller difference between the size of the two constituencies, $(s_B - s_A)$; a larger fraction and/or a more densely distribution of unattached voters, $\phi(1 - s_B - s_A)$; and a greater advantage in the non-economic issues (η). But in this simple probabilistic voting model with rational and informed voters, these are all fixed parameters from the perspective of the political parties. Accordingly, the incumbent party is unable to do anything to alter its reelection prospects unless it can credibly commit to implement distinct policies. I now show that an FTA can play the role of such a credible commitment device.

An FTA in this context alters p^A through its effect on Δ. By making any government less able to affect national welfare, the arrangement reduces the disadvantage of party *A* in that respect, thus shifting the election's probabilistic outcome toward party *A*. Proposition 6 proves this claim.

Proposition 6*: By engaging the country in an FTA, Party A lowers Δ, thereby enhancing its electoral chances.*

Proof: It follows directly from (6.5) that a lower value of Δ improves p^A. What remains to be shown, hence, is only that an FTA decreases Δ. This happens iff:

$$W_M^B - W_M^A < W^B - W^A \Leftrightarrow W_{\Delta M}^B < W_{\Delta M}^A ,$$

which is true because of Proposition 3 – which asserts that, all else equal, the welfare impact of an FTA in a country is higher, the larger is the political bias of its government – and since $b_B < b_A$ by assumption. ∎

Proposition 6 illustrates a type of commitment role played by an FTA that is distinct from the one analyzed in the previous section. Rather than "tying its successor's hands," now the incumbent government can use an FTA also to "tie its *own* hands," as that may make it more likely to win an incoming election. The argument relies essentially on the electors viewing the incumbent party as relatively weak in one of the electorally relevant dimensions. If the incumbent is able to credibly reduce the relevance of that issue, it improves its likelihood of electoral success. The proposition shows that an FTA is a possible instrument toward such a commitment when the voters see the incumbent party as more prone to distort the economy through redistributive trade policies than its contender.

Even in that case, however, the incumbent party still needs to decide whether it is worthwhile to implement the FTA. The interesting case occurs when assumption A1 holds, so the incumbent is against the arrangement in the absence of strategic motivations. Party A would then need to weight its gain in having an increased prospect of reelection against its loss from implementing the FTA. The condition that ensures that it will indeed support the arrangement is:

$$p_M^A G_M^A + (1 - p_M^A)W_M^B \geq p^A G^A + (1 - p^A)W^B, \tag{6.6}$$

where $p_M^A (> p^A)$ denotes party A's probability of reelection with the FTA in place. The left-hand-side (right-hand-side) of (6.6) represents the incumbent's expected utility with (without) the FTA.

Defining $p_{\Delta M}^A$ as the increase in the reelection probability due to the FTA and subtracting $[p_M^A G^A + (1 - p_M^A)W^B]$ from each side of (6.6), it can be rewritten as:

$$\begin{aligned} p_M^A G_{\Delta M}^A + (1 - p_M^A)W_{\Delta M}^B &\geq p_{\Delta M}^A[W^B - G^A] \\ &= p_{\Delta M}^A\left[\left(W^B - W(b=0)\right) - b_A \alpha_A PR^A\right]. \end{aligned} \tag{6.6'}$$

The left-hand-side of (6.6') displays the impact of the FTA on party A's expected payoff when the arrangement does *not* alter p^A, the case analyzed in the previous section. There I assert that an FTA would be supported for purely strategic reasons only if the value of that expression were positive. Now, party A's incentives to adopt the FTA are enhanced by the arrangement's effect on the probability of reelection. Accordingly, even if party A's expected payoff from the FTA were negative under a fixed p^A, it may still want to establish the arrangement if the FTA improves its chances of keeping office sufficiently enough. This can be seen by noting that the right-hand-side of (6.6') is unambiguously negative, since PR^A is always positive and the difference between the welfare levels achieved under a party B's government and a social planner ($b = 0$) administration is necessarily negative.

The downside of having an FTA to improve reelection prospects is that it may create an "excess" of incentives for integration. Thus, in contrast with the results in the previous sections, now a welfare-reducing arrangement may be politically feasible as well. The next proposition demonstrates this possibility.

