

A ‘New Trade’ Theory of GATT/WTO Negotiations*

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Abstract

I develop and quantify a novel theory of GATT/WTO negotiations. This theory provides new answers to two prominent questions in the trade policy literature. First, what do GATT/WTO negotiators negotiate about? And second, what is the role played by the fundamental GATT/WTO principles of reciprocity and nondiscrimination? My main result is that in ‘new trade’ environments, GATT/WTO negotiations governed by the principles of reciprocity and nondiscrimination no longer necessarily have to be interpreted as helping countries overcome a terms-of-trade externality but can instead also be viewed as helping countries internalize a production relocation externality.

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1 Introduction

International trade has been liberalized dramatically since the end of World War II. According to WTO estimates, the average ad valorem tariff on manufacturing goods has been reduced from over 40 percent to below 4 percent during this time period.

This dramatic liberalization was largely the result of a sequence of successful rounds of trade negotiations governed by the General Agreement on Tariffs and Trade (GATT) and its successor the World Trade Organization (WTO).¹ The GATT/WTO is an institution regulating trade negotiations through a set of prenegotiated articles. The principles of reciprocity and nondiscrimination are usually considered to be the essence of these articles. Generally speaking, the former advises that tariff changes keep changes in imports equal across trading partners and the latter requires that the same tariff must be applied against all trading partners for any given traded product.²

In this paper, I develop and quantify a novel theory of GATT/WTO negotiations. This theory provides new answers to two prominent questions in the trade policy literature. First, what do GATT/WTO negotiators negotiate about? And second, what is the role played by the fundamental GATT/WTO principles of reciprocity and nondiscrimination?

My benchmark is, of course, the standard neoclassical theory of GATT/WTO negotiations. Its main idea goes back to Johnson (1953-54) and builds on the classic optimal tariff argument:³ in a neoclassical environment, each country has an incentive to impose import tariffs in order to improve its terms-of-trade. However, if all countries impose import tariffs in an attempt to improve their terms-of-trade, no country actually succeeds and inefficiently high

¹According to WTO statistics, industrial countries have cut their tariffs on industrial products by an average 36 percent during the first five GATT rounds (1942-62), an average 37 percent in the Kennedy Round (1964-67), an average 33 percent in the Tokyo Round (1973-79), and an average 38 percent in the Uruguay Round (1986-94). There is some controversy about the scope of GATT/WTO negotiations. Rose (2004) finds that GATT/WTO members did not benefit more from GATT/WTO negotiations than non-members. However, Subramanian and Wei (2007), and Tomasz et al. (2007) argue that this finding is not robust.

²I adopt here Bagwell and Staiger's (1999) interpretation of the principles of reciprocity and nondiscrimination which I will discuss in more detail later on.

³The classic optimal tariff argument itself is actually much older than Johnson (1953-54). See Irwin (1996) for a history of thought.

tariffs prevail. This inefficiency then creates incentives for cooperative trade policy setting. Essentially, tariffs entail an international terms-of-trade externality and trade negotiations serve to internalize this externality.⁴ Grossman and Helpman (1995) extended this main argument to the case in which governments are subject to pressure from domestic interest groups. They demonstrated that tariffs continue to entail a terms-of-trade externality in this case which can be internalized in trade negotiations. Bagwell and Staiger (1999) built on this literature and developed a unified framework of GATT/WTO negotiations. In a very general neoclassical trade model in which governments have preferences consistent with all leading political economy approaches, they showed that the fundamental GATT/WTO principles of reciprocity and nondiscrimination can be interpreted as simple negotiation rules which help governments internalize the terms-of-trade externality. They also demonstrated that the terms-of-trade externality is the only trade policy externality which can arise in this environment thus making it the only trade policy externality GATT/WTO negotiations can be about.⁵

Instead of analyzing GATT/WTO negotiations in a neoclassical trade model, my ‘new trade’ theory builds on a Krugman (1980) ‘new trade’ model.⁶ My main result is that in this ‘new trade’ environment, GATT/WTO negotiations governed by the principles of reciprocity and nondiscrimination no longer necessarily have to be interpreted as helping countries over-

⁴See also Kuga (1973), Mayer (1981), Riezman (1982), Dixit (1987), Kennan and Riezman (1988), Maggi (1999), and Syropoulos (2002) for other important contributions to that literature.

⁵An alternative theory of trade agreements was offered by Maggi and Rodriguez-Clare (1998). It stresses commitment considerations, pointing out that trade agreements may help governments commit vis-à-vis domestic special interest groups. It differs fundamentally both from the standard terms-of-trade theory of GATT/WTO negotiations as well as from my ‘new trade’ theory of GATT/WTO negotiations in that it does not view trade negotiations as a means to internalize an international trade policy externality. Maggi and Rodriguez-Clare (2007) show how this commitment theory can be combined with the standard terms-of-trade theory. See also Staiger and Tabellini (1987) and Mitra (2002).

⁶While the argument can be made most cleanly in the context of the simple Krugman (1980) model, it generalizes to more complicated environments. For example, all results can also be derived in a variant of the Arkolakis et al (2008) version of Melitz (2003), as I discuss in detail in a separate appendix which is available upon request. This is not surprising since the effect I emphasize is closely related to the home market effect. The home market effect is generally considered to be a fundamental feature of environments with increasing returns to scale and transport costs (see, for example, Helpman and Krugman 1985: 209). It is also the basis of the ‘new economic geography’ literature initiated by Krugman (1991) and synthesized by Fujita et al. (1999). See Feenstra, Markusen, and Rose (1998), Davis and Weinstein (1999, 2003), Head and Ries (2001), and Hanson and Xiang (2004) for evidence on the home market effect.

come a terms-of-trade externality but can instead also be interpreted as helping countries internalize a production relocation externality. In my model, a production relocation externality arises in the sense that countries can use trade policy to gain at the expense of other countries by attracting a larger share of manufacturing production. In particular, a unilateral increase in import tariffs makes foreign manufacturing goods more expensive in the domestic market so that domestic consumers shift expenditure towards domestic manufacturing goods. As a consequence, domestic manufacturing firms sell more thus making profits and foreign manufacturing firms sell less thus making losses which triggers entry into the domestic manufacturing sector and exit out of foreign manufacturing sectors. This relocation of manufacturing production increases domestic welfare but reduces foreign welfare since it reduces the share of manufacturing goods consumed by domestic consumers which is subject to trade costs but increases the share of manufacturing goods consumed by foreign consumers which is subject to trade costs. The GATT/WTO principles of reciprocity and nondiscrimination help governments internalize this externality since they jointly ensure that tariff changes no longer entail production relocations. This is because, under these principles, tariff-induced changes in domestic consumer expenditure towards or away from domestic manufacturing goods are exactly offset by changes in foreign consumer expenditure away from or towards these goods. By neutralizing the production relocation externality, the principles of reciprocity and nondiscrimination not only guide countries away from the inefficient noncooperative equilibrium in a way which monotonically increases welfare in all countries, but they also secure negotiated tariff concessions by eliminating all incentives to reverse them.

This is important since many economists have questioned the practical relevance of terms-of-trade considerations for actual trade negotiations. Krugman (1997: 113), for example, finds the optimal tariff argument so irrelevant to real-world disputes over trade policy that he even concludes one cannot make economic sense of GATT/WTO negotiations at all. However, I do not aim to disprove the importance of terms-of-trade effects.⁷ Instead, I hope to strengthen

⁷In fact, recent studies by Broda, Limao, and Weinstein (2008) and Bagwell and Staiger (forthcoming) suggest that terms-of-trade considerations do play a role in governments' tariff choices.

the literature's most fundamental claim that economic logic can be used to make sense of GATT/WTO negotiations by providing an alternative economic explanation of GATT/WTO negotiations. One advantage of this explanation is that it can be linked directly to trade policy debates. While trade policymakers are assumed to maximize domestic welfare in the model, their tariff choices are exactly as if they maximized the number of domestic manufacturing firms. And since the number of domestic manufacturing firms translates directly into the number of domestic manufacturing jobs, this is equivalent to maximizing the number of domestic manufacturing jobs.

Given the gravity structure of my model, I can quantify it using an extension of the technique developed by Dekle, Eaton, and Kortum (2007). An attractive feature of this technique is that it relies directly on bilateral trade data and only requires few parameter estimates. Focusing on the six major players in recent GATT/WTO negotiations, I show that my stylized production relocation model generates Nash tariffs of the same order of magnitude than the actual tariffs observed during the tariff war following the Smoot-Hawley Tariff Act of 1930.⁸ I also show that my model predicts the welfare losses from reverting to Nash tariffs to be moderate never exceeding 1.2 percent for any country in any specification.

While I am, I believe, the first to study trade negotiations in a 'new trade' model, I am by no means the first to study trade policy in such a model. It is well-known that, in Krugman (1980) type environments, import tariffs generally have production relocation and terms-of-trade effects. Venables (1987) was the first to develop a version of the Krugman (1980) model which isolates production relocation effects. Gros (1987) was the first to develop a version of

⁸In particular, I focus on Brazil, China, the European Union, India, Japan, and the United States as these are typically considered to be the main players in GATT/WTO negotiations. I aggregate all other countries into a seventh trade bloc referred to as the Rest of the World.

the Krugman (1980) model which isolates terms-of-trade effects.^{9,10,11} Essentially, the positive profits made by manufacturing firms as a result of import tariffs can be competed away either through entry leading to a production relocation effect or through an increase in wages leading to a terms-of-trade effect. The relative strength of these two effects is determined by the elasticity of the labor supply curve facing the manufacturing sector as a whole. Models with freely traded homogeneous non-manufacturing goods generate a perfectly elastic labor supply curve and therefore isolate production relocation effects. Models without non-manufacturing goods at all generate a perfectly inelastic labor supply curve and therefore isolate terms-of-trade effects. Intermediate cases can be constructed with freely or costly traded differentiated non-manufacturing goods.

In order to emphasize the novel features of my ‘new trade’ theory of GATT/WTO negotiations, I isolate production relocation effects throughout. In the next section, I lay out the basic model and explain how GATT/WTO negotiations governed by the principles of reciprocity and non-discrimination can be interpreted as helping governments internalize a production relocation externality. I keep this analysis deliberately simple with the purpose of clearly conveying my qualitative point. In the third section, I then calibrate a more realistic version of the basic model and demonstrate that it generates Nash tariffs of the same order of magnitude than the actual tariffs observed during the tariff war following the Smoot-Hawley Tariff Act of 1930.

