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**Theoretical Considerations of  
Multilateralism and Regionalism**

**Gen Yamamoto**

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**APEC STUDY CENTER**  
**INSTITUTE OF DEVELOPING ECONOMIES**

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## I. Introduction

The basic role of this paper is to survey and to analyze the arguments concerning the relationship between the formation and expansion of regional blocs such as FTAs (Free Trade Agreements) or customs unions, and the multilateral liberalization process known as the WTO (World Trade Organization) liberalization process in the field of international economics.

Traditionally, the international economics community has formed the foundation of the research of this issue, and has provided clues to the formation of the empirical research model in the field of international political economy (IPE) and international relations (IR). It is proof that they have shared many basic concepts regarding the issue of economic regionalism, such as trade creation, trade diversion, or the terms of trade.

As a result of this intellectual situation, their research programs have been affected by their theoretical achievements, and IPE scholars have shown some sensitivity to the work of economists in constructing explanations.<sup>1</sup> In this intellectual inclination, Theodore Moran (1996: 192), who is a political scientist, expresses the “one way” situation as follows:

The point, of course, is not that Mowrey and Samuels are wiser or more knowledgeable about aerospace policy (for example) than Krugman and Baldwin, but that Krugman, Baldwin and their successors would be even wiser and more knowledgeable than they already are if they were in close dialogue with their counterparts in the international relations/political science community, and vice versa. (On the other side of the international political economy dialogue, in contrast, the two volumes by Gowa and Mansfield..., engaging and debating with a large fraction rather than merely citing them.)<sup>2</sup>

In short, Moran observes that economists have been much slower to draw on relevant works such as that of political science or sociology. However, it is also true that the research on this issue has not fully accumulated in political science because the main focus of “regionalists” in political science has been on the mechanism of economic integration accompanied by “political” integration.

Hence, to begin with, I will survey the theoretical achievement on this issue in international economics. Note that because of our objectives, this survey is limited to

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<sup>1</sup> Mastanduno (1998).

<sup>2</sup> Mowrey, Samuels, Gowa, and Mansfield are political scientists.

models of more than three countries, because of our objectives.

### **I-1. Purpose**

The main purpose of this chapter is to clarify what international economics teaches us and what it does not, in order to set the basis of our research. Especially, this chapter selectively surveys studies using the dynamic approach, because these types of theoretical studies and our research project share the same purpose or question which is as follows: Will the two processes act as friends or foes? (Bhagwati 1993)

To express the purpose more concretely, I will:

- a. survey the representative theories concerning the relationship between multilateralization and regionalization,
- b. point out the problem structure on this issue,
- c. clarify what international economics teaches and what it does not,
- d. consider how political scientists contribute to this issue.

I would like to emphasize here that the purpose of this survey is to reconsider how political science theories can be complementary to the existing works of international economics on this issue.

### **I-2. Configuration of This Chapter**

Next is the configuration of this chapter. I will:

- a. arrange arguments in chronological order,
- b. clarify the dilemma and its structure on this issue, which has been discussed among economists,
- c. show that the traditional ways of formulating this problem caused the dilemma,
- d. point out that the dilemma resolution requires us to reconsider the appropriateness of assumptions of models, and to expand the scope of the formulation,
- e. get the implications of economists' ideas in shape,

- f. point out that the dilemma resolutions needs counterfactual elements (international side payments for liberalization, international institutions in force, or government's support for facilitating specializing process),
- g. clarify that counterfactual elements require political efforts of governments to be realized.

### **I-3. Strategy of Survey**

Basically, the existing research on this issue can be classified into four types according to the type of independent variables which analysts focus on, and the approach of the analysis.

First, the series of researches on this problem are classified according to which effect a researchers' attention is paid. One is the static effect, a revenue transfer effect. The other is the dynamic effects, which are non-revenue transfer effects such as the effects of technology diffusion, the direction of investments, the development of productivity, the change of institutions, and so on.<sup>3</sup>

**Second, we can divide the approaches into a static approach and a dynamic approach. According to Gilpin (2001: 57-58), the (comparative) static approach can be explained as follows: it is a method of analysing the impact of a change in a model by comparing the equilibrium resulting from the change with the original equilibrium.**

On the other hand, expressing the difference between dynamic approaches and static approaches, Bhagwati, Greenway, and, Panagariya (1998: 1141) define dynamic approaches as follows:

In contrast to the question whether the immediate (static) effect of a PTA (Preferential Trade Agreement) is good, we may ask whether the (dynamic time-path) effect of the PTA is to accelerate or decelerate the continued reduction of trade barriers towards the goal of reducing them worldwide.

In short, we can conclude that a static approach is a methodology in which we substitute values for parameters of a model and observe the outcomes. In dynamic analysis, time is included in the models explicitly as a variable. Using this classification by independent variables and approaches, we can summarize existing studies and the representative scholars related to this issue into the following matrix:

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<sup>3</sup> Balassa (1961); Baldwin (1989).