Proposition 7: *When an FTA improves the probability of reelection of the incumbent government, the government may support the arrangement even if it reduces national welfare.*

Proof: The condition under which the government supports the FTA, given in (6.6), can be rewritten as:

$$p_M^A G_M^A - p^A G^A \geq (1 - p^A) W^B - (1 - p_M^A) W_M^B,$$

whereas the condition under which the FTA is welfare-improving (in expected terms) is equivalent to:

$$p_M^A W_M^A - p^A W^A \geq (1 - p^A) W^B - (1 - p_M^A) W_M^B.$$

Note that the right-hand-side of the two expressions is identical. Suppose then that, as before, the arrangement enhances welfare whenever the government supports it. If so, we would need that:

$$p_M^A W_M^A - p^A W^A \geq p_M^A G_M^A - p^A G^A.$$

Using the definition $p_{\Delta M}^A \equiv p_M^A - p^A$ and adding and subtracting $(p^A W_M^A)$ in the left-hand-side and $(p^A G_M^A)$ in the right-hand-side of this inequality, it becomes:

$$p^A W_{\Delta M}^A + p_{\Delta M}^A W_M^A \geq p^A G_{\Delta M}^A + p_{\Delta M}^A G_M^A,$$

which is equivalent to:

$$p^A \left[W_{\Delta M}^A - W_{\Delta M}(b=0) - b_A \alpha_A PR_{\Delta M}^A \right] \geq p_{\Delta M}^A \left[G_M^A - W_M^A \right] = p_{\Delta M}^A b_A D_M^A.$$

The left-hand-side of this expression is definitely positive, by propositions 2 and 3. But since the right-hand-side is positive as well, the inequality may not hold. In particular, if $p_{\Delta M}^A$ is large relative to p^A, so the FTA is particularly useful in enhancing party A's probability of keeping office, that inequality will be less likely to hold, and a welfare-reducing arrangement may become politically viable. ∎

The intuition of Proposition 7 is straightforward. Because of the "office rents," each government benefits from incumbency. If an FTA enhances the probability by which a party will acquire these rents in the future, it creates a bias in making that party too eager to adopt the arrangement, vis-à-vis the socially optimal decision. This bias goes in the opposite direction of the bias created by the "rent dissipation" effect, which reduces the governments' willingness to enter in FTAs relatively to the socially optimum. The net effect will nevertheless depend on their relative magnitudes, so it cannot be assessed a priori.

It is worth noting that this "excess" of incentives to institute an FTA is driven by the assumption that the incumbent has a smaller "loyal constituency" – and thus is more rent-seeker – than its contender. I pursued this case because of the distinct nature of results that it produces. It should nonetheless be clear from the previous analysis that the opposite outcome would arise if one reverses the assumption regarding the inclination of the two parties toward special interest politics. In that case, the bias toward too little incentives to enter in an FTA, introduced by the rent dissipation effect, would be reinforced further.

7. FTAs as Insurance Against an Authoritarian Takeover

In this section, I consider a country that faces the threat of political disruption by an authoritarian group. This type of analysis is relevant whenever a country has not yet "consolidated its democracy," meaning that the institutions that make the breakdown of a democratic system prohibitively costly (free press, autonomous judicial system, well-established property rights and the like) are not solid enough in the country.

I assume that the potential dictatorial group cares predominantly about its own well-being. That is, rather than considering the potential dictatorship as "benevolent," as often assumed in economic analysis, I treat it as "kleptocratic." Moreover, since the supporting group of a dictatorship tends to be considerably smaller than that of a democratic party, the motives constraining rent-seeking behavior are considered weaker for the dictatorship. In terms of expression (2.2), this perspective implies that the weight put by the potential dictator on rents is higher than the weight put by democratic governments.[27]

Suppose then that an authoritarian group is in a position to decide whether or not to attempt to subvert the country's democratic order. Modeling such a problem as simply as possible, I assume that, if the takeover attempt is successful, the group imposes a dictatorship in the country and obtains its office payoff, G^D (where the identifier D stands for dictatorship). By contrast, if it is unsuccessful, it bears a fixed cost of $K > 0$.[28]

If the authoritarian faction actually attempts to takeover, the probability that the endeavor is successful is given by p_s. This probability depends on the stability of the country's democratic institutions. In regions with enduring democratic tradition, where the rule of law is strong, it tends to be insignificantly low, virtually precluding the possibility of political disruption. However, in countries lacking such solid institutions, where the rule of law is weak and democracy has not yet "consolidated," p_s can be much higher, thus opening a tangible opportunity for successful coups.

Knowing these parameters, the (risk-neutral) authoritarian group attempts to takeover if and only if its expected utility from the endeavor is positive. That is, iff:

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[27] This presumption has empirical support. Nalin and Torstensson (1997), e.g., find that dictatorships are more likely than democracies to pursue distortionary redistributive policies. Specifically to trade policies, Banerji and Ghanem (1997) and Rama (1994) present evidence that authoritarian regimes are associated with increased trade protection and trade regulations. Mitra et al. (2001) provide additional support for the presumption that the importance of welfare concerns vis-à-vis special interests is lower under dictatorships than under democracies. Their finding arises from their estimation and comparison of Grossman and Helpman's (1994) type of weights for welfare/contributions for Turkey between periods of democratic and authoritarian administrations.

$$G^D p_s - K(1 - p_s) > 0 , \tag{7.1}$$

or equivalently, iff:

$$p_s > K/(G^D + K) . \tag{7.1'}$$

In a consolidated democracy, where p_s is close to zero, it is clear from (7.1') that an attempt against the county's democratic system would happen only if the costs of failure were substantially low. Since this is usually not the case anywhere, the country's political system would then be safely protected. Conversely, a democracy with underdeveloped democratic institutions (high p_s) typically has the stability of its political system at risk.