⁹The classic optimal tariff argument therefore also applies in ‘new trade’ environments. An extra twist is that a tariff can now also be used to correct the domestic distortion originating from the monopoly pricing of domestic manufacturing firms. Gros (1987) shows that therefore the optimal tariff is positive even if the country is so small that it has no market power in world markets. See also Flam and Helpman (1987) and Helpman and Krugman (1989).

¹⁰Venables (1987) studies unilateral trade policy only. Gros (1987) studies unilateral trade policy and also characterizes the noncooperative trade policy equilibrium. Neither Venables (1987) nor Gros (1987) consider trade negotiations.

¹¹My paper is also related to the analysis of Baldwin and Robert-Nicoud (2000) who study Venables (1987) type trade policy effects in an economic geography model developed by Martin and Rogers (1995). They show that symmetric liberalization between asymmetric countries leads to international firm relocations from the small to the large country. They also show that the large country needs to liberalize faster than the small country if international firm relocations are to be prevented. See also Baldwin et al. (2003).

2 Basic model

In this section, I lay out the basic model and explain how GATT/WTO negotiations governed by the principles of reciprocity and non-discrimination can be interpreted as helping governments internalize a production relocation externality. I first focus on a two-country case to highlight the role played by the principle of reciprocity. I then move to a three-country extension to shed light on the role played by the principle of nondiscrimination.

2.1 Two-country case: GATT/WTO and reciprocity

2.1.1 Setup

There are two countries: country 1 and country 2. Consumers have access to a continuum of differentiated manufacturing goods and a single homogeneous non-manufacturing good. Preferences over these goods are identical in both countries. They are given by the following utility functions

$$U_j = \left(\sum_{i=1}^2 \int_0^{n_i} m_{ij} (v_i)^{\frac{\sigma-1}{\sigma}} dv_i \right)^{\frac{\mu\sigma}{\sigma-1}} Y_j^{1-\mu} \quad (1)$$

where m_{ij} is the quantity of a manufacturing good from country i consumed in country j , Y_j is the quantity of the non-manufacturing good consumed in country j , n_i is the ‘number’ of manufacturing goods produced in country i , $\sigma > 1$ is the elasticity of substitution between manufacturing goods, and μ is the share of income spent on manufacturing goods. Technologies are also identical in both countries. They are summarized by the following (inverse) production functions

$$l_j^M = f + cq_j^M \quad (2)$$

$$l_j^Y = q_j^Y \quad (3)$$

where l_j^M is the labor requirement for producing q_j^M units of a manufacturing good in country j , l_j^Y is the labor requirement for producing q_j^Y units of the non-manufacturing good in

country j , f denotes the fixed labor requirement of manufacturing production, and c denotes the marginal labor requirement of manufacturing production. The manufacturing goods market is monopolistically competitive whereas the non-manufacturing good market is perfectly competitive.

Tariffs are introduced as a component of ‘iceberg’ trade costs which apply only to manufacturing goods.¹² For one unit of a manufacturing good from country i to arrive in country j , $\theta(1 + t_{ij})$ units must be shipped and the remainder ‘melts away’ in transit, where $\theta > 1$ is a transport cost and $t_{ij} \geq 0$ is the tariff imposed by country j against imports from country i .¹³ To economize notation, I make frequent use of the shorthand $\tau_{ij} \equiv 1 + t_{ij}$ throughout. Notice that, modeled this way, tariffs do not generate any revenue. This is essential for the model’s tractability but naturally restricts tariffs to be nonnegative. The results presented in this section of the paper are therefore best compared to a version of the standard neoclassical model of GATT/WTO negotiations in which tariffs are also restricted to be nonnegative. I discuss the implications of allowing for revenue-generating tariffs in the context of the quantitative analysis in section 3.

Motivated by the fact that import tariffs have always been by far the most important trade policy instruments in practice, my analysis abstracts from export policy instruments. The tariff war following the Smoot-Hawley Tariff Act of 1930 is an important case in point. It occurred before the use of export policy instruments was constrained by GATT/WTO regulations suggesting that there are reasons why governments typically refrain from using them.¹⁴ I do not explore these reasons in this paper but simply assume that import tariffs are the only available trade policy instruments. Bagwell and Staiger (2009) have recently argued

¹²As will become clear shortly, the production relocation effect is closely related to the home market effect. Davis (1999) shows that in simple setups like the one developed here, the home market effect disappears if outside good sector trade costs are sufficiently high. However, Krugman and Venables (1999) demonstrate that this no longer holds in more general environments. Essentially, all that is needed for the home market effect to survive is a margin through which aggregate manufacturing employment can adjust.

¹³As usual, internal trade is assumed to be free of any barriers.

¹⁴GATT/WTO regulations require countries to concentrate national protective measures into the form of tariffs. In particular, article XI requires the elimination of quantitative restrictions and article XVI prohibits export subsidies. Both articles do not apply to agricultural products.

that this assumption is crucial to be able to interpret the production relocation externality as a fundamental problem trade agreements are designed to solve. Allowing for import and export policy instruments in a framework similar to the one developed here, they show that the noncooperative equilibrium is inefficient only because of export-tax-induced terms-of-trade effects since all import-tariff-induced production relocation effects are exactly undone by export-subsidy induced production relocation effects. Readers uncomfortable with my assumption should therefore not give my analysis this broad interpretation but instead view it as an examination of the specific properties of real-world trade negotiations. In particular, GATT article XVI prohibits export subsidies for manufacturing goods and the United States constitution prohibits export taxes so that countries only have access to an incomplete set of trade policy instruments in practice. Fundamental problem or not, it seems important to understand the implications of this institutional arrangement for the motivation of trade negotiators and the efficiency of trade negotiations.

I also make the following three additional assumptions: first, I restrict t_{ij} to be finite so that $\bar{t} \geq t_{ij} \geq 0$ overall, where \bar{t} is an arbitrarily large but finite upper bound. This upper bound is purely introduced for technical convenience. Removing it would somewhat complicate the exposition without changing the results in any interesting way (see the appendix for a detailed discussion of the consequences of letting $\bar{t} \rightarrow \infty$). Second, I assume that the manufacturing sector is always active in both countries. This requires transport costs to be sufficiently large (see the appendix for the precise restriction on θ). It ensures that countries can never attract all manufacturing firms through trade policy and thereby eliminates uninteresting corner solutions. Finally, I assume that the non-manufacturing good sector is always active in both countries. This requires the demand for manufacturing goods to be sufficiently small (see the appendix for the precise parameter restriction on μ). It ensures, together with the assumptions made on market structure, non-manufacturing good technology, preferences, and trade costs that there is no role for terms-of-trade effects in this environment. I comment further on this latter point below.

2.1.2 Solution for given trade policy

I choose the price of the non-manufacturing good as the numeraire which implies that wages are equal to one in both countries since the non-manufacturing good sector is always active in both countries, the non-manufacturing good market is perfectly competitive, the non-manufacturing good is produced using the above technology, and is freely traded among countries. For given tariffs, the model's solution is then determined by the market clearing conditions for manufacturing firms in country 1 and country 2

$$q = p^{-\sigma} G_1^{\sigma-1} \mu L_1 + p^{-\sigma} (\theta \tau_{12})^{1-\sigma} G_2^{\sigma-1} \mu L_2 \quad (4)$$

$$q = p^{-\sigma} (\theta \tau_{21})^{1-\sigma} G_1^{\sigma-1} \mu L_1 + p^{-\sigma} G_2^{\sigma-1} \mu L_2 \quad (5)$$

where $q \equiv \frac{f(\sigma-1)}{c}$ are the break-even outputs determined by free entry, $p \equiv \frac{\sigma c}{\sigma-1}$ are the ex-factory prices determined by profit maximization, $G_1 \equiv \left(n_1 p^{1-\sigma} + n_2 (p \theta \tau_{21})^{1-\sigma} \right)^{\frac{1}{1-\sigma}}$ and $G_2 \equiv \left(n_1 (p \theta \tau_{12})^{1-\sigma} + n_2 p^{1-\sigma} \right)^{\frac{1}{1-\sigma}}$ are the ideal manufacturing price indices, and L_1 and L_2 are the numbers of consumers or workers. Equations (4) and (5) can be solved immediately for the equilibrium manufacturing price indices

$$G_1 = \left(\frac{qp^\sigma}{\mu L_1} \frac{1 - (\theta \tau_{12})^{1-\sigma}}{1 - (\theta \tau_{21} \theta \tau_{12})^{1-\sigma}} \right)^{\frac{1}{\sigma-1}} \quad (6)$$

$$G_2 = \left(\frac{qp^\sigma}{\mu L_2} \frac{1 - (\theta \tau_{21})^{1-\sigma}}{1 - (\theta \tau_{21} \theta \tau_{12})^{1-\sigma}} \right)^{\frac{1}{\sigma-1}} \quad (7)$$

If the definitions of the manufacturing price indices are substituted, they can also be solved for the equilibrium numbers of manufacturing firms

$$n_1 = \frac{\mu}{qp} \left(\frac{L_1}{1 - (\theta \tau_{12})^{1-\sigma}} - \frac{L_2 (\theta \tau_{21})^{1-\sigma}}{1 - (\theta \tau_{21})^{1-\sigma}} \right) \quad (8)$$

$$n_2 = \frac{\mu}{qp} \left(\frac{L_2}{1 - (\theta\tau_{21})^{1-\sigma}} - \frac{L_1 (\theta\tau_{12})^{1-\sigma}}{1 - (\theta\tau_{12})^{1-\sigma}} \right) \quad (9)$$

Notice that this equilibrium has three special features. First, the world number of manufacturing firms is constant since $n_1 + n_2 = \frac{\mu(L_1+L_2)}{qp}$. Second, tariffs affect welfare only through the manufacturing price indices since indirect utilities are given by $V_j = \mu^\mu (1 - \mu)^{(1-\mu)} L_j G_j^{-\mu}$. Finally, there can be no role for terms-of-trade effects since ex-factory prices are independent of trade policy.¹⁵ These features all help to clarify the argument but are not crucial for the main results.