**Table 1**

	<b>Approach</b>		
	<b>Static analysis</b>	<b>Dynamic analysis</b>	
<b>Independent variable</b>	<b>Static Effects</b>	(area <i>A</i> ) Kemp=Wan (1976) Krugman (1993)	(area <i>C</i> ) Riezman (1985) Freud (1998) Yi (1996) Bagwell=Staiger (1997)
	<b>Dynamic Effects</b>	(area <i>B</i> ) Balassa (1961) Baldwin (1989)	(area <i>D</i> ) Either (1998) Baldwin (1995)

The configuration of this survey is as follows: First, the static analysis of a FTA is surveyed. Although studies of this approach can be divided into two pairs ({approach, effect (variable)}) as I mentioned, the pair {Static approach, Static effect} has given many basic concepts to the subsequent discussion between multilateralists and regionalists since the 1940s. The other pair {Static approach, Dynamic effect} is the approach regarding the dynamic effects of a FTA as important, however, most scholars belonging to this area have never paid much attention to this issue until recently. Therefore, I will concentrate on surveying the “area *A* “ of the above matrix for the preparation of this survey.

Next, I will survey the studies using dynamic analysis, which is inherent in this research project directly. To begin with, it becomes clear in this survey that we encounter difficulties in the framework of the pair {Dynamic approach, Static effect} (area *C*) when we expect the natural development of FTAs into a global free trade system through expansion. And then, by considering the theoretical outcomes in the framework of the pairs {Dynamic approach, Static/Dynamic effect}, it is shown that in a case in which some effective institutions exist or governments make some political efforts, multilateral free trade may be a rational outcome.

Then, by clarifying the premised theoretical elements of international economists, we can understand that these premises restrict our freedom to expand the scope of modeling. As a final point, I will emphasize that the research of political science is required in order to develop this discussion in economics, referring to the recent theoretical trend called institutional comparative analysis.

## II. Static Approaches as Normative Theories

### II-1. Free Trade Theories

#### II-1-(1). *Ricardo: Comparative Advantage Hypothesis*

The theoretical basis of free trade affirmation groups called “multilateralists” or “globalists” has initially been based on the comparative advantage hypothesis of David Ricardo who was one of the founders of classical economics, and the theoretical development of neo-classicism that followed it.

Ricardo and his fellow classical economists shared a number of basic assumptions, such as the idea that every economic value was created by labor (the labor theory of value) and a belief that the three basic factors of production (land, labor, and capital) could not move across national boundaries. Ricardo and other economists, however, were interested in learning what law governs the distribution of national income among the factors production, and what are the determinants of international trade patterns.

Seeking the answers to these questions, by utilizing basic mathematical techniques and models Ricardo formulated the law of diminishing returns to account for the distribution of national income, and the principle of comparative advantage to explain the trade pattern. According to Ricardo’s explanation, the domestic value of any commodity depended upon its labor costs (Ricardo 1973: 9). Also in international trade, the cost of production, which is the *relative* or *comparative* labor cost of commodities in two (or more) countries instead of the *absolute* one, determines values in an exchange.

Expressed in general terms, the Ricardian principle of comparative cost can be stated as follows: If  $a_1$  and  $b_1$  are the unit labor costs of producing commodities  $A$  and  $B$  in country 1, and  $a_2$  and  $b_2$  are the costs in country 2, then country 1 will export commodity  $A$  on the other hand, and import commodity  $B$  if  $a_1/b_1 < a_2/b_2$ . This states algebraically that, before trade, commodity  $A$  is relatively cheaper and commodity  $B$  relatively dearer in country 1 than in country 2. This situation gives a nation shift production from a high-cost domestic producer to a low-cost trading partner (specialization). Using this simple concept of the difference of production functions, Ricardo shows that international trade can improve economic welfare not only nationally, but also internationally.



Although this model gave a more convincing and adequate proof of the benefits of trade than previous explanations, it would be exposed to various criticisms. One of the typical criticisms is that this model left the actual ratio of international exchange or international price, undetermined. That is, Ricardo focused exclusively on the supply or cost side of international trade and paid no attention to the demand side. Also many economists criticized the fact that Ricardo's theory argued that free trade among nations would maximize global welfare, taking all production technology (function) as a given. In response to this kind of criticism, economists have extended and created many methods and theories about international trade over the past century and a half, however, Ricardo's basic approach to the subject has continued to guide his economic successors.

### ***II-1-(2). Heckscher-Ohlin***

The Ricardian theory employed presents a highly stylized model of technological differences. It assumes the existence of a single factor of production, labor that exhibits constant productivity in generating commodity outputs. This simplification led the analysis to some sharp theoretical predictions, including constant opportunity costs, the likelihood of complete specialization in trade, and the existence of "positive income gains" from trade for all workers "in both countries." In practice, however, we rarely observe such outcomes from trade.

After this Ricardian model, two Swedish economists, Heckscher and Ohlin, further developed the essentials of this model in two fundamental ways. First, their assumes the existence of a second factor, which is capital, allowing for a much richer specification of production functions. Second, rather than assuming different technologies, the model rests on the notion of identical production functions in both countries. This assumption is made explicitly to neutralize the important possibility that trade is based on international technological variations in favor of the possibility that trade is based solely on differences in supplies of capital and labor.