It is also straightforward to see that, for a given pair $(p_s, K) >> 0$, the authoritarian group is more likely to attempt to subvert the country's democratic system the larger is its payoff in office, G^D. Recall that, for a given b_D, the other factor that increases G^D is a higher α_D, corresponding to a higher bargaining power vis-à-vis the private sector in the division of the political rents. Because of the aptitude of authoritarian administrations to resort to violence to settle conflict, it is plausible that this bargaining power will tend to be relatively high.

In this framework, an FTA may critically reduce the incentives of the authoritarian group to attempt a takeover. Note first that, since the arguments above imply that $b_D > b_A$ and $\alpha_D \geq \alpha_A$, Proposition 2 indicates that the FTA reduces the political rents, and particularly the share of political rents acquired by the government, by more under a dictatorship than under a democracy – i.e., $b_D \alpha_D PR_{\Delta M}^D < b_A \alpha_A PR_{\Delta M}^A$. Supposing that assumption A1 holds, so the incumbent government does not support the arrangement for ordinary reasons (i.e., $G_{\Delta M}^A < 0$), we then have that $G_{\Delta M}^D$ must be strictly negative.[29] But by reducing the potential gains from the attainment of political power, the FTA may reverse the incentives of the authoritarian group in seeking power. That is, if condition (7.1') were initially satisfied, the FTA may make it stop holding by diminishing G^D, thus freeing the country from the threat of an authoritarian takeover.

There is actually no novelty in arguing that the availability of rents might entice political turbulence. This is the main message of Wantchekon (2000), for instance. Likewise, Olson (1993) points out that the *un*availability of such rents may work as a constraint to the emergence of authoritarian regimes. Ellman and Wantchekon (2000) show further that, in elections where one

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[28] The parameter K should be regarded as a proxy for the many kinds of penalties that could apply in such a case – incarceration, extradition, death and the like.

[29] This is so because, from (4.2), the impact of the FTA on the equilibrium payoff of any government is given by $G_{\Delta M} = W_{\Delta M}^I(b = 0) + \Pi_{\Delta M}^{ROW} + b\alpha PR_{\Delta M}$. From the previous observation in the text, it then follows that $G_{\Delta M}^D < G_{\Delta M}^A < 0$.

party controls a source of political unrest, its competitor might be able to win the election while at the same time preventing the breakdown of the political system. It could obtain that by (credibly) proposing policies similar to those preferred by the violent-prone party, as this would reduce the gains of the latter from holding office and, consequently, its incentives to destabilize the political system. The outlook from which I argue here that an FTA may be able to prevent political unrest closely parallels that perspective, as it is based precisely on the reduction of such "office premium."

However, we still need to ask whether the incumbent democratic government would *want* to implement the arrangement. One may argue that, for purely ideological reasons, it would. But this may be true also within the narrower perspective of the model used here. First, applying the rationale of Section 5, the FTA could be useful to the incumbent party even when the breakdown of the democratic system seems inevitable. Since it cares about the well-being of its constituency, the forward-looking incumbent could institute the FTA aiming to mitigate the welfare losses arising from the distortions that a dictatorship would tend to introduce in the economy. Moreover, as the rationale developed in Section 6 indicates, the incumbent is more likely to support an FTA if the arrangement increases its likelihood of keeping power. Since the institution of a dictatorship tends to be especially harmful to the prospects of a democratic party in regaining power, that argument is strengthened further under the threat of a dictatorial takeover.

This reasoning suggests, therefore, that an FTA might be useful to prevent the emergence of authoritarian regimes in countries where democracy is not fully consolidated. Nascent democracies are possibly the most prominent candidates to display this characteristic, given the unstable political periods that typically follow the end of dictatorial regimes. Interestingly, there is indeed considerable anecdotal evidence linking the creation of preferential trade agreements to the establishment of new democracies. This was the case, for example, of all Mercosur members, of Greece, Portugal and Spain in their accession to the European Community, and of the EU agreements with the countries of Central and Eastern Europe. Likewise, the European Community itself was established few years after the end of autocrat regimes in some of its original members (Germany and Italy). The consolidation of democratic regimes is also presented as one of the primary goals of the potential free trade area of the Americas, aggregating at times even more attention than the trade issues.[30]

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[30] As *The Economist* (4/19/2001) points out, "the elected leaders of Latin America look to the United States as an export market but also as a source of support for democracy in the region."