2.1.3 Production relocation effect and import price effect

Equations (6) and (7) reveal that each country's price index is monotonically decreasing in its own tariff regardless of the other country's tariff but monotonically increasing in the other country's tariff regardless of the own tariff so that each country can always use trade policy to gain at the other country's expense. This trade policy externality is brought about by a production relocation effect. In particular, a unilateral increase in import tariffs makes foreign manufacturing goods more expensive in the domestic market so that domestic consumers shift expenditure towards domestic manufacturing goods. As a consequence, domestic manufacturing firms sell more thus making profits and foreign manufacturing firms sell less thus making losses which triggers entry into the domestic manufacturing sector and exit out of the foreign manufacturing sector, as is also reflected in equations (8) and (9). This reduces the domestic price index but increases the foreign price index since it reduces the share of manufacturing goods consumed by domestic consumers which is subject to trade costs but increases the share of manufacturing goods consumed by foreign consumers which is subject

¹⁵I follow Helpman and Krugman (1989: 143) in defining the terms-of-trade as the ratio of ex-factory prices which is equal to 1 in this model. One may object that this is a too narrow definition since terms-of-trade effects should really operate through price indices in this environment. I show below that, even if such a wider definition is adopted, my results can still not be interpreted as terms-of-trade effects.

to trade costs.^{16,17} While this production relocation effect is the only channel through which domestic tariffs affect foreign welfare, domestic welfare is also affected by a counteracting but dominated import price effect. In particular, domestic import tariffs also directly increase the domestic price index by making still-imported manufacturing goods more expensive. The reason why the production relocation effect always dominates the import price effect can be best understood with the help of equations (4) and (5). A unilateral increase in import tariffs initially increases the domestic price index because of the import price effect which increases sales and profits of domestic firms. To restore equilibrium, there has to be entry into the domestic manufacturing sector and exit out of the foreign manufacturing sector which reduces the domestic price index and increases the foreign price index. This makes it harder for domestic firms to sell goods in the domestic market but easier for domestic firms to sell goods in the foreign market so that the domestic post-tariff equilibrium price index must be below its pre-tariff level. If it merely returned to its pre-tariff level, domestic firms could still export more than before and would therefore make positive profits.

2.1.4 Noncooperative trade policy

I now consider what happens if governments choose trade policy noncooperatively in an attempt to maximize their citizens' welfare. While welfare maximization is first and foremost a simplifying assumption, it is actually more realistic than one might think. Maggi and Goldberg (1999), for example, find that the weight of welfare in the government's objective function is many times larger than the weight of trade-policy-influencing campaign contributions.

Notice first that the noncooperative equilibrium is maximum protection. This follows

¹⁶Notice that the production relocation effect depends crucially on increasing returns to scale. Essentially, it is a tariff-induced change in the pattern of specialization brought about by changes in relative market size which cannot arise in neoclassical environments.

¹⁷Notice that the production relocation gain could still not be interpreted as a terms-of-trade gain even if a price-index-based definition of the terms-of-trade was adopted. This is because country j 's terms-of-trade would then have to be defined as $\frac{G_j^{\text{exp}}}{G_j^{\text{imp}}} = \left(\frac{n_j}{n_i}\right)^{\frac{1}{1-\sigma}}$ since $G_j^{\text{exp}} = (n_j p^{1-\sigma})^{\frac{1}{1-\sigma}}$ is the world price index of country j 's manufacturing exports and $G_j^{\text{imp}} = (n_i p^{1-\sigma})^{\frac{1}{1-\sigma}}$ is the world price index of country j 's manufacturing imports and would therefore deteriorate and not improve in country j 's tariff.

immediately from the fact that each country's price index is monotonically decreasing in its own tariff regardless of the other country's tariff and is stated more formally in lemma 1:¹⁸

Lemma 1 *Suppose that governments choose tariffs simultaneously in an attempt to maximize their citizens' welfare. Then the unique Nash equilibrium is $(t_{21}, t_{12}) = (\bar{t}, \bar{t})$.*

Proof. Follows immediately from equations (6) and (7). ■

Observe second that a tariff combination is efficient if and only if the tariff is zero in at least one of the countries. Intuitively, there always exists a bilateral tariff reduction which reduces one country's price index without affecting the other country's price index by appropriately balancing the import price effect and the production relocation effect. However, bilateral tariff reductions are only possible if tariffs are positive in both countries so that Pareto improvements cannot be achieved if the tariff is zero in at least one of the countries.¹⁹

Lemma 2 *The set of Pareto-efficient tariff combinations consists of all (t_{21}, t_{12}) such that $(t_{21}, t_{12}) = (\text{any } t_{21}, 0)$ or $(t_{21}, t_{12}) = (0, \text{any } t_{12})$.*

Proof. See the appendix for a formal proof. ■

Thus, the noncooperative equilibrium is inefficient. While the details of lemma 1 and 2 clearly reflect specific modeling assumptions, this result captures a first fundamental point: tariffs entail a production relocation externality which governments fail to internalize when setting tariffs noncooperatively. It is therefore stated as proposition 1:

Proposition 1 *The noncooperative equilibrium is inefficient.*

Proof. Follows immediately from lemmas 1 and 2. ■

¹⁸This stark result emerges because production relocations are the only motivation for protection in this environment. In the presence of tariff revenue, the noncooperative equilibrium involves less than maximum protection, as I discuss in detail in the quantitative application in section 3. Nevertheless, the noncooperative equilibrium remains inefficient in this case since tariffs continue to entail a production relocation externality.

¹⁹Recall that the iceberg trade barriers assumption restricts tariffs to be nonnegative. Lemma 2 therefore characterizes a constrained efficiency frontier. This should be kept in mind when comparing this efficiency frontier to the Mayer locus featuring in the neoclassical theory of GATT/WTO negotiations.

2.1.5 Trade policy under the GATT/WTO: the principle of reciprocity

I now contrast this with the outcome achieved under the GATT/WTO principle of reciprocity as interpreted by Bagwell and Staiger (1999).²⁰ Generally speaking, the principle of reciprocity advises that tariff changes keep changes in imports equal across trading partners. However, this principle has two particular applications in GATT/WTO practice and is not binding to the same degree in both these applications. First, governments are to seek a ‘balance of concessions’ during rounds of trade liberalization in the sense that they cut tariffs reciprocally. While this application is considered to be an important negotiation norm in practice it is actually not encoded in GATT/WTO articles and is therefore not binding in a legal sense. Second, governments are entitled to ‘withdraw substantially equivalent concessions’ if a trading partner increases previously bound tariffs in the sense that they retaliate reciprocally. This right is encoded in GATT/WTO articles and therefore has legal status. In light of this discussion, I adopt the following formal definition of reciprocity:²¹

Definition 1 *Define a tariff change to be reciprocal if it is such that $dTB_1^M = dTB_2^M = 0$, where $TB_j^M \equiv EXP_j^M - IMP_j^M$ and $EXP_j^M (IMP_j^M)$ refers to the value of country j 's manufacturing exports (imports).*

Notice first that the principle of reciprocity completely eliminates all trade policy externalities. Given aggregate manufacturing market clearing, the number of manufacturing firms operating in country j can be decomposed as follows:

$$n_j = \frac{\mu L_j}{qp} + \frac{TB_j^M}{qp} \quad (10)$$

The numerator is just the total expenditure on country j 's manufacturing goods by country i 's and country j 's consumers, since this can be decomposed into the total expenditure on

²⁰Of course, the principle of nondiscrimination is trivially satisfied in a two-country world.

²¹While I follow Bagwell and Staiger's (1999) interpretation of the principle of reciprocity, I adapt their formal definition to my specific setting by applying it only to manufacturing trade. This makes it distinct from the definition used by Bagwell and Staiger (2001) in the comparable ‘outside good’ setting since they continue to include non-manufacturing trade.

country i 's and country j 's manufacturing goods by country j 's consumers (μL_j), plus the total expenditure on country j 's manufacturing goods by country i 's consumers (EXP_j^M), minus the total expenditure on country i 's manufacturing goods by country j 's consumers (IMP_j^M). The denominator is just the (constant) sales of country j 's manufacturing firms. Hence, if TB_j^M is fixed by reciprocity, country j 's number of manufacturing firms is fixed as well. Intuitively, tariff-induced changes in country j 's consumer expenditure towards or away from country j 's manufacturing goods are then exactly offset by tariff-induced changes in country i 's consumer expenditure away from or towards these goods. This result is summarized as lemma 3:²²

Lemma 3 *Tariff changes leave the number of firms unchanged in both countries if and only if they are reciprocal.*

Proof. Follows immediately from equation (10) and the definition of reciprocity. ■

Observe second that reciprocal tariff concessions increase welfare monotonically in both countries. Recall that a country's price index is affected by its own tariff through two opposing effects: the production relocation effect which tends to make a country's price index decreasing in its own tariff; and the import price effect which tends to make a country's price index increasing in its own tariff. As was discussed above, the production relocation effect dominates the import price effect so that a country's price index is decreasing in its own tariff. However, if the production relocation effect is eliminated by reciprocity, only the import price effect remains so that a country's price index then becomes increasing in its own tariff. While the details of lemma 3 again reflect specific modeling assumptions, this result captures a second fundamental point: the principle of reciprocity makes countries internalize the production relocation externality by ruling out changes in the manufacturing trade balance which

²²Of course, reciprocal tariff changes only leave the number of firms unchanged in both countries if the world number of manufacturing firms is independent of trade policy. This is the case in this environment but depends on functional form assumptions. More generally, the principle of reciprocity prevents countries from gaining at the expense of one another by ruling out changes in the manufacturing trade balance which shift expenditure away from one country's manufacturing sector towards the other country's manufacturing sector.

shift expenditure away from one country's manufacturing sector towards the other country's manufacturing sector. It is therefore stated as proposition 2:

Proposition 2 *Reciprocal trade liberalization (trade protection) monotonically increases (decreases) welfare in both countries.*

Proof. Follows immediately from lemma 3 and the definitions of manufacturing price indices.