Thus, in the Heckscher-Ohlin model, comparative advantage and trade are determined by national differences in factor endowments. For example, countries that have abundant supplies of agricultural land such as Australia, tend to be net exporters of grains and food. On the other hand, developing nations with abundant endowments of low-skilled labor such as China tend to export labor-intensive goods such as clothing

and consumer electronics. While there are certain technical differences in achieving unambiguous evidence on this model in the real world, the consensus among trade economists is that factor endowments provide one of the most important explanations for observed international trade patterns. (Markusen-Melvin-Kaempfer-Maskus 1995) Thus, the evident empirical relevance of the model provides a strong motivation for its study as well.

## **II-2. Regionalism as Normative Theories**

### ***II-2-(1). Viner: Trade Creation and Diversion***

The classic work on the welfare consequences of regional trade agreements is Viner's *The Customs Union Issue* (1950). This is the first academic article which theoretically showed the possibility of the improvement of worldwide economic welfare.

Prior to Viner's analysis, the conventional wisdom of the economics profession – based on Ricardo's theory – had been that regional agreements were beneficial to members and nonmembers alike, as was global trade liberalization. Viner challenged this optimistic assumption in his work.

Viner's analysis pointed out that a common external tariff would have trade diverting as well as trade-creating effects, which means that it could have beneficial and detrimental effects on welfare. In other words, these effects move the world both closer to and further away from completely free trade. On the one hand, by eliminating the barriers among its members, an arrangement can create trade and improve efficiency through the specialization of the arrangement. On the other hand, by granting members market access on preferential terms, it can divert trade, by expanding the production of less efficient members and reducing the production of more efficient nonmembers.

### ***II-2-(2). Kemp and Wan: Welfare-Increasing Customs Unions and FTAs***

The theoretical probability of Welfare-Increasing customs unions and FTAs was first stated by Murray Kemp (1964) and Vanek (1965) independently, and proved by Ohyama (1972) and Kemp and Henry Wan (1976), in a proof, which is known as the Kemp-Wan (-Vanek-Ohyama) theorem. The logic behind the theorem is as follows: consider a situation where any number of countries in a group, produce and exchange

any number of commodities, and in which any country is allowed to have any kind of tariffs, domestic taxes, or other distortionary policies. Now consider the possibility that a subgroup of these countries,  $S$ , forms a customs union. Suppose it is actually possible to combine this subgroup of these countries  $S$  into a single economy whose resources are equal to the sum of the individual subgroup members.

Suppose further that this fictitious single country is now faced with the same excess demands and supplies that faced subgroup  $S$  before the union. The question now is whether this new economy can organize itself in such a manner that individual consumers are better off than they were before the union. Unless the initial situation happened to have been the optimum, the answer is yes. After all, given the same excess demands and supplies from foreigners, and given that the initial situation contained distortions, a preferred equilibrium position will clearly exist. Note finally that to ensure that the same excess demands and supplies face the new union, a system of external taxes, subsidies, and so on can be defined that maintains the initial world terms of trade for all commodities. (Kemp and Wan 1976)

In other words, freezing the net trade vector of  $A$  and  $B$  (  $S$ ) with the rest of the world ensures that the rest of the world can be made neither better off nor worse off by the union. Then taking the external trade vector as a constraint, the aggregate welfare of  $A$  and  $B$  is maximized by equating the marginal rate of transformation (MRT) and marginal rate of substitution (MRS) for each pair of goods across all players in the union. This is accomplished by eliminating all intra-union trade barriers and by setting the common external tariff vector at just the right level to hold the extra-union trade vector at the pre-union level.

Also, in the Kemp and Wan model, a customs union formed by  $S$  can be enlarged progressively until it embraces the entire world, provided that side payments are possible between members to guarantee that everyone is not worse off after the entry of outsiders.

### ***II-2-(3). Krugman: Regional Blocs and the World Welfare***

With these positive interpretations with regionalism, some multilateral liberalists would criticize from the viewpoint of the number and the size of blocs. (Krugman 1993).

Krugman's approach is to imagine that all countries are identical, and then to

consider their division into two or more identical blocs, consisting of a large number of small, identical units, called “provinces.” Each province specializes in the production of distinct goods. Products of all provinces enter symmetrically into the utility function with an identical, constant elasticity of substitution between each pair of products.

Given that the world is divided into  $B$  identical blocs where  $B$  is exogenous, there are no barriers to within-bloc trade and a common external tariff on extra-bloc trade. Given complete symmetry, the external tariff of each bloc is the same. Though each bloc acts as a Nash player and chooses the external tariff optimally, since this endogeneity is not crucial to the results, it is best not to introduce it at this stage. A key point of this model is that a change in the number of blocs and hence the size of each bloc generates no terms-of-trade effects.