Naturally, a more systematic empirical evaluation of the relationship between nascent democracies and the establishment of trade agreements is still needed to establish its general validity.[31] Similarly, the role that the rent dissipation effects of an FTA play in this regard also needs a quantitative assessment. Nevertheless, the rent dissipation effects provide the first formal explanation for this relationship.

8. CONCLUDING REMARKS

This paper shows that the "economics of politics" are critical for the political viability of a free trade agreement. The key driving force in the analysis is the "rent dissipation" that an FTA generates. That is, by lowering the incentives for lobbying against imports from the outside countries, an FTA reduces the rents created in the lobbying process. This reduction, being anticipated by the governments, makes them more "conservative" in their decisions to participate in FTAs. This implies that some welfare-improving arrangements will not gain political support, although no welfare-reducing FTA will become politically feasible either.

I analyze the political viability of free trade agreements also in environments in which political turnover is possible. Despite being one of the central characteristics of democratic systems, the relationship between political turnover and the viability of free trade agreements has not yet been addressed in the literature. The framework of this paper is particularly adequate for such an analysis; an FTA, by inducing rent dissipation, imposes a constraint on the future availability of rents, and may for this reason create "strategic" motivations for its adoption.

I model the possibility of political turnover in three related ways, representing distinct circumstances under which this sort of uncertainty may affect the political feasibility of FTAs. Overall, the analysis confirms that, in order to fully understand the political determinants of FTAs, one must account for such uncertainty. It is shown, in particular, that a trade bloc may be formed *only* because of the prospect of political turnover.

These findings, although presented primarily as a contribution to the theory of preferential trade agreements, are also closely related to the political economics literature that studies the consequences of political uncertainty. This line of research has evaluated the impact of political

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[31] Mansfield et al. (2000) take one step towards such evaluation, showing that pairs of democratic countries are more likely to create trade agreements than pairs in which at least one of the countries has an authoritarian political regime.

instability on e.g. the management of debt, the timing of tax reforms and the viability of stabilization programs. Here, I show that it can be useful to explain the timing and the consequences of FTAs as well.

Interestingly, the analysis indicates that the effects of political uncertainty on the feasibility of FTAs, in contrast with the typical findings in the macroeconomic applications, may be "benign:" the possibility of political turnover can promote the creation of otherwise unfeasible welfare-enhancing FTAs, which are useful to prevent distortionary trade policies and may even help "consolidate" unstable democracies. Yet I do not intend to provide here an exhaustive examination of the relationship between political uncertainty and the viability of free trade agreements, but rather to provide the initial step towards such understanding. The need for further research to investigate these links in more detail is warranted.

Appendix I – Proofs of Propositions

Proof of Proposition 1:

The initial statement in the proposition is that an FTA reduces the difference between its members' political and optimal tariffs, so that $t_M^p - t_M^* < t^p - t^*$. In order to show that, let us first calculate a country's political tariff. Developing the expression in (3.1) and manipulating, we find the political tariff as a function of the size of the FTA, M (which equals one in the case of no FTA), and the government's political bias, b:

$$t_M^p(b, M) = \frac{(A - c)(3 + 2b)}{(2M - 2b - 1)N + (5 + 2b)M + 2}. \tag{AI.1}$$

Differentiating this function with respect to M and b, we obtain:

$$\frac{\partial^2 t_M^p}{\partial M \partial b} = -\frac{1}{\left(DEN(t_M^p)\right)^2}\left\{\left[\frac{\partial t_M^p}{\partial b}(5 + 2b + 2N) + 2t_M^p\right]DEN(t_M^p) - t_M^p(5 + 2b + 2N)\frac{\partial DEN(t_M^p)}{\partial b}\right\}, \tag{AI.2}$$

where $DEN(t_M^p)$ represents the denominator of $t_M^p(b, M)$. For any value of $b \in$ [0, ½] and $M \in$ [1, N], both $DEN(t_M^p)$ and the square bracket in (AI.2) are positive; since $\partial DEN(t_M^p)/\partial b = -2(N - M) < 0$, we have that $\partial^2 t_M^p / \partial M \partial b < 0$ as well.