■

Notice finally that the principle of reciprocity therefore not only guides countries away from the inefficient noncooperative equilibrium in a way which monotonically increases welfare in all countries but also secures negotiated tariff concessions by eliminating all incentives to reverse them. Suppose that, starting at the noncooperative equilibrium, country j assumes the leadership in trade negotiations. Then, since country i is to respond reciprocally to any tariff reduction by country j , i.e. since country i is to seek a 'balance of concessions', country j immediately has an incentive to initiate reciprocal trade liberalization which monotonically increases welfare in both countries. Also, since country i is entitled to respond reciprocally to any tariff increase by country j , i.e. since country i is entitled to 'withdraw substantially equivalent concessions', country j never has an incentive to increase its tariff so that negotiated tariff concessions can be secured.²³ In summary, the principle of reciprocity can thus be seen as helping governments escape the inefficient noncooperative equilibrium in a way which monotonically increases welfare in all countries.²⁴

²³Thus, any tariff combination can be sustained under reciprocity in this environment. Together with lemma 2, this implies that all efficient tariff combinations can be sustained under reciprocity. This differs from the finding of Bagwell and Staiger (1999) that, absent political economy forces, free trade is the only efficient tariff combination which can be sustained under reciprocity. Recall, however, that lemma 2 characterizes constrained efficient tariffs so that this difference should not be overemphasized.

²⁴In fact, the principle of reciprocity not only helps governments escape the inefficient equilibrium but also directly guides them to efficient tariffs. This is because countries can liberalize their trade reciprocally unless one country has completely eliminated all its tariffs which is sufficient for efficiency from lemma 2.

2.2 Three-country case: GATT/WTO and nondiscrimination

While the basic two-country model is thus useful to illustrate the role played by the GATT/WTO principle of reciprocity, it is too simple to shed light on the role played by the GATT/WTO principle of nondiscrimination. For this reason, I now consider an extension of this model. In particular, I focus on the simplest possible setup that allows for discriminatory tariff setting. There are now three countries: country 1, country 2, and country 3. Country 1 trades with both country 2 and country 3, but country 2 and country 3 trade with country 1 only so that only country 1 can set discriminatory tariffs. Everything else is just as in the basic model.

All results regarding noncooperative trade policy naturally generalize to the three-country case. Most importantly, the noncooperative equilibrium is still inefficient because tariffs entail a production relocation externality which governments fail to internalize when setting tariffs noncooperatively. Readers interested in the details of the noncooperative equilibrium can find the solution of the three-country model together with the three-country versions of lemma 1, lemma 2, and proposition 1 in the appendix.

However, this similarity conceals that tariffs now have more complicated international implications. Besides the import price effect, there is now both a bilateral as well as a multilateral production relocation effect. The bilateral production relocation effect is an effect between the two countries directly affected by the tariff and is just the production relocation effect familiar from the two-country model: for example, a tariff imposed by country 1 against country 2 leads to production relocations from country 2 to country 1 since this increases the sales and profits of manufacturing firms in country 1 and reduces the sales and profits of manufacturing firms in country 2. The multilateral production relocation effect is an additional effect on the third country which is not directly affected by the tariff. This multilateral production relocation effect works through changes in country 1's manufacturing price index: for example, since a tariff imposed by country 1 against country 2 leads to production relocations from country 2 towards country 1, country 1's manufacturing price index falls. If country 1's manufacturing price index falls, country 1's market becomes more

competitive which makes it harder for firms in country 3 to sell their products to country 1. If it becomes harder for firms in country 3 to sell their products to country 1, the number of firms operating in country 3 has to fall in equilibrium so that a tariff imposed by country 1 against country 2 does not only lead to production relocations from country 2 to country 1 but also from country 3 to country 1.

The presence of this multilateral production relocation effect implies that the properties of the principle of reciprocity only all generalize to the three-country case if countries engage in multilateral trade negotiations. In particular, the principle of reciprocity now only completely eliminates all trade policy externalities if it is applied in multilateral trade negotiations. Also, the principle of reciprocity now only ensures that negotiated tariff concessions increase welfare monotonically in all countries if it is applied in multilateral trade negotiations. Adapting the earlier definition of reciprocity to the three country case, tariff changes are now to be bilaterally reciprocal in bilateral trade negotiations and multilaterally reciprocal in multilateral trade negotiations, where bilaterally reciprocal and multilaterally reciprocal tariff changes are formally defined as follows:

Definition 2 *Define a tariff change to be bilaterally reciprocal between country 1 and country 2 if it is such that $dTB_2^M = 0$ and bilaterally reciprocal between country 1 and country 3 if it is such that $dTB_3^M = 0$, where $TB_j^M \equiv EXP_j^M - IMP_j^M$ and EXP_j^M (IMP_j^M) refers to the value of manufacturing exports (imports) in country j . Define a tariff change to be multilaterally reciprocal if it is such that $dTB_1^M = dTB_2^M = dTB_3^M = 0$.*

Given aggregate manufacturing market clearing, the number of manufacturing firms operating in country j can again be decomposed as follows:

$$n_j = \frac{\mu L_j}{qp} + \frac{TB_j^M}{qp} \quad (11)$$

Hence, if country 1 and country 2 change tariffs in a bilaterally reciprocal way, the number of firms in country 2 remains unchanged. Therefore, the principle of reciprocity completely elim-

inates the bilateral production relocation effect if it is applied in bilateral trade negotiations. Also, if all countries change tariffs in a multilaterally reciprocal way, the number of firms remains unchanged in all countries. Therefore, the principle of reciprocity completely eliminates both the bilateral as well as the multilateral production relocation effect if it is applied in multilateral trade negotiations. Although not obvious from equation (11), the principle of reciprocity is not sufficient to also eliminate the multilateral production relocation effect if it is applied in bilateral trade negotiations. This is because bilaterally reciprocal tariff changes between country 1 and country 2 change country 1's price index thereby affecting the sales of firms in country 3. In particular, if country 1 and country 2 liberalize in a bilaterally reciprocal way, country 1's price index falls which makes it harder for firms in country 3 to export their goods to country 1. As a consequence, firms in country 3 make losses unless some production relocates to country 1. This is summarized in lemma 6:

Lemma 4 *Tariff changes leave the number of firms unchanged in all countries if and only if they are multilaterally reciprocal. Moreover, bilaterally reciprocal trade liberalization (trade protection) between country 1 and country 2 leaves the number of firms unchanged in country 2 but monotonically increases (decreases) the number of firms in country 1 at the expense of (to the benefit of) country 3. Similarly, bilaterally reciprocal trade liberalization (trade protection) between country 1 and country 3 leaves the number of firms unchanged in country 3 but monotonically increases (decreases) the number of firms in country 1 at the expense of (to the benefit of) country 2.*

Proof. See the appendix for a formal proof. ■

Moreover, if country 1 and country 2 liberalize in a bilaterally reciprocal way, only the bilateral production relocation effect is neutralized so that country 2 gains because of the import price effect, country 1 gains because of the import price effect and the multilateral production relocation effect, but country 3 loses because of the multilateral production relocation effect. If, instead, country 1, country 2, and country 3 liberalize in a multilaterally

reciprocal way, the multilateral production relocation effect is also neutralized so that all countries gain because of the import price effect. This is summarized in proposition 4:

Proposition 3 *Multilaterally reciprocal trade liberalization (trade protection) monotonically increases (decreases) welfare in all countries. Moreover, bilaterally reciprocal trade liberalization (trade protection) between country 1 and country 2 monotonically increases (decreases) welfare in country 1 and country 2 but monotonically decreases (increases) welfare in country 3. Similarly, bilaterally reciprocal trade liberalization (trade protection) between country 1 and country 3 monotonically increases (decreases) welfare in country 1 and country 3 but monotonically decreases (increases) welfare in country 2.*

Proof. See appendix A2 for a formal proof. ■

Hence, the principle of reciprocity alone is now only sufficient to help countries overcome the inefficient noncooperative equilibrium in a way which monotonically increases welfare in all countries if it is applied in multilateral trade negotiations. This suggests that an important role played by the principle of nondiscrimination simply is to multilateralize trade negotiations.^{25,26} Under the principle of nondiscrimination, country 1 has to impose the same tariff against country 2 and country 3 so that country 1 cannot change its tariff against country 2 or country 3 only. As a consequence, country 2 and country 3 are then both authorized to respond to any tariff change by country 1 in a way which keeps their manufacturing trade balances unchanged so that multilateral reciprocity prevails. This simple interpretation actually squares well with the justification given by US Secretary of State Cordell Hull for making the principle of nondiscrimination a cornerstone of the US Reciprocal Trade Agreements Act

²⁵Notice that countries do not necessarily have an incentive to engage in multilateral trade negotiations. For example, it is easy to show that country 1 would always prefer sequential bilateral trade negotiations to simultaneous multilateral trade negotiations in the special case of symmetric countries. This is because country 1 gains only because of the import price effect in simultaneous multilateral trade negotiations but also because of the multilateral production relocation effect in sequential bilateral trade negotiations.

²⁶GATT/WTO articles allow countries to sign preferential trade agreements as an important exception to the principle of nondiscrimination. This has generated a debate on whether preferential trade agreements are ‘building blocs’ or ‘stumbling blocs’ on the way to multilateral free trade. See Panagariya (2000) for a survey of the literature.

of 1934 on which the GATT/WTO is largely based. As summarized by Bagwell and Staiger (2002: 72), Hull regarded the principle of nondiscrimination as beneficial "since it offered a way to multilateralize the reciprocal tariff reductions that governments might negotiate bilaterally". It is important to emphasize that, according to this interpretation, the principle of reciprocity alone continues to reverse all incentives for protection so that the principle of nondiscrimination plays no efficiency enhancing role. Instead, it only ensures that all trade policy externalities are eliminated so that governments cannot gain at the expense of one another and welfare increases monotonically in all countries during all stages of the liberalization process.^{27,28}

3 Quantitative application

In this section, I calibrate a more realistic version of the basic model and demonstrate that it generates Nash tariffs of the same order of magnitude than the actual tariffs observed during the tariff war following the Smoot-Hawley Tariff Act of 1930. This version is more realistic in four ways. First, there are now J countries and trade can flow between all of them. Second, tariffs now generate revenue which is distributed in a lump-sum fashion to consumers. Third, production and trading technologies are now asymmetric in the sense that marginal costs c and fixed costs f are allowed to vary across countries and transport costs θ are allowed to vary across exporter-importer pairs. And finally, there are now aggregate trade imbalances

²⁷Notice that the principle of nondiscrimination plays a different role in Bagwell and Staiger (1999). There, it does not neutralize the multilateral terms-of-trade effect by multilateralizing trade negotiations but instead by equalizing all bilateral terms-of-trade. In fact, multilateralizing trade negotiations would not be sufficient to neutralize the multilateral terms-of-trade effect because the multilateral terms-of-trade are a trade-weighted average of the bilateral terms-of-trade and thus depend on trade shares unless the bilateral terms-of-trade are equalized. One implication of this difference is that the principles of reciprocity and nondiscrimination neutralize all third party externalities without requiring any third party response in Bagwell and Staiger (1999).