Initially, on the assumption that the world trade system is a single bloc (worldwide free trade) in this model, we conclude that this structure maximizes the welfare of each province and the world. Secondly, assuming that the world is divided into two blocs, we conclude that this structure leads to trade diversion and world welfare necessarily declines. Thirdly, suppose that the world is divided into three blocs. In this case, trade diversion becomes prominent and world welfare declines to its lowest point. It can be shown, however, that as the number of blocs grows, the trade creation effect increases again, and comes to dominate the trade diversion effect.

To summarize, the results of Krugman’s model are as follows: given a large number of blocs, the representative bloc is small, and most of its trade is with outside provinces. Therefore, when another bloc is created, the expansion of trade with these outside provinces dominates the contraction of trade with the provinces that are moved out to create the new bloc. As it turns out, welfare must rise. Because from one bloc to three blocs there is a negative correlation between the world welfare and the number of blocs, welfare exhibits a  $U$ -shape pattern as a function of the number of blocs.

Of the scholars who study this relationship in the framework of the dynamic approach, most of them have a pessimistic view. By contrast to this dominant discourse, some studies show that the route from regional blocs to global liberalization is feasible.

In the next chapter, firstly I will introduce the typical logic of multilateralism, and then, the argument on a few theories of regionalists is surveyed. Next, I point out that in reality these optimistic results need some political efforts by governments.

### III. Dynamic Approaches

#### III-1. Multilateralism in Dynamic Approaches

Traditionally, the normative opinions of multilateralists had been based on theorems of the (neo) classic school, however, at present multilateralists are insistent in pointing out the infeasibility of the global free trade system by bloc expansion. In short, today's multilateralism is "passive" multilateralism in the sense that multilateralists cannot show logical feasibility of multilateral liberalization in the framework of the dynamic approach. That is to say, the multilateralist's claim is only a normative opinion. Referring to this "passiveness," regionalists claim that the GATT is only a "General Agreement to Talk and Talk." (Bhagwati 1993)<sup>4</sup>

##### *III-1-(1). The Basic Logic of Multilateralists: Riezman (1985)*

Here, as the first step, by introducing Riezman's model (1985), we consider infeasibility of the bloc expansion which many multilateralists' models point out.

In Riezman's work, customs union formation is modeled as a two-stage game. In this model, three countries and three goods are assumed.<sup>5</sup> In the first stage countries make coalitional choices according to the core theory. In the second stage optimal tariff rates are determined: if countries 1 and 2 form a bloc, either country will choose the joint tariff rate. In this three-player (country) model, their preferences defined in Cobb-Douglas type are the same for each country and symmetric in the three goods. Each country differs only in the endowments of commodities.

Based on this model, Riezman presented some examples of numerical computation in order to investigate the condition of equilibriums. In the set of equilibriums, many of them represent the conflicts between social rationality and individual rationality. The structure of endowments is given by the matrix  $Y$ , where the vertical axis represents countries and the horizontal axis sectors. For example 1:

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<sup>4</sup> Krugman (1993) suggests that to expect multilateral liberalization by a multilateral process is to do nothing politically.

<sup>5</sup> Two-country tariff games have been formulated in many ways and been analyzed by many scholars. For example, Kennan and Riezman (1988).

**Table 2-1**

$$Y = \begin{pmatrix} 1.1 & 0.1 & 0.1 \\ 0.1 & 1.1 & 0.1 \\ 0.1 & 0.1 & 1.1 \end{pmatrix}$$

Under the condition that each country has one strong commodity (sector) symmetrically, the equilibrium will go to global free trade ( $\{1,2,3\}$ ).

This is an ideal situation for global free trade as Ricardo showed, however, it will become irrational for each player if the structure deviates from this ideal one.

**Table 2-2**

$$Y = \begin{pmatrix} 0.3 & 0.1 & 0.1 \\ 0.1 & 0.3 & 0.1 \\ 0.1 & 0.1 & 0.3 \end{pmatrix}$$

In example 2,  $\{2,3\}$  blocks both  $\{1,2,3\}$  and  $\{1\},\{2\},\{3\}$ , however, the others are unblocked (the core). In this example, the joint strategy by any kind of pairs results in a situation where terms of trade gains outweigh the efficiency loss that the tariffs induce, because the allocation is no longer symmetric.

**Table 2-3**

$$Y = \begin{pmatrix} 2 & 0.6 & 0.6 \\ 0.1 & 1.1 & 0.1 \\ 0.1 & 0.1 & 1.1 \end{pmatrix}$$

Example 3 is a case in which only countries 2 and 3 are symmetric and country 1 enjoys a great advantage in the endowment of a commodity. In this situation,  $\{2,3\}$  or  $\{3,2\}$  becomes the equilibrium. In this case, 2 and 3 are better at forming a customs union than at the noncooperative optimal tariff equilibrium. Notice that the aggregate benefit (social welfare) by free trade, which is addressed  $\{1,2,3\}$ , improved. In this equilibrium,  $\{1,2,3\}$  is blocked by  $\{1\}$ ,  $\{1,2\}$ ,  $\{1,3\}$ ,  $\{2,1\}$ , and  $\{3,1\}$ . On the other hand, country 1 is better off with tariffs regardless of whether or not 2 and 3 form a customs union.