The significance of this result is that it implies that the function $t_M^p(b, M)$ is strictly *submodular* in the interior of I = [0, ½] $\times$ [1, N]. Thus, letting x and x' represent any distinct pairs $(b, M) \in$ I, we have that:

$$t_M^p(\max\{x, x'\}) + t_M^p(\min\{x, x'\}) < t_M^p(x) + t_M^p(x'), \tag{AI.3}$$

Accordingly, for any $\underline{b}$, $\overline{b}$, M_1 and M_2 in the domain and such that $\overline{b} > \underline{b}$ and $M_2 > M_1$, the following relationship holds:

$$t_M^p(\overline{b}, M_2) + t_M^p(\underline{b}, M_1) < t_M^p(\overline{b}, M_1) + t_M^p(\underline{b}, M_2), \tag{AI.4}$$

or equivalently:

$$t_M^p(\overline{b}, M_2) - t_M^p(\underline{b}, M_2) < t_M^p(\overline{b}, M_1) - t_M^p(\underline{b}, M_1). \tag{AI.4'}$$

Now, let $\underline{b} = 0$, $\overline{b} \in$ (0, ½), $M_1 = 1$ and $M_2 = M \in$ (2, N). Then, applying (AI.4'), we have that:

$$t_M^p(b, M) - t_M^p(0, M) < t_M^p(b, 1) - t_M^p(0, 1).$$

Using the notation in the text, this is exactly the Proposition's initial claim:

$$t_M^p - t_M^* < t^p - t^*,$$

which means that an FTA reduces the difference between its members' political and optimal tariffs.

The last part of the Proposition says that the reduction in this difference is larger, the larger is the size of the bloc and the government's political bias. It is obtained in exactly the same way, by re-applying (AI.4) successively with different values of b and M.

Proof of Proposition 2:

Proposition 2 states first that an FTA should reduce the volume of political rents. Using the expression for the political rents displayed in Section 2, this can be represented as:

$$\frac{1}{b}\left[\left(W_M^l(t_M^p)+b\pi(t_M^p)\right)-\left(W_M^l(t_M^*)+b\pi(t_M^*)\right)\right]<\frac{1}{b}\left[\left(W^l(t^p)+b\pi(t^p)\right)-\left(W^l(t^*)+b\pi(t^*)\right)\right]. \quad \text{(AI.5)}$$

This is equivalent to saying that an FTA reduces the function $[W^l(t) + b\pi(t)]$ by more when it is evaluated at $t = t^p$ than when it is measured at $t = t^*$. The proposition also states that the fall of political rents is deeper the larger is the bloc. Thus, I need to show that the inequality:

$$\frac{\Delta\left[W^l(t^p)+b\pi(t^p)\right]}{\Delta M}<\frac{\Delta\left[W^l(t^*)+b\pi(t^*)\right]}{\Delta M} \quad \text{(AI.6)}$$

holds for any increase in M ($\Delta M > 0$). Evaluating condition (AI.6) with derivatives and showing that it holds for all possible M suffices to show that it holds. Thus, I first evaluate the function $[W^l(t) + b\pi(t)]$ with the "political tariff" [for the left-hand-side of (AI.6)] and with the "optimal tariff" [for the right-hand-side of (AI.6)], and differentiate each of it with respect to M. After substituting the two expressions back in (AI.6), tedious but straightforward calculations reveal that it is equivalent to:

$$-\left(t_M^p\right)^2<-\left(t_M^*\right)^2\left[1+\frac{\tfrac{8}{3}b(1+N)(1+M)}{(2M-1)N+5M+2}\right], \quad \text{(AI.7)}$$

which can be shown to hold for all possible parameter values.

The last part of the proposition asserts that the change in the volume of political rents induced by an FTA is more negative the higher is the parameter b. That change can be represented as:

$$PR_{\Delta M}=\left[\pi_{\Delta M}-\pi_{\Delta M}(b=0)\right]-\frac{1}{b}\left[W_{\Delta M}^l(b=0)-W_{\Delta M}^l\right], \quad \text{(AI.8)}$$

with the proposition stating that $\partial PR_{\Delta M}/\partial b<0$. Evaluating this derivative, we find that:

$$\begin{aligned}\frac{\partial PR_{\Delta M}}{\partial b}&=\frac{\partial\pi_{\Delta M}}{\partial b}+\frac{1}{b^2}\left[W_{\Delta M}^l(b=0)-W_{\Delta M}^l\right]+\frac{1}{b}\frac{\partial W_{\Delta M}^l}{\partial b}\\&=\frac{1}{b}\frac{\partial(W_{\Delta M}^l+b\pi_{\Delta M})}{\partial b}+\frac{1}{b^2}\left[W_{\Delta M}^l(b=0)-W_{\Delta M}^l\right].\end{aligned} \quad \text{(AI.9)}$$

Now, evaluating $(W_{\Delta M}^l+b\Pi_{\Delta M})$ with derivatives, using the calculations above the first element of (AI.9) becomes equivalent to $[-2t_M^p(\partial t_M^p/\partial b)/b]$, and therefore is negative. Since Proposition 3 ensures that its second element is negative as well, (AI.9) is indeed negative and the proof is complete. ∎

Proof of Proposition 3:

The Proposition states that, ceteris paribus, the impact of an FTA on the welfare of each of its members is higher, the higher is the political bias of the country's government. Defining