²⁸Notice that reciprocal trade liberalization no longer necessarily leads to efficient tariffs if the principle of nondiscrimination is imposed. This is because reciprocity and nondiscrimination can only be satisfied if all tariffs are lowered simultaneously, as can be easily established by differentiating the three-country versions of the manufacturing market clearing conditions. But this is impossible if at least one of the tariffs is equal to zero which is not sufficient for efficiency, as can be seen from the three-country version of lemma 2. Recall, however, that the requirement to liberalize reciprocally is not binding in a legal sense so that this feature of the principle of nondiscrimination should not be overemphasized.

captured by an exogenous trade surplus parameter TB_j . Everything else is just as in the basic model.

For given tariffs, the model's solution is now determined by the following equations which represent manufacturing market clearing conditions, manufacturing price index definitions, and consumer expenditure conditions, respectively

$$q_i = \sum_{j=1}^J p_i^{-\sigma} \theta_{ij}^{1-\sigma} \tau_{ij}^{-\sigma} G_j^{\sigma-1} \mu X_j \quad i = 1, \dots, J \quad (12)$$

$$G_j = \left(\sum_{i=1}^J n_i (p_i \theta_{ij} \tau_{ij})^{1-\sigma} \right)^{\frac{1}{1-\sigma}} \quad j = 1, \dots, J \quad (13)$$

$$X_j = L_j - TB_j + \sum_{i=1}^J t_{ij} n_i (p_i \theta_{ij})^{1-\sigma} \tau_{ij}^{-\sigma} G_j^{\sigma-1} \mu X_j \quad j = 1, \dots, J \quad (14)$$

The key difference compared to the basic model is that consumer expenditure now consists of labor income minus the aggregate trade surplus plus tariff revenue necessitating the introduction of the consumer expenditure variable X_j and the consumer expenditure condition (14).²⁹

Denoting the counterfactual value of t_{ij} by t'_{ij} and counterfactual changes in τ_{ij} by $\hat{\tau}_{ij} \equiv \frac{\tau'_{ij}}{\tau_{ij}}$ et cetera, it is easy to verify using the technique of Dekle, Eaton, and Kortum (2007) that equations (12) - (14) can be rewritten in changes as

$$1 = \sum_{j=1}^J \alpha_{ij} (\hat{\tau}_{ij})^{-\sigma} (\hat{G}_j)^{\sigma-1} \hat{X}_j \quad i = 1, \dots, J \quad (15)$$

$$\hat{G}_j = \left(\sum_{i=1}^J \beta_{ij} \hat{n}_i (\hat{\tau}_{ij})^{1-\sigma} \right)^{\frac{1}{1-\sigma}} \quad j = 1, \dots, J \quad (16)$$

$$\hat{X}_j = \gamma_j + \sum_{i=1}^J \delta_{ij} t'_{ij} \hat{n}_i (\hat{\tau}_{ij})^{-\sigma} (\hat{G}_j)^{\sigma-1} \hat{X}_j \quad j = 1, \dots, J \quad (17)$$

²⁹Also, q_j and p_j are now country specific since marginal costs and fixed costs are allowed to vary across countries, θ_{ij} is exporter-importer-pair specific, and τ_{ij} enters only with a coefficient of $-\sigma$ into the manufacturing market clearing condition since it is no longer part of the iceberg trade barriers and therefore does not generate any indirect demand.

where α_{ij} , β_{ij} , γ_j , and δ_{ij} are simple functions of μ , tariffs, and trade flows which can be found in the appendix. Given estimates of μ and σ as well as data on tariffs and trade flows only, equations (15) - (17) can be used to compute the counterfactual changes in manufacturing price indices \widehat{G}_j , numbers of manufacturing firms \widehat{n}_i , and consumer expenditures \widehat{X}_j induced by counterfactual tariffs t'_{ij} . Counterfactual changes in welfare can then be calculated from $\widehat{V}_j = \widehat{X}_j (\widehat{G}_j)^{-\mu}$ since indirect utility is now given by $V_j = \mu^\mu (1 - \mu)^{(1-\mu)} X_j G_j^{-\mu}$.

I use trade and tariff data for the year 2004. I focus on the main players in recent GATT/WTO negotiations - Brazil, China, the European Union, India, Japan, and the United States - and aggregate all other countries into a seventh trade bloc which I refer to as the Rest of the World.³⁰ I construct the matrix of trade flows exactly as in Dekle, Eaton, and Kortum (2007) and also work with their parameter estimates $\mu = 0.188$ and $\sigma = 9.28$ or alternatively $\sigma = 4.60$.³¹ I construct the matrix of tariffs by taking simple averages over the applied manufacturing protection rates reported by Boumellassa, Laborde, and Mitaritonna (2009).³² I present my trade and tariff data in Tables 1 and 2.

Before implementing the full seven-trade-bloc-case, it is instructive to briefly turn to a simple two-trade-bloc example to illustrate the implications of tariff revenue and to motivate the algorithm used for computing Nash tariffs. I generate such an example by keeping the United States only and aggregating all other countries into the Rest of the World. Figure 1 shows how the United States' welfare varies in the United States' tariff and reveals that there is now an interior optimal tariff. The reason is that tariff revenue is hump-shaped in the tariff and the welfare loss due to a reduction in tariff revenue dominates the welfare gain due to additional production relocations at some point. Figure 2 plots the optimal tariff of

³⁰I aggregate Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, and the United Kingdom into the European Union as these were the member states at the beginning of 2004. The European Union is a customs union and therefore sets a common external tariff. I include Hong Kong in my definition of China.

³¹In particular, I downloaded their GDP data, trade balance data, and international trade data from the website of Sam Kortum and followed their exact procedure to compute internal trade flows. Notice that μ compares to α in their paper and σ compares to $1 + \theta$ in their paper.

³²Consistent with the principle of nondiscrimination, these manufacturing protection rates vary by importer only.

the United States against the tariff of the Rest of the World and vice versa and suggests that Nash tariffs can be computed using a simple iterative algorithm. In particular, the Nash equilibrium can be found by first computing the United States' optimal tariff given a guess of the Rest of the World's optimal tariff, then computing the Rest of the World's optimal tariff given the United States' optimal tariff, and so on, as this procedure quickly converges to the point at which both reaction functions cross. Both figures take all factual tariffs to be zero for simplicity and focus on the case $\sigma = 9.28$ only but look similar under alternative assumptions.

Tables 3 and 4 report the Nash tariffs for the full seven-trade-bloc case computed using this simple algorithm under the assumption of $\sigma = 9.28$ and $\sigma = 4.60$, respectively. Nash tariffs are predicted to be relatively similar across trade-bloc pairs. They range between 10.3 percent and 13.0 percent in the case of $\sigma = 9.28$ and between 25.6 percent and 28.9 percent in the case of $\sigma = 4.60$. The tariffs observed during the trade war following the Smoot-Hawley Tariff Act of 1930 are typically reported to be around 50 percent.³³ While a direct comparison is difficult given the differences in the set of players and the timing of the experiment, it is still noteworthy that my stylized production relocation model generates Nash tariffs which are of the same order of magnitude than these actual noncooperative tariffs. This stands in contrast to the stylized terms-of-trade model calibrated by Perroni and Whalley (2000) which predicts Nash tariffs of up to 1000 percent.³⁴

Table 5 presents the counterfactual welfare losses from moving to the predicted Nash tariffs. They range between 0 percent and -0.4 percent in the case of $\sigma = 9.28$ and between 0 percent and -1.2 percent in the case of $\sigma = 4.60$. All countries are therefore predicted to be weakly worse off in the case of a tariff war.

³³See, for example, Bagwell and Staiger (2002: 43).

³⁴To the best of my knowledge, Perroni and Whalley (2000) is the only quantitative study of noncooperative trade policy which is of similar scope than the analysis provided here. Earlier studies such as Whalley (1985: 231-249) were forced to restrict attention to simple two country cases due to computational constraints faced at the time.

4 Conclusion

In this paper, I developed and quantified a ‘new trade’ theory of GATT/WTO negotiations. My main result was that in a ‘new trade’ environment, GATT/WTO negotiations governed by the principles of reciprocity and nondiscrimination no longer necessarily have to be interpreted as helping countries internalize a terms-of-trade externality but can instead also be interpreted as helping countries internalize a production relocation externality.

This ‘new trade’ theory builds on a rationale for unilateral protection which can be linked directly to trade policy debates. In the model, the higher the import tariff, the larger is the number of domestic manufacturing firms; the larger the number of domestic manufacturing firms, the lower is the domestic price index; and the lower the domestic price index, the higher is domestic welfare. Therefore, while trade policymakers are assumed to maximize domestic welfare in the model, their tariff choices are exactly as if they maximized the number of domestic manufacturing firms. And since the number of domestic manufacturing firms translates directly into the number of domestic manufacturing jobs, this is equivalent to maximizing the number of domestic manufacturing jobs. Of course, the model cannot capture the differential role played by exporting and import-competing interests in real-world GATT/WTO negotiations. This is because all firms are simultaneously exporting and import-competing in this simple ‘new trade’ environment.

Many of the arguments made in the context of the neoclassical theory of GATT/WTO negotiations could be revisited in the context of this ‘new trade’ theory of GATT/WTO negotiations. For example, one could introduce political economy forces into the model as in Bagwell and Staiger (1999) to see whether GATT/WTO negotiations can be viewed as a response to politically motivated protectionism. Or one could consider labor and environmental standards as in Bagwell and Staiger (2001) to assess whether they should be part of the GATT/WTO agreement. Or one could introduce domestic production subsidies into the model as in Bagwell and Staiger (2006) to evaluate the GATT/WTO rules on production subsidies.