Following this research, as an equilibrium of the model, Kennan and Riezman

depict the dilemma where individual rationality is superior to social rationality as follows: Given that the economic scale of the customs union by two countries is fully large, they may found a Customs Union and put a high tariff on the rest of the world. This choice is rational for them even when multilateral liberalization maximizes the world welfare (Kennan and Riezman 1988.)

***III-1-(2). Feasibility Problems: Levy (1997); Krishna (1998)***

Following these works in the late 1980s, this dilemma has been expressed in many kinds of models in the 1990s where the setting is different. One of the major works is a median voter's model by Levy (1997). Levy addressed the following two questions:

- (a) Can the option to form a trade bloc make a previously infeasible multilateral liberalization feasible?
- (b) Can the additional option render a previously feasible multilateral liberalization infeasible?

His answer to the first question is a simple "no." The initial infeasibility of multilateral liberalization implies that the median voter enjoys higher utility under autarky than under free trade. The option to form a bloc is exercised only if it increases the voter's utility further. But this raises his/her reservation utility and must make him/her even less willing to accept multilateral liberalization.

The second question is addressed within two models: a two-sector, two-factor, multi-country, Heckscher-Ohlin model and a variant of this model in which one of the sectors produces a differentiated, monopolistically competitive good. He shows that in the first model, the option of a trade bloc can or cannot block a previously feasible multilateral accord, but in the second one, it can. In other words, in the standard Heckscher-Ohlin framework, regionalism neither helps nor hinders multilateralism. If one of the goods is differentiated, however, the trade bloc can become a stumbling block to multilateralism. The main difference now is that benefits from trade also arise from an increase in the variety of the differentiated product. The utility function of a country depends on not only the relative factor endowment of the economy, but also product variety. Since multilateral free trade offers an even larger variety than the bloc, it might shift the utility curve further up, however, if the multilateral accord also decreases the country's endowment ratio, it will yield a lower utility to the median voters than the

trade bloc. Therefore, even though median voters would have accepted the multilateral accord in the absence of the trade bloc, they will reject it in its presence.

An alternative approach to this problem is in terms of a Cournot oligopoly model in which the decisions are driven by producer profits. This is the setting of the Pravin Krishna (1998) model discussed earlier in the context of the decision to form an FTA. Using this model, Krishna analyzes the similar question asked by Levy: Does an initially feasible multilateral liberalization remain necessarily feasible after two of the three countries have formed an FTA? Krishna addresses this question and answers it in the negative, stating that the more FTA benefits from trade diversion, the more likely it will turn into a stumbling block.<sup>6</sup> Through multilateral liberalization, the members of the FTA obtain tariff free access to the third world country's market in return for offering it access to their own market on equal terms. If, however, the FTA was heavily trade diverting to begin with, the benefit in terms of the government's objective function from the former change is less than the loss due to the latter change. In the absence of trade diversion, this is more or less a zero-sum game.<sup>7</sup>

### ***III-1-(3). Multilateral Liberalization and PTAs: Freund (1998)***

To analyze whether great openness, which is the feature of the recent regionalism, may imply greater sustainability of PTAs, Caroline Freund (1998) formulates a symmetric, three-country, oligopoly, repeated games-model. Initially, each country levies the same multilateral tariff on the other two countries. She shows that, in this setting, the welfare gain from jointing a PTA is greater than the gain from a move to free trade when the multilateral tariff is low while the reverse is true when it is high. She goes on to show that this feature makes PTAs more sustainable when multilateral tariffs are low. Hence, PTAs may proliferate and be sustained as a result of multilateral freeing of trade.

According to her model, in the case of autarky, when two countries form a FTA, there is no room for exploiting the third country via better terms of trade. On the other hand, when the multilateral tariff is initially low, however, the partner countries can

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<sup>6</sup> Krishna (1995) also models the political process in the fashion of the government acting in response to implicit lobbying by firms as a "Clearinghouse," showing in his model that the FTA reduces the incentive of the two member countries to liberalize tariffs reciprocally with the nonmember world.

<sup>7</sup> Grossman and Helpman (1995) also point out that the greater the degree of trade diversion, the more likely that the FTA may be formed.



benefit from multilateral liberalization as well as an improvement in the terms of trade with respect to the third country that accompanies preferential liberalization. Under multilateral liberalization, by contrast, no terms-of-trade benefits accrue: the benefits are limited to the conventional efficiency triangles. These factors increase the attractiveness of preferential liberalization over multilateral liberalization at low tariffs.

### **III-2. Regionalism in Dynamic Approaches<sup>8</sup>**

Following multilateralism in the framework of dynamic approaches, I will now explain the logic of new theories using the framework of the DTPA that shows that regional blocs work as stepping stones to multilateral liberalization.<sup>9</sup>

#### ***III-2-(1). Static Effects: Open Regionalism: Yi (1996)***

In the existing researches of regionalists, the work of Yi (1996) has had the highest evaluation. Based on the static effect (the revenue transfer effect) in the framework of comparative institutional analysis, Yi shows that regional customs unions are stepping stones toward global free trade under the “open regionalism” rule but stumbling blocs against global free trade under the “unanimous regionalism” rule.