$W_{\Delta M}^{l}(b) \equiv W_{M}^{l}[t_{M}^{p}(b)] - W^{l}[t^{p}(b)]$, the impact of an FTA on the welfare of a participating country can be denoted as $W_{\Delta M}^{l}(b) + \Pi_{\Delta M}^{ROW}$. Since $\Pi_{\Delta M}^{ROW}$ depends only on the *external* political conditions, the proposition's claim can be represented simply as $\partial W_{\Delta M}^{l}(b)/\partial b > 0$, and in spite of M being an integer, showing that $\partial^{2}W_{M}^{l}(t_{M}^{p})/\partial M \partial b > 0$ is sufficient to prove it. After substituting t_{M}^{p} [from (A.1)] into the definition of local welfare, that derivative can be straightforwardly computed. Calculations reveal that:

$$\frac{\partial}{\partial b}\left[\frac{\partial W_{M}^{l}(t_{M}^{p})}{\partial M}\right] = \frac{4(A-c)^{2}b(M+1)(N+1)[(N/2-1-b)M+(2+b)N-\frac{1}{2}]}{[(M-\frac{1}{2}-b)N+(\frac{5}{2}+b)M+1]^{4}},$$

which is strictly positive $\forall\ N \geq 3$, $M \geq 1$ and $b < \frac{1}{2}$, thus ratifying the proposition. ∎

Appendix II – Lobbying For and Against FTAs

In the body of the paper, the government decides alone whether or not to join/create a specific FTA, after considering its impact on the country's political equilibrium. Now, I show that allowing the oligopolistic firm to lobby directly for or against FTAs would not alter the paper's results qualitatively.

This possibility requires the introduction of new stages in the game between the firm and the government. The new game can be described as follows.

t = 0: An FTA with $M-1$ other countries becomes exogenously available.

t = 1: The firm offers a transfer T to the government, conditioned on a specific decision regarding the FTA.

t = 2: The government decides whether or not to accept the transfer.

    A.   If it accepts, it follows the firm's request regarding the FTA and receives the transfer.

    B.   Otherwise, it makes itself the decision regarding the FTA and does not receive the transfer.

t = 3: If the firm requests the implementation of the FTA and the government chooses option A, the arrangement is implemented. If the government chooses instead option B, and decides in favor of the FTA, it is formed as well. Otherwise, the FTA is not created.

In the main text, where the firm were not allowed to lobby explicitly for the formation/blocking of FTAs, an FTA would become politically viable if and only if $G_{\Delta M} > 0$. In the game above, a distinct condition is required for the political feasibility of an FTA, as Proposition 8 shows.

Proposition 8 *When the oligopolistic firm can lobby directly for or against an available FTA, the arrangement becomes politically feasible if and only if it enhances the joint payoff of the firm and the government, as measured by $(G_{DM} + bV_{DM})$.*

Proof: The equilibrium of the game depends on the effects of the FTA in question on the payoffs of the firm and the government. There are four possibilities: (i) $G_{\Delta M} \leq 0$, $V_{\Delta M} \leq 0$; (ii) $G_{\Delta M} > 0$, $V_{\Delta M} \leq 0$; (iii) $G_{\Delta M} \leq 0$, $V_{\Delta M} > 0$; (iv) $G_{\Delta M} > 0$, $V_{\Delta M} > 0$. Cases (i) and (iv) are trivial: in any perfect equilibrium, the FTA is formed in the latter but not in the former. The proposition's claim then follows immediately.

In case (ii), the government forms the FTA unless the firm compensates it for not doing so. This would require a transfer that satisfies:

$$W_M + bD_M \leq W + bD + bT , \tag{AII.1}$$

so that,

$$T \geq (W_{\Delta M} + bD_{\Delta M})/b = G_{\Delta M}/b . \tag{AII.2}$$

If the firm wants to block the arrangement, it sets the transfer at the minimum T satisfying (AII.2). It will indeed do so if and only if the payoff that it obtains by blocking the arrangement, $V - T$, is superior to what it gets by letting it be implemented, V_M. Or substituting for the equilibrium transfer $T = G_{\Delta M}/b$, iff:

$$V_{\Delta M} + G_{\Delta M}/b \leq 0 \iff G_{\Delta M} + bV_{\Delta M} \leq 0 . \tag{AII.3}$$

Take case (iii) now. In that instance, the government blocks the FTA unless the firm compensates it for implementing it. Proceeding analogously to the previous case, the transfer that the firm offers if it wants to alter the government's decision is $T = - G_{\Delta M}/b$. The firm does indeed offers this transfer iff:

$$V_M - T > V \iff G_{\Delta M} + bV_{\Delta M} > 0 . \tag{AII.4}$$

Considering the four cases altogether, it is then clear that when we allow the oligopolistic firm to lobby explicitly for and against FTAs, the sign of $(G_{\Delta M} + bV_{\Delta M})$ fully determines whether or not an arrangement is or not politically feasible. ∎