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5 Appendix

5.1 Basic model: Two-country case

5.1.1 Parameter restrictions

The manufacturing sector is active in both countries for all possible (t_{21}, t_{12}) if and only if $\theta \geq \left(\frac{L_1}{L_1+L_2}\right)^{\frac{1}{1-\sigma}}$ and $\theta \geq \left(\frac{L_2}{L_1+L_2}\right)^{\frac{1}{1-\sigma}}$. The non-manufacturing good sector is active in both countries for all possible (t_{21}, t_{12}) if and only if $\mu \leq 1 - \theta^{1-\sigma}$.

5.1.2 Proof of lemma 2

Proof. A tariff combination (t_{21}, t_{12}) cannot be Pareto efficient if there exist possible Pareto improving tariff changes (dt_{21}, dt_{12}) at (t_{21}, t_{12}) . This includes tariff changes (dt_{21}, dt_{12}) such that $dG_2 < 0$ and $dG_1 = 0$. From total differentiation, $dG_1 = \frac{\partial G_1}{\partial t_{21}} dt_{21} + \frac{\partial G_1}{\partial t_{12}} dt_{12}$ and $dG_2 = \frac{\partial G_2}{\partial t_{21}} dt_{21} + \frac{\partial G_2}{\partial t_{12}} dt_{12}$. Therefore, $dG_1 = 0$ if $dt_{21} = -\frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}} dt_{12}$ so that $dG_2 = \left(\frac{\partial G_2}{\partial t_{12}} - \frac{\partial G_2}{\partial t_{21}} \frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}}\right) dt_{12}$ along $dG_1 = 0$. Notice that $\frac{\partial G_2}{\partial t_{12}} - \frac{\partial G_2}{\partial t_{21}} \frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}} > 0$ for all (t_{21}, t_{12}) . This is because $\frac{\partial G_1}{\partial t_{21}} = -\frac{(\theta\tau_{21}\theta\tau_{12})^{-\sigma}\theta\tau_{12}}{1-(\theta\tau_{21}\theta\tau_{12})^{1-\sigma}}\theta G_1$, $\frac{\partial G_1}{\partial t_{12}} = \frac{(1-(\theta\tau_{21})^{1-\sigma})(\theta\tau_{12})^{-\sigma}}{(1-(\theta\tau_{12})^{1-\sigma})(1-(\theta\tau_{21}\theta\tau_{12})^{1-\sigma})}\theta G_1$, $\frac{\partial G_2}{\partial t_{21}} = \frac{(1-(\theta\tau_{12})^{1-\sigma})(\theta\tau_{21})^{-\sigma}}{(1-(\theta\tau_{21})^{1-\sigma})(1-(\theta\tau_{21}\theta\tau_{12})^{1-\sigma})}\theta G_2$, and $\frac{\partial G_2}{\partial t_{12}} = -\frac{(\theta\tau_{21}\theta\tau_{12})^{-\sigma}\theta\tau_{21}}{1-(\theta\tau_{21}\theta\tau_{12})^{1-\sigma}}\theta G_2$ so that $\frac{\partial G_2}{\partial t_{12}} - \frac{\partial G_2}{\partial t_{21}} \frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}} = \frac{G_2}{\tau_{12}}$. Hence, there exist Pareto improving tariff changes (dt_{21}, dt_{12}) for all (t_{21}, t_{12}) . These (dt_{21}, dt_{12}) are such that $dt_{21} < 0$ and $dt_{12} < 0$ and are thus possible if and only if $t_{21} > 0$ and $t_{12} > 0$. Therefore, only (t_{21}, t_{12}) such that $(t_{21}, t_{12}) = (\text{any } t_{21}, 0)$ or $(t_{21}, t_{12}) = (0, \text{any } t_{12})$ can be Pareto efficient. It is easy to verify that for none of these (t_{21}, t_{12}) there exists another (t_{21}, t_{12}) which makes one country better off without making the other country worse off. Therefore, they are also indeed Pareto efficient. ■

5.2 Basic model: Three-country case

5.2.1 Parameter restrictions

The manufacturing sector is active in all countries for all possible $(t_{21}, t_{31}, t_{12}, t_{13})$ if and only if $\theta \geq \left(\frac{L_1}{L_1+L_2+L_3}\right)^{\frac{1}{1-\sigma}}$ and $\theta \geq \left(\frac{L_2}{L_1+2L_2}\right)^{\frac{1}{1-\sigma}}$ and $\theta \geq \left(\frac{L_3}{L_1+2L_3}\right)^{\frac{1}{1-\sigma}}$.³⁵ The non-manufacturing good sector is active in all countries for all possible $(t_{21}, t_{31}, t_{12}, t_{13})$ if and only if $\mu \leq 1 - 2\theta^{1-\sigma}$.

5.2.2 Solution for given trade policy

For given tariffs, the model's solution is determined by the manufacturing market clearing conditions

$$q = p^{-\sigma} G_1^{\sigma-1} \mu L_1 + p^{-\sigma} (\theta \tau_{12})^{1-\sigma} G_2^{\sigma-1} \mu L_2 + p^{-\sigma} (\theta \tau_{13})^{1-\sigma} G_3^{\sigma-1} \mu L_3 \quad (18)$$

$$q = p^{-\sigma} (\theta \tau_{21})^{1-\sigma} G_1^{\sigma-1} \mu L_1 + p^{-\sigma} G_2^{\sigma-1} \mu L_2 \quad (19)$$

$$q = p^{-\sigma} (\theta \tau_{31})^{1-\sigma} G_1^{\sigma-1} \mu L_1 + p^{-\sigma} G_3^{\sigma-1} \mu L_3 \quad (20)$$

where $q \equiv \frac{f(\sigma-1)}{c}$ and $p \equiv \frac{\sigma c}{\sigma-1}$ as in the two-country case but the ideal manufacturing price indices are now given by $G_1 \equiv \left(n_1 p^{1-\sigma} + n_2 (p\theta\tau_{21})^{1-\sigma} + n_3 (p\theta\tau_{31})^{1-\sigma}\right)^{\frac{1}{1-\sigma}}$, $G_2 \equiv \left(n_1 (p\theta\tau_{12})^{1-\sigma} + n_2 p^{1-\sigma}\right)^{\frac{1}{1-\sigma}}$, and $G_3 \equiv \left(n_1 (p\theta\tau_{13})^{1-\sigma} + n_3 p^{1-\sigma}\right)^{\frac{1}{1-\sigma}}$. Equations (18) - (20) can be solved immediately for the equilibrium manufacturing price indices

$$G_1 = \left(\frac{qp^\sigma \Phi_1}{\mu L_1 \Omega}\right)^{\frac{1}{\sigma-1}} \quad (21)$$

$$G_2 = \left(\frac{qp^\sigma \Phi_2}{\mu L_2 \Omega}\right)^{\frac{1}{\sigma-1}} \quad (22)$$

³⁵Notice that this restriction gets stronger the more countries are featured in the analysis. It should, however, not be taken literally empirically since wage adjustments are ruled out in order to cleanly isolate production relocation effects. If positive profits could also be competed away by wage adjustments instead of entry, a milder parameter restriction would be sufficient to guarantee diversified manufacturing production.

$$G_3 = \left(\frac{qp^\sigma \Phi_3}{\mu L_3 \Omega} \right)^{\frac{1}{\sigma-1}} \quad (23)$$

where

$$\Phi_1 \equiv 1 - (\theta\tau_{12})^{1-\sigma} - (\theta\tau_{13})^{1-\sigma} \quad (24)$$

$$\Phi_2 \equiv 1 - (\theta\tau_{21})^{1-\sigma} - (\theta\tau_{13})^{1-\sigma} \left((\theta\tau_{31})^{1-\sigma} - (\theta\tau_{21})^{1-\sigma} \right) \quad (25)$$

$$\Phi_3 \equiv 1 - (\theta\tau_{31})^{1-\sigma} - (\theta\tau_{12})^{1-\sigma} \left((\theta\tau_{21})^{1-\sigma} - (\theta\tau_{31})^{1-\sigma} \right) \quad (26)$$

$$\Omega \equiv 1 - (\theta\tau_{21}\theta\tau_{12})^{1-\sigma} - (\theta\tau_{31}\theta\tau_{13})^{1-\sigma} \quad (27)$$

It is easy to verify that Φ_1, Φ_2, Φ_3 , and $\Omega > 0$ given the assumed parameter restrictions. If the definitions of manufacturing price indices are substituted, they can also be solved for the equilibrium numbers of manufacturing firms

$$n_1 = \frac{\mu}{qp} \left(\frac{L_1}{\Phi_1} - \frac{L_2 (\theta\tau_{21})^{1-\sigma}}{\Phi_2} - \frac{L_3 (\theta\tau_{31})^{1-\sigma}}{\Phi_3} \right) \quad (28)$$

$$n_2 = \frac{\mu}{qp} \left(\frac{L_2 \left(1 - (\theta\tau_{31}\theta\tau_{13})^{1-\sigma} \right)}{\Phi_2} + \frac{L_3 (\theta\tau_{12}\theta\tau_{31})^{1-\sigma}}{\Phi_3} - \frac{L_1 (\theta\tau_{12})^{1-\sigma}}{\Phi_1} \right) \quad (29)$$

$$n_3 = \frac{\mu}{qp} \left(\frac{L_3 \left(1 - (\theta\tau_{21}\theta\tau_{12})^{1-\sigma} \right)}{\Phi_3} + \frac{L_2 (\theta\tau_{21}\theta\tau_{13})^{1-\sigma}}{\Phi_2} - \frac{L_1 (\theta\tau_{13})^{1-\sigma}}{\Phi_1} \right) \quad (30)$$

As in the two-country case, the world number of manufacturing firms is constant, tariffs affect welfare only through the manufacturing price indices, and there can be no role for terms-of-trade effects.

5.2.3 Three-country version of lemma 1

Suppose that governments choose tariffs simultaneously in an attempt to maximize their citizens welfare. Then the unique Nash equilibrium is $(t_{21}, t_{31}, t_{12}, t_{13}) = (\bar{t}, \bar{t}, \bar{t}, \bar{t})$.

Proof. Follows immediately from equations (21) - (23). ■

5.2.4 Three-country version of lemma 2

The set of Pareto-efficient tariff combinations consists of all $(t_{21}, t_{31}, t_{12}, t_{13})$ such that $(t_{21}, t_{31}, t_{12}, t_{13}) = (\text{any } t_{21}, \text{any } t_{31}, 0, 0)$ or $(t_{21}, t_{31}, t_{12}, t_{13}) = (0, 0, \text{any } t_{12}, \text{any } t_{13})$.