Yi’s research is formed with the analysis of 3 stages as follows. First, Yi establishes the welfare effects of the formation, expansion, and the merger of customs unions. Second, the relationship between customs-union structures and welfare is studied. Third, two rules of customs-union formation are compared in the framework of the non-cooperative theory.

In this model, there are  $N$  countries. Each country produces one good at a constant marginal cost in terms of the numeraire good. The good is transferred across countries to settle the balance of trade. Assume that each country’s endowment of the numeraire good is the same across countries and is sufficient to guarantee a positive consumption of the numeraire good in each country. The profits of a domestic firm and the tariff revenues are rebated back to the consumers. Just as in the traditional settings,

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<sup>8</sup> Bhagwati named this approach the “second regionalism.” Bhagwati (1998: 1129)

<sup>9</sup> Bhagwati states in the article as follows: “the question of the dynamic time-path is particularly difficult: it is almost virgin territory.” However, this approach using game theories became the dominant one in 1990s.

the utility function of a country consists of four components: the domestic consumer surplus, the domestic firm's profit in its home market, the tariff revenue, and the domestic firm's profit in export's profits.

If a group of countries forms a customs union, they abolish tariffs among union members and jointly choose their external tariffs to maximize the *aggregate* welfare of members. Suppose that there are no side-payments among union members. In this setting, it is shown that the relationship between the optimal tariff level of a customs union and the size of the customs union is ambiguous,<sup>10</sup>

*Proposition 1: The unique optimal external tariffs of a customs union of size  $k$  is ambiguous.*<sup>11</sup>

This result is because of the quasi-linear nature of the utility function of consumers.<sup>12</sup>

Therefore, next, this study investigates the welfare of member and non-member countries and the expansion of a customs union. The propositions concerning them are shown as follows:

*Proposition 2: Assume that  $0 < \sigma < 1$ . A non-member country's volume of Exports and export profit to a customs union of size  $k$  is a decreasing function of  $k$ . The formation or expansion of customs unions reduces the welfare of non-member countries.*

The  $\sigma$  is the substitution index, which ranges from 0 (independent goods) to 1 (homogeneous goods). And,

*Proposition 3: The formation or expansion of customs unions increases the aggregate welfare of member countries.*<sup>13</sup>

Combining Propositions 2 and 3, we can see the effect on *global* welfare of the formation, expansion, or merger of customs unions is in general ambiguous because the aggregate welfare of members improves but non-members are made worse off. An exception occurs when a grand customs union (global free trade) is created. In other words, world welfare is maximized under the grand customs union provided that import

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<sup>10</sup> This is because consumers value not only the volume of the consumption goods, but also the variety of products.

<sup>11</sup>  $k$  is the number of member countries in a customs union.

<sup>12</sup> Notice that the optimal tariff of a customs union of size  $k$  depends only on  $k$ .

<sup>13</sup> The idea behind Proposition 3 is not trivial. For the proof, see Yi (1996: 162).

tariffs are the only policy instruments.

*Proposition 4: The effects on global welfare of the formation or expansion of customs unions are ambiguous, except when the grand customs union is created. The world welfare is higher under the grand customs union (global free trade) than under any other customs union structure*

For exploring how welfare changes when customs-union structures change, Yi formulates it as follows. Let  $P$  be the set of countries:  $P = \{P_1, P_2, \dots, P_n\}$ .

**Definition 1.** A customs-union structure  $C = \{n_1, n_2, \dots, n_m\}$  is a partition of the set of countries  $P$ .  $B_i \cap B_j = \emptyset$ ,  $i \neq j$ . Since all members of a given union receive the same welfare,  $W_i$  denote the welfare of a country belonging to a customs union of size- $k$  in a given union structure  $C$  as  $W(k; C)$ ,  $k = n_1, n_2, \dots, n_m$ . The next result shows how the merger of customs unions affects outsiders.

*Proposition 5.  $W(n_i; C) < W(n_i; C')$  if  $n_i \in C, C'$ , and  $C - \{n_i\}$  can be derived from  $C' - \{n_i\}$  by merging customs unions in  $C' - \{n_i\}$ : If customs unions merge to form a larger union, outside countries not involved in the merger are worse off.<sup>14</sup>*

The next proposition ranks the per-member welfare of customs unions in a given union structure.

*Proposition 6.  $W(n_i; C) > W(n_j; C)$ , if  $n_i > n_j$ : In any customs-union structure, a member of a large customs union has a higher level of welfare than does a member of a small customs union.<sup>15</sup>*

The following result examines how changes in the customs-union structure affect the welfare of countries involved in the change.

