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Preferential Trading Arrangements (PTAs)

I. What are PTAs?

Any use of differentiation of tariffs among countries. The WTO requires that every nation follow the MFN (most favored nation) policy of having the same tariffs for each member (showing no preferential treatment). So, PTAs are a violation of the MFN. However, the WTO features many permitted violations.

Examples of PTAs allowed:

European Union (EU), NAFTA: groups that have zero tariffs within group but can set their own tariffs against nations outside group.

GSP (Generalized System of Preferences): rich countries can give lower tariffs to poor countries than they do to other rich countries that are exporting goods to them.

Anti-dumping and countervailing duties: both feature high tariffs on a specific country.

FTA (free trade area): zero tariffs within group, original (own) tariffs on imports from outside (not necessarily the same amongst the countries in the group).

These zero tariff rules are subject to ROOs (rules of origin). This prevents an outside nation from exporting to the lowest tariff nation for their good of export and then sending the good to another country in the FTA (thus bypassing this country's higher tariff).

Customs Union: FTA + common external tariff (same tariffs for trade outside union

Example: Mercosur (4 South American nations: Brazil, Argentina, Uruguay, Paraguay).

Common Market: customs union + free movement of factors (labor and capital). Example: EU.

II. Examples

A. European Union (EU)

Started with a treaty in 1956 involving France, Germany, Italy, Belgium, Netherlands, and Luxembourg. Before this they had agreed to free trade in coal and steel. The 1956 agreement was called the European Economic Community. These nations begin cooperating in more and more ways, changing the name of the agreement several times. The European Union features 15 (note that lecture said 14 – that was wrong) nations (UK, Spain, etc.). It is possible it could expand to include many eastern European nations.

B. NAFTA (US, Canada, Mexico)

Started in 1994, was preceded by a US-Canada FTA that started around 1989.

III. Effects of PTAs

A. NOT the same as Free Trade

It is not free trade on everything, different suppliers are treated differently and this distorts market prices.

B. Two Main Effects of PTAs

1. Trade Creation: trading things that would not have been traded prior to the agreement. Importing what would have been purchased at home before. This is motivated by comparative advantage; it makes the nation as a whole better off (in the same sense as the gains from trade).
2. Trade Diversion: importing from PTA member what would have been imported from outside the PTA prior to the agreement. This is BAD. Why?

   -Diverted nations are hurt; they no longer export to the nation. However, this is not the main reason.

   -Inside the importing country there is also harm from trade diversion. Before the agreement, the trade pattern was determined by comparative advantage, which means that goods were being bought from the least-cost source. So, now that imports are coming from a different country inside the PTS, the nation is paying more for imports now than they were before. To see this, note that the country as a whole pays the price excluding the tariff (since tariff revenue goes to the country, it is not thrown into the ocean or burned up). This price is higher than the price that prevailed under the original trading pattern.

   Since these two Effects are of different direction (good vs. bad), we cannot say *a priori* whether a PTA is beneficial or not. The benefits/costs depend on the relative size of trade creation and trade diversion. So, a particular PTA may or may not be beneficial (welfare improving) for the participants themselves. And non-participants definitely lose.