Proof. A tariff combination $(t_{21}, t_{31}, t_{12}, t_{13})$ cannot be Pareto efficient if there exist possible Pareto improving tariff changes $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$ at $(t_{21}, t_{31}, t_{12}, t_{13})$. This includes tariff changes $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$, $dt_{31} = dt_{13} = 0$, such that $dG_2 < 0$ and $dG_1 = dG_3 = 0$. From total differentiation, $dG_1 = \frac{\partial G_1}{\partial t_{21}} dt_{21} + \frac{\partial G_1}{\partial t_{12}} dt_{12}$, $dG_2 = \frac{\partial G_2}{\partial t_{21}} dt_{21} + \frac{\partial G_2}{\partial t_{12}} dt_{12}$, and $dG_3 = \frac{\partial G_3}{\partial t_{21}} dt_{21} + \frac{\partial G_3}{\partial t_{12}} dt_{12}$. Therefore, $dG_1 = 0$ if $dt_{21} = -\frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}} dt_{12}$ and $dG_3 = 0$ if $dt_{21} = -\frac{\partial t_{21}}{\partial G_3} \frac{\partial G_3}{\partial t_{12}} dt_{12}$. Notice that these two conditions are identical. This is because $\frac{\partial G_1}{\partial t_{21}} = -\frac{(\theta\tau_{21}\theta\tau_{12})^{-\sigma}\theta\tau_{12}}{\Omega}\theta G_1$, $\frac{\partial G_1}{\partial t_{12}} = \frac{\Phi_2(\theta\tau_{12})^{-\sigma}}{\Omega\Phi_1}\theta G_1$, $\frac{\partial G_3}{\partial t_{21}} = \frac{\Phi_1(\theta\tau_{21}\theta\tau_{12})^{-\sigma}\theta\tau_{12}(\theta\tau_{31})^{1-\sigma}}{\Omega\Phi_3}\theta G_3$, and $\frac{\partial G_3}{\partial t_{12}} = -\frac{\Phi_2(\theta\tau_{12})^{-\sigma}(\theta\tau_{31})^{1-\sigma}}{\Omega\Phi_3}\theta G_3$ so that $-\frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}} = -\frac{\partial t_{21}}{\partial G_3} \frac{\partial G_3}{\partial t_{12}}$. Hence, along $dG_1 = dG_3 = 0$, $dG_2 = \left(\frac{\partial G_2}{\partial t_{12}} - \frac{\partial G_2}{\partial t_{21}} \frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}}\right) dt_{12}$. Notice that $\frac{\partial G_2}{\partial t_{12}} - \frac{\partial G_2}{\partial t_{21}} \frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}} > 0$ for all $(t_{21}, t_{31}, t_{12}, t_{13})$. This is because $\frac{\partial G_2}{\partial t_{12}} = -\frac{(\theta\tau_{21}\theta\tau_{12})^{-\sigma}\theta\tau_{21}}{\Omega}\theta G_2$ and $\frac{\partial G_2}{\partial t_{21}} = \frac{\Phi_1(1-(\theta\tau_{31}\theta\tau_{13})^{1-\sigma})(\theta\tau_{21})^{-\sigma}}{\Omega\Phi_2}\theta G_2$ which, together with the derivatives given above, implies that $\frac{\partial G_2}{\partial t_{12}} - \frac{\partial G_2}{\partial t_{21}} \frac{\partial t_{21}}{\partial G_1} \frac{\partial G_1}{\partial t_{12}} = \frac{G_2}{\tau_{12}}$. Hence, there exist Pareto improving tariff changes $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$, $dt_{31} = dt_{13} = 0$, such that $dG_2 < 0$ and $dG_1 = dG_3 = 0$ for all $(t_{21}, t_{31}, t_{12}, t_{13})$. These $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$ are such that $dt_{21} < 0$ and $dt_{12} < 0$ and are thus possible if and only if $t_{21} > 0$ and $t_{12} > 0$. This also includes tariff changes $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$, $dt_{31} = dt_{12} = 0$, such that $dG_2 < 0$ and $dG_1 = dG_3 = 0$. From total differentiation, $dG_1 = \frac{\partial G_1}{\partial t_{21}} dt_{21} + \frac{\partial G_1}{\partial t_{13}} dt_{13}$, $dG_2 = \frac{\partial G_2}{\partial t_{21}} dt_{21} + \frac{\partial G_2}{\partial t_{13}} dt_{13}$, and $dG_3 = \frac{\partial G_3}{\partial t_{21}} dt_{21} + \frac{\partial G_3}{\partial t_{13}} dt_{13}$. Therefore, $dG_1 = 0$ if $dt_{13} = -\frac{\partial t_{13}}{\partial G_1} \frac{\partial G_1}{\partial t_{21}} dt_{21}$ and $dG_3 = 0$ if $dt_{13} = -\frac{\partial t_{13}}{\partial G_3} \frac{\partial G_3}{\partial t_{21}} dt_{21}$. Notice that these two conditions are identical. This is because $\frac{\partial G_1}{\partial t_{13}} = \frac{\Phi_3(\theta\tau_{13})^{-\sigma}}{\Omega\Phi_1}\theta G_1$ and $\frac{\partial G_3}{\partial t_{13}} = -\frac{(\theta\tau_{31}\theta\tau_{13})^{-\sigma}\theta\tau_{31}}{\Omega}\theta G_3$ which, together with the derivatives given above, implies that $-\frac{\partial t_{13}}{\partial G_1} \frac{\partial G_1}{\partial t_{21}} = -\frac{\partial t_{13}}{\partial G_3} \frac{\partial G_3}{\partial t_{21}}$. Hence, along $dG_1 = dG_3 = 0$, $dG_2 = \left(\frac{\partial G_2}{\partial t_{21}} - \frac{\partial G_2}{\partial t_{13}} \frac{\partial t_{13}}{\partial G_1} \frac{\partial G_1}{\partial t_{21}}\right) dt_{21}$. Notice that $\frac{\partial G_2}{\partial t_{21}} - \frac{\partial G_2}{\partial t_{13}} \frac{\partial t_{13}}{\partial G_1} \frac{\partial G_1}{\partial t_{21}} > 0$ for all $(t_{21}, t_{31}, t_{12}, t_{13})$. This is because $\frac{\partial G_2}{\partial t_{13}} = -\frac{\Phi_3(\theta\tau_{13})^{-\sigma}(\theta\tau_{21})^{1-\sigma}}{\Omega\Phi_2}\theta G_2$ which, together with the derivatives given above, implies that $\frac{\partial G_2}{\partial t_{21}} - \frac{\partial G_2}{\partial t_{13}} \frac{\partial t_{13}}{\partial G_1} \frac{\partial G_1}{\partial t_{21}} = \frac{\Phi_1(\theta\tau_{21})^{-\sigma}}{\Phi_2}\theta G_2$. Hence, there exist Pareto improving

tariff changes $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$, $dt_{31} = dt_{12} = 0$, such that $dG_2 < 0$ and $dG_1 = dG_3 = 0$ for all $(t_{21}, t_{31}, t_{12}, t_{13})$. These $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$ are such that $dt_{21} < 0$ and $dt_{13} < 0$ and are thus possible if and only if $t_{21} > 0$ and $t_{13} > 0$. Symmetric arguments can be made for tariff changes $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$, $dt_{21} = dt_{12} = 0$, such that $dG_3 < 0$ and $dG_1 = dG_2 = 0$ and tariff changes $(dt_{21}, dt_{31}, dt_{12}, dt_{13})$, $dt_{21} = dt_{13} = 0$, such that $dG_3 < 0$ and $dG_1 = dG_2 = 0$. Therefore, only $(t_{21}, t_{31}, t_{12}, t_{13})$ such that $(t_{21}, t_{31}, t_{12}, t_{13}) = (\text{any } t_{21}, \text{any } t_{31}, 0, 0)$ or $(t_{21}, t_{31}, t_{12}, t_{13}) = (0, 0, \text{any } t_{12}, \text{any } t_{13})$ can be Pareto efficient. It is easy to verify that for none of these $(t_{21}, t_{31}, t_{12}, t_{13})$ there exists another $(t_{21}, t_{31}, t_{12}, t_{13})$ which makes one country better off without making at least one of the other countries worse off. Therefore, they are also indeed Pareto efficient. ■

5.2.5 Three-country version of proposition 1

The noncooperative equilibrium is inefficient.

Proof. Follows immediately from the three-country versions of lemmas 1 and 2 ■

5.2.6 Proof of lemma 4

Proof. The statement that tariff changes leave the number of firms unchanged in all countries if and only if they are multilaterally reciprocal follows immediately from equation (11) and the definition of multilateral reciprocity. Similarly, the statement that bilaterally reciprocal trade liberalization between country 1 and country 2 (country 3) leaves the number of firms unchanged in country 2 (country 3) follows immediately from equation (11) and the definition of bilateral reciprocity. Finally, the statement that bilaterally reciprocal trade liberalization between country 1 and country 2 (country 3) monotonically increases the number of firms in country 1 at the expense of country 3 (country 2) follows from the fact that $dn_1 + dn_2 + dn_3 = 0$ together with the observation that $\frac{dn_3}{dt_{21}} > 0$ if $dt_{31} = dt_{13} = dn_2 = 0$ ($\frac{dn_2}{dt_{31}} > 0$ if $dt_{21} = dt_{12} = dn_3 = 0$) which can be easily established from equation (20) (equation (19)). ■

5.2.7 Proof of proposition 3

Proof. Follows immediately from lemma 4 and the definitions of manufacturing price indices.

■

5.3 Quantitative application

The coefficients in equations (12) - (14) are defined as $\alpha_{ij} \equiv \frac{T_{ij}}{S_i}$, $\beta_{ij} \equiv \frac{\tau_{ij}T_{ij}}{\mu X_j}$, $\gamma_j \equiv \frac{X_j - R_j}{X_j}$, and $\delta_{ij} \equiv \frac{T_{ij}}{X_j}$, where T_{ij} denotes the total value of trade flowing from country i to country j evaluated at world prices, $S_i \equiv \sum_{j=1}^J T_{ij}$ denotes the total value of manufacturing sales of firms from country i evaluated at world prices, $X_j \equiv \frac{1}{\mu} \sum_{i=1}^J \tau_{ij}T_{ij}$ denotes the total expenditure of consumers in country j , and $R_j \equiv \sum_{i=1}^J t_{ij}T_{ij}$ denotes the tariff revenue of country j .