*Proposition 7.  $W(k; C) > W(kp; C')$ , where  $(C) k = k_i$ ,  $(C') \{k_1, k_2, \dots, k_p\} \subset C$ ,  $k_p = k_i$ ,  $i = 1, \dots, p-1$ , and  $(C) C = C' - \{k_1, k_2, \dots, k_p\} \cup \{k\}$ : if customs unions merge, the members of the smallest customs union involved in the merger become better off.<sup>16</sup>*

It is worth emphasizing that *Proposition 7* does not imply that the merger of customs union necessarily benefits the members of the larger customs unions involved. It may well be the case that, for example, when two customs unions combine, the

<sup>14</sup> For example,  $W(4; \{5, 4\}) < W(4; \{4, 3, 2\})$ .

<sup>15</sup> For example,  $W(4; \{5, 4\}) < W(4; \{4, 3, 2\})$ .

<sup>16</sup> For example,  $W(5; \{5, 4\}) < W(2; \{4, 3, 2\})$ .

welfare of the members of the larger customs union declines.<sup>17</sup>

*Proposition 8.*  $W(n_j; C) < W(n_j+1; C')$ , where  $n_i = n_j$ ,  $C' = C - \{n_i, n_j\} \cup \{n_i+1, n_j-1\}$ : A member of a customs union becomes better off if it leaves its customs union to join another customs union of equal or larger size.

Also, *Proposition 8* does not imply that, when a members of a small customs union joins a larger one, the existing members of the larger customs unions necessarily become better off.<sup>18</sup>

Using these propositions, Yi formulates an abstract model of coalition formation. The coalition formation game consists of two stages. In the first stage, countries form customs unions. In the second stage, countries set tariffs optimally given the customs-union structure. In addition, Yi considers two rules of customs union formation, which are “open membership” and “unanimous regionalism.” The open membership game is the game in which membership in a coalition is open to all players who are willing to abide by the rules of the coalition. Respectively, membership of unanimous regionalism is not open to non-members.

In this game, each country announces an “address.” The countries that announce the same address belong to the same customs union. Yi analyze both the simultaneous-move and the finite-horizon sequential-move versions of the game. In the simultaneous-move version, countries announce addresses at the same time. In the sequential-move version,  $P_1$  first makes an announcement. After observing  $P_1$ 's decision,  $P_2$  makes its announcement, and so on up to  $P_N$ .

Analyzing the (pure strategy) Nash equilibrium of this game, Yi postulates some propositions as follows:

*Proposition 9-1.* (Under the rule of the open regionalism) the grand Customs union is the unique Nash equilibrium customs-union structure of the simultaneous-move.

*Proposition 9-2.* (Under the rule of the open regionalism) the grand customs union is the unique Nash equilibrium customs-union structure of the sequential-move.

Also Yi specifies the subgame perfect equilibrium outcome of this game as follows:

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<sup>17</sup> For example,  $W(5; \{5,4\})$  can be bigger or smaller than  $W(3; \{4,3,2\})$ .

<sup>18</sup> For example,  $W(5; \{5,3,1\})$  can be bigger or smaller than  $W(3; \{4,3,2\})$ .

*Proposition 10. A subgame perfect equilibrium custom- union structure of the open regionalism game is asymmetric. There is a unique largest customs union in any subgame perfect equilibrium customs-union structure.*

On the other hand, equilibriums under the rule of unanimous regionalism are as follows:

*Proposition 11. The unique subgame perfect equilibrium customs union has a unique smallest customs union, which is the last customs union to form.*

Hence, the grand customs union is a subgame perfect equilibrium outcome of open regionalism, but is not that of unanimous regionalism.<sup>19</sup> Through this model analysis, it became clear that on the one hand, regional customs unions are stepping stones toward global free trade when the membership of the customs unions are open to non-member countries. On the other hand, however, they can become stumbling blocks against global free trade if membership becomes exclusive.

### ***III-2-(2). Dynamic Effects***

#### *Domino theory: Baldwin (1995)*

In the works concerning dynamic effects in the framework of the dynamic approach, Baldwin's bloc expansion theory known as the "domino theory" is the most famous. Baldwin is presently the most famous "bloc expansionist," therefore, his theory has been criticized by many multilateralists.

Baldwin (1995) analyzes formally the incentive of outsiders to seek entry to a bloc. He assumes that potential entrants face non-economic costs of acceding to a bloc. The entrants can be indexed along the real line such that a rising value of the index is associated with higher non-economic costs of entry. This means that successive countries require larger and larger economic incentives to seek entry. Notice that the protected market within the bloc becomes larger while the outside market becomes smaller.

Trade barriers in this model take the form of transport costs, and entry into an existing bloc is modeled as a reduction in the transport cost. At the initial equilibrium,

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<sup>19</sup> For the unanimous regionalism game, a necessary condition for the grand customs union to be the subgame perfect equilibrium outcome is  $W(N; \{N\}) > W(N-1, \{N-1, 1\})$ .

the economic benefit of membership to the last member in the bloc equals its non-economic costs. Baldwin disturbs this equilibrium by introducing an exogenous shock, which Baldwin named an “idiosyncratic event,” such as the European Single Market initiative in 1992. This shock increases relative profitability within the bloc, thereby encouraging the firms in the outside country at the margin to lobby their government harder for entry. As this country accedes to the bloc, the potential economic benefits of entry for the next country on the outside margin rise and may offset the higher non-economic costs of entry it faces. Thus, bloc expansion generates a domino effect. Unless non-economic costs rise faster than the benefits of entry, given his assumption of open entry, the bloc can come to encompass the entire world (global free trade).