Hence, allowing the firm to lobby directly for/against the formation of an FTA alters the requirement for its political viability from $G_{\Delta M} > 0$ to $G_{\Delta M} + bV_{\Delta M} > 0$. This condition is more likely to hold – (1) when the local political parameter b is relatively low, in which case the decrease in the political rents induced by an FTA is less accentuated; (2) when the political parameter of the partner countries, say b_f, is relatively high, in which case the gain in export profits is heightened; and (3) when the total number of countries, N, is relatively low, in which case the initial tariffs are high and, therefore, the gain from preferential access in the partners' markets is more relevant.

The impact of each of these parameters is illustrated in Figure 2. It displays the loci where a bilateral FTA is politically "neutral," i.e. the loci where $G_{\Delta M} + bV_{\Delta M} = 0$, in the plan $(b \times N)$ under three different values for b_f. In the region below each curve, where the local political parameter b is relatively low, the bilateral agreement is politically feasible; by contrast, in the region above each curve the decrease in the political rents is too deep to make the arrangement viable. The lowest curve corresponds to the case where $b_f = 0$, the intermediate has $b_f = \frac{1}{4}$, and the highest has $b_f = \frac{1}{2}$. Naturally, the FTA is politically feasible

under a wider (narrower) range of pairs $\{b, N\}$ in the last (first) case, when the greater (smaller) preferential access provides more (less) sizable export gains.

Having showed how the possibility for bbbying explicitly for/against a specific FTA affects its political feasibility, I need now to assess how it would affect Proposition 4, which summarizes the results for the case where the government is permanently in power.* In establishing the robustness of Proposition 4 to this new possibility of lobbying, I use the fact that $(G_{\Delta M} + bV_{\Delta M}) = (W_{\Delta M} + b\Pi_{\Delta M})$, which can be straightforwardly obtained by substituting and rearranging the expressions developed in Section 2.

Proposition 4': *Suppose that we allow the oligopolistic firm to lobby directly for or against a proposed FTA when the government expects to remain permanently in office. In this case, as in Proposition 4, welfare-reducing FTAs would never be politically feasible, although welfare-improving FTAs may be obstructed.*

Proof: I prove each of the proposition's claims in turn.
(i) 'A welfare-reducing FTA will not gain political support'

Since now an FTA is politically viable iff $W_{\Delta M} + b\Pi_{\Delta M} > 0$, I need to show that this cannot happen when $W_{\Delta M} < 0$. In order to show that, I first prove that in this setting the effect of an FTA on the sum of consumer surplus and tariff revenue in any of its members is always positive. Using the equilibrium values for tariff and quantities as a function of M, this sum can be tediously, but straightforwardly evaluated under an FTA with generic size M. Differentiating that expression with respect to M, calculations reveal that it is always increasing in M:

$$\frac{\partial(CS_M + TR_M)}{\partial M} = \frac{(A-c)^2(3+2b)\{4b[(2+b)(N-M)+(2+M)N]+(11+2M)N-7M+2\}}{[(2M-2b-1)N+(5+2b)M+2]^3},$$

which is positive for any $M < N$, so an FTA enhances the sum $(CS_M + TR_M)$.

Since $CS_{\Delta M} + TR_{\Delta M} > 0$, $W_{\Delta M} < 0$ requires that $\Pi_{\Delta M} < 0$; accordingly, $W_{\Delta M} < 0$ implies that $W_{\Delta M} + b\Pi_{\Delta M} < 0$ as well, and hence no welfare-reducing FTA can be politically viable.

(ii) 'A welfare-improving FTA may not gain political support'

We need to assess now whether $W_{\Delta M} > 0$ implies that $G_{\Delta M} + bV_{\Delta M} > 0$. Both conditions may be satisfied simultaneously, but as in the main text, this is not necessarily the case. The examples in Figure 2, in particular, suffice to show that: in Figure 2, the bilateral agreement is always welfare-improving, but as indicated before, it is not politically feasible in the region above each curve. ∎

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* Since the forces affecting the incentives for lobbying for/against FTAs have the same nature regardless of the possibility of political turnover, this is shown only for the case where the government remains permanently in power. But a similar line of argument could be pursued to show the robustness of the other cases/propositions as well, after the natural adaptations.

Hence, allowing the oligopolistic firm to lobby directly for or against FTAs would not alter Proposition 4. This confirms the argument exposed in the body of the text regarding the difference between the political feasibility of welfare-reducing FTAs in this paper and in Grossman and Helpman (1995), who maintain that those types of FTAs are the most likely to be politically feasible. The analysis above ensures that the distinction between the two views is indeed not due to my disregard of explicit lobbying for trade regimes; rather, it is a result of Grossman and Helpman's disregard of the endogeneity of the post-FTA external tariffs and lobbying equilibrium.