5.4 Effects of $\bar{t} \rightarrow \infty$

If $\bar{t} \rightarrow \infty$, the two-country version of lemma 1, the three-country version of lemma 1, lemma 4, and proposition 3 would have to be modified as follows:

Effect on the two-country version of lemma 1: If $\bar{t} \rightarrow \infty$, (\bar{t}, \bar{t}) would no longer be the unique Nash equilibrium but instead the unique trembling-hand perfect Nash equilibrium. In particular, $\frac{\partial G_1}{\partial t_{21}} \rightarrow 0$ if $t_{12} \rightarrow \infty$ and $\frac{\partial G_2}{\partial t_{12}} \rightarrow 0$ if $t_{21} \rightarrow \infty$ as can be seen from equations (6) and (7). Therefore, all (t_{21}, t_{12}) such that $(t_{21}, t_{12}) = (\text{any } t_{21}, \bar{t})$ or $(t_{21}, t_{12}) = (\bar{t}, \text{any } t_{12})$ would then also be Nash equilibria. However, only (\bar{t}, \bar{t}) would be robust to small perturbations in the governments' strategies because $\frac{\partial G_1}{\partial t_{21}} < 0$ as soon as $t_{12} < \infty$ and $\frac{\partial G_2}{\partial t_{12}} < 0$ as soon as $t_{21} < \infty$.

Effect on the two-country version of lemma 1: This is analogous to the effect on the two-country version of lemma 1. If $\bar{t} \rightarrow \infty$, $(\bar{t}, \bar{t}, \bar{t}, \bar{t})$ would no longer be the unique Nash equilibrium but instead the unique trembling-hand perfect Nash equilibrium since all other Nash equilibria would not be robust to small perturbations in the governments' strategies.

Effect on lemma 4: If $\bar{t} \rightarrow \infty$, the statement on bilaterally reciprocal trade liberalization (trade protection) would have to be qualified. In particular, bilaterally reciprocal trade liber-

alization (trade protection) between country 1 and country 2 would then leave the number of firms unchanged in country 2 but increase (decrease) the number of firms in country 1 at the expense of (to the benefit of) country 3 if $t_{31} < \infty$ and leave the number of firms unchanged in all countries if $t_{31} \rightarrow \infty$. The latter case arises because $\frac{\partial G_3}{\partial t_{21}} = \frac{\partial G_3}{\partial t_{12}} = 0$ if $t_{31} \rightarrow \infty$, as can be seen from equation (23). Similarly, bilaterally reciprocal trade liberalization (trade protection) between country 1 and country 3 would then leave the number of firms unchanged in country 3 but increase (decrease) the number of firms in country 1 at the expense of (to the benefit of) country 2 if $t_{21} < \infty$ and leave the number of firms unchanged in all countries if $t_{21} \rightarrow \infty$. The latter case arises because $\frac{\partial G_2}{\partial t_{31}} = \frac{\partial G_2}{\partial t_{13}} = 0$ if $t_{21} \rightarrow \infty$, as can be seen from equation (22).

Effect on proposition 3: This follows directly from the effect on lemma 4. If $\bar{t} \rightarrow \infty$, the statement on bilaterally reciprocal trade liberalization would have to be qualified. In particular, bilaterally reciprocal trade liberalization between country 1 and country 2 would then monotonically increase welfare in country 1 and country 2 but monotonically decrease welfare in country 3 if $t_{31} < \infty$ and monotonically increase welfare in country 1 and country 2 but leave welfare unchanged in country 3 if $t_{31} \rightarrow \infty$. Similarly, bilaterally reciprocal trade liberalization between country 1 and country 3 would then monotonically increase welfare in country 1 and country 3 but monotonically decrease welfare in country 2 if $t_{21} < \infty$ and monotonically increase welfare in country 1 and country 3 but leave welfare unchanged in country 2 if $t_{21} \rightarrow \infty$.

6 Figures and tables

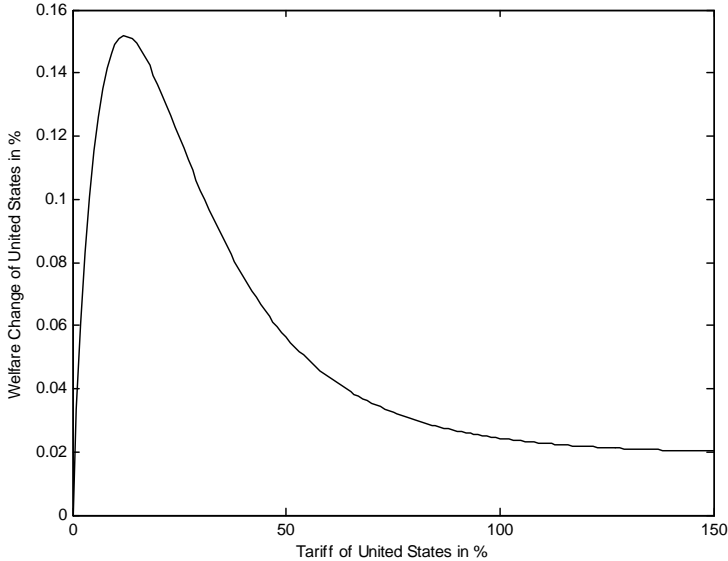


Figure 1: Optimal tariff with tariff revenue

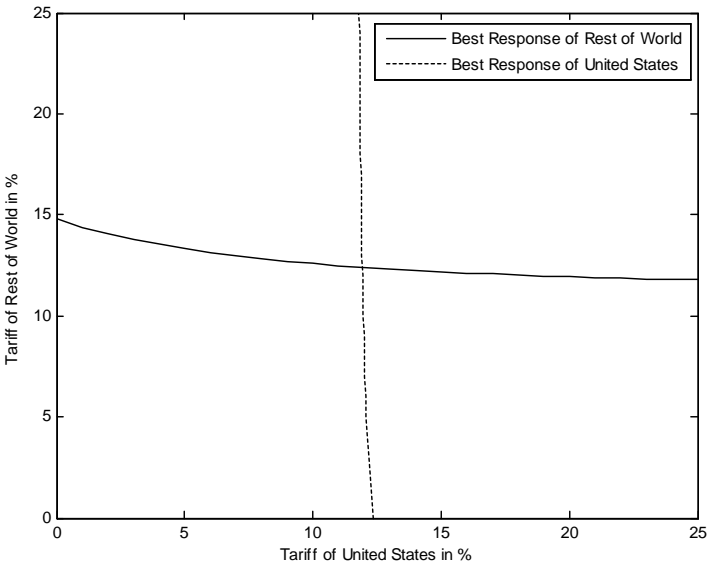


Figure 2: Reaction functions and Nash equilibrium

	ROW	EU	Brazil	China	India	Japan	US
ROW	3907.4	551.6	15.1	434.4	20.4	91.2	550.8
EU	656.9	6372.9	14.3	83.6	16.9	48.3	235.9
Brazil	24.1	9.3	314.6	2.1	0.3	1.0	16.4
China	349.7	161.6	3.9	801.7	7.0	82.4	212.2
India	18.6	17.3	0.4	6.2	387.0	1.4	14.6
Japan	191.8	96.1	2.9	123.1	2.9	3074.1	128.4
US	390.4	177.4	10.7	45.6	5.5	44.0	5201.3

Notes: Entry(i,j) are factual exports from i to j in US\$ billion in 2004

Table 1: Aggregated trade matrix from Dekle, Eaton, and Kortum (2007)

	ROW	EU	Brazil	China	India	Japan	US
ROW	0.0	2.5	12.7	4.2	14.8	1.3	2.2
EU	7.0	0.0	12.7	4.2	14.8	1.3	2.2
Brazil	7.0	2.5	0.0	4.2	14.8	1.3	2.2
China	7.0	2.5	12.7	0.0	14.8	1.3	2.2
India	7.0	2.5	12.7	4.2	0.0	1.3	2.2
Japan	7.0	2.5	12.7	4.2	14.8	0.0	2.2
US	7.0	2.5	12.7	4.2	14.8	1.3	0.0

Notes: Entry (i,j) is factual tariff imposed by j against imports from i in % in 2004

Table 2: Aggregated tariff matrix from Boumellassa, Laborde, and Mitaritonna (2009)

	ROW	EU	Brazil	China	India	Japan	US
ROW	0.0	13.0	12.1	11.6	12.0	12.4	12.4
EU	11.0	0.0	12.1	11.9	12.0	12.1	12.0
Brazil	11.6	12.5	0.0	12.0	12.1	12.2	12.3
China	10.3	11.5	12.0	0.0	12.0	12.5	11.0
India	12.2	12.5	12.1	12.0	0.0	12.1	12.1
Japan	11.4	12.0	12.1	11.6	12.1	0.0	11.9
US	11.4	12.1	12.1	12.0	12.1	12.1	0.0

Notes: Entry (i,j) is counterfactual Nash tariff imposed by j against imports from i in %

Table 3: Nash tariffs with $\sigma = 9.28$

	ROW	EU	Brazil	China	India	Japan	US
ROW	0.0	28.7	27.8	26.2	27.7	28.3	27.8
EU	26.3	0.0	27.7	27.6	27.8	27.8	27.7
Brazil	26.7	28.2	0.0	27.6	27.8	27.9	27.8
China	28.4	26.9	27.7	0.0	27.7	28.9	25.6
India	27.5	28.0	27.8	27.5	0.0	27.8	27.6
Japan	26.6	27.5	27.8	26.9	27.8	0.0	27.5
US	27.0	27.8	27.8	27.8	27.8	27.9	0.0

Notes: Entry (i,j) is counterfactual Nash tariff imposed by j against imports from i in %

Table 4: Nash tariffs with $\sigma = 4.60$

	sigma=9.28	sigma=4.60
ROW	-0.3	-0.7
EU	0.0	-0.2
Brazil	-0.1	-0.3
China	-0.4	-1.2
India	-0.1	-0.3
Japan	-0.1	-0.3
US	0.0	0.0

Entries are counterfactual welfare changes in %

Table 5: Welfare losses from moving to Nash tariffs