Appendix III – FTAs with Political Turnover and Endogenous Irreversibility

I now extend the analysis of Section 5 to show that the non-reversibility of an FTA by a future government need not be regarded simply as an assumption, but can be viewed also as an equilibrium result. Analogous developments could be carried out for the results of sections 6 and 7 as well.

The extension developed here is very simple and maintains all the results of Section 5 qualitatively unaltered. It is based on the concept of "negotiating costs," which consist of costs that a government has to incur if it wants either to establish/join an FTA or to withdraw the country from a previously established FTA. I do not discuss the plausibility of these costs here, rather remitting the reader to McLaren (1999), who argues forcefully that negotiating costs constitute an important element among those that define the political feasibility of trade agreements. Alternatively (or complementarily), these costs can be regarded also as a proxy of other costs related to the introduction/termination of a preferential arrangement, such as the sectoral adjustment costs typically present in those circumstances.

Thus, let λ (λ^u) denote the negotiating costs that a government has to incur in order to have its country participating in (out of) an FTA, where both λ and λ^u are positive and measured in terms of the numeraire good. Accounting for that, conditions A1, A2 and SC from Section 5 can be re-stated as follows:

A1': $\quad G_{\Delta M}^A - \lambda < 0 \,,$ (AIII.1)

A2': $\quad G_{\Delta M}^B - \lambda < 0 < W_{\Delta M}^B - \lambda \Leftrightarrow G_{\Delta M}^B < \lambda < W_{\Delta M}^B \,,$ (AIII.2)

SC': $\quad \rho G_{\Delta M}^A + (1-\rho)W_{\Delta M}^B - \lambda > 0 \,.$ (AIII.3)

The interpretation of these conditions is entirely analogous to those provided in Section 5, with the only change being the subtraction of the negative costs λ from each payoff.

The question then becomes: if the political party B gets in office, will it want to undo the FTA? The FTA is called "non-reversible" if party B does not, which is the case when it does not benefit from overturning the FTA:

$$G_M^B > G^B - \lambda^u \Leftrightarrow G_{\Delta M}^B > -\lambda^u \,.$$ (AIII.4)

The successful establishment of an FTA requires now, in addition to conditions A1', A2' and SC', also the satisfaction of this non-reversibility condition, since otherwise the incumbent government would be only wasting resources worth λ of the numeraire good when creating the FTA – and would therefore never establish it. Incorporating (AIII.4) into A2', the latter becomes:

A2'': $\quad -\lambda^u < G^B_{\Delta M} < \lambda < W^B_{\Delta M}$. $\hfill$ (AIII.5)

Hence, the incumbent government now engages the country in an FTA for strictly strategic reasons if and only if conditions A1', A2'' and SC' hold.

The existence of negotiating costs obviously reduces the attractiveness of any FTA. Nevertheless, as these conditions closely parallel those laid out in Section 5, the logic behind an arrangement established for strategic reasons remain unaltered. It is also worth noting that, although both λ and λ^u are likely to be significant, equilibrium non-reversibility could be ensured even if one of them were zero.

An alternative extension, which puts greater emphasis on the timing of the establishment of an FTA, could specify λ^u as a function that increases monotonically after the agreement starts operating. This time pattern would reflect the progressive reallocation of resources within the integrating economies that is induced by the FTA. In such a framework, if the incumbent party decides to implement the FTA, it would also need to choose the right timing to do it, according to the following trade-off. If the government establishes the FTA too late in its mandate, it runs the risk that the rival party will find λ^u too low when it takes office, being thus encouraged to undo the arrangement. On the other hand, if the incumbent government implements the FTA too early in its mandate, it incurs in higher costs in terms of foregone political rents.

Finally, a yet simpler way to endogenize the non-reversibility of an FTA is to assume that the opportunity to create the FTA is "unique," in the sense that it will not be available to the next government, whichever is the party in command. In that case, we need to have $G^B_{\Delta M} \geq 0$, so B does not want to undo it. Even then, A may still want to implement an FTA only for strategic reasons, provided that $\rho < 1$. In such a case, party B also gains with the FTA, whether elected or not, but does not have the option to implement it. But as before, the general point is that the FTA becomes more beneficial for a government the lower is its probability of holding power in the future, as in that case it cares less about the reduction of political rents induced by the FTA. It is this possibility of political turnover that might induce the incumbent government to adopt an FTA even if it would not ordinarily (i.e., abstracting from the possibility of political turnover) benefit from the arrangement.

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Figure 2 - Political Feasibility of a Bilateral Agreement