*Domestic Politics: Wei and Frankel (1996)*

For analyzing the formation of a FTA, there exist some studies that model domestic politics as dynamic effects in the framework of the two-country setup (Grossman and Helpman, 1994). However, the research is rare that mentions the relationship between the formation of the FTA and multilateral liberalization from such a viewpoint.

In such an academic situation, Shang-Jin Wei and Jeffrey Frankel (1996) show that, even though it was infeasible initially, regional blocs as an intermediate step could divide the original opposition force in a country so that a sequence of liberalization now becomes feasible. Their setup is as follows: the domestic politics game consists of two periods. Country *A* and *B* are two small open countries. The rest of the world is labeled as country *C*. There are three goods, *x*, *y* and *z*. The labor distribution in Countries *A* and *B* has the feature that no single sector has a majority, and the sum of any two sectors constitutes a majority. On the other hand, in country *C*, workers in sector *z* constitute a majority. Therefore, country *C* whose sector *z* is competitive internationally always seeks global free trade if it can get it.

With this configuration, each country has an unambiguous winner (e.g. sector *x* for *A* or *y* for *B*).<sup>20</sup> Suppose that, in countries *A* and *B*, the two less efficient sectors receive tariff protection with the *ad valorem* rate. Therefore, from the viewpoint of

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<sup>20</sup> By this assumption, we can concentrate now on analysis of Countries *A* and *B*.

country *A*, global free trade means removal of tariffs on goods *y* and *z*. With the removal of the two tariffs, the wage rates must fall.

This model assumes that the cost of job relocation is high and workers in less efficient sectors can stay in the original sector or switch to the efficient sector (e.g. *x* for *A* or *y* for *B*). Notice if the workers ever switch, they will do so in the first period. Hence, workers' options are only two: either staying in the original sector for both periods or switching to *x* and staying there in the second period.

Based on this setup, Wei and Frankel consider a proposal to form a FTA between *A* and *B*. As a result of tariff removal, the price of good *y* in country *A* and that of good *x* in country *B* will decline. Moreover, people in sector *x* (and *z*) in *A* benefit from this and will support the regional bloc with *B*. Namely, since they base their decision on this period's utility, they will also support the move, which makes the number of supporters in country *A* a majority.<sup>21</sup>

The next consideration is to consider the second stage for investigating the political feasibility of a proposal for global free trade. Those people that remain in sector *y* in *A*, although they suffer a real income loss from the regional bloc, realize that further liberalization (global free trade) will not cause another drop in their wages, but will lead to a drop in the price of good *z*. Therefore, people in sector *y* together with those in sector *x* will now collectively support global free trade.

Finally, Wei and Frankel analyze whether this result will be the Nash equilibrium in the framework of dynamic games or not. For this analysis, they assume that the government is able to set an agenda and commit to it. The agenda is simply a two-stage plan: In period 1, the government will hold a referendum on forming a free trade bloc with country *B*; and in period 2, regardless of the outcome of the first referendum, the government will hold another referendum on forming a free trade bloc with country *C*.

Assume that at  $t=2$ , people in sector *y* together with those in *x* push the country for further trade liberalization. Therefore, in order to block the regional trade arrangement, which by itself is in the interest of people in sector *z*, people in sector *y* have to promise and convince people in sector *z* that they will not agree to free trade with country *C* at  $t=2$ . But such a promise is not time-consistent. That is, at  $t=2$ , it is the optimal strategy of people in sector *y* to vote for free trade with *C*. Given that free trade

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<sup>21</sup> Grossman and Helpman (1994) also show that the allowance for the exclusion of certain sectors from an FTA agreement can make a previously infeasible FTA feasible.

with  $C$  will likely be the outcome at  $t=2$ , the best strategy for people working in sector  $z$  at  $t=1$  is to vote for free trade with  $B$ . In this way, they at least get the benefit of a lower price on good  $y$ .

Hence, the government can pursue global free trade as an end result of a two-step process by using a regional bloc as an intermediate step.

*FDI and Political Reform Effects: Ethier (1998)*

Some of the recent FTAs have formed along North-South lines. Needless to say, the “North” means a developed country and the “South” a developing country. These agreements have also been concluded in the wake of considerable liberalization among the countries in the North. Inspired by these observations and paying attention to dynamic effects in the formation of FTAs, Ethier (1998) constructs a model in which preferential liberalization by the South is the result of multilateral liberalization in the North and a happy accommodation with it.

A highly simplified account of Ethier’s basic story can be given as follows. The world is divided into two regions to be called here “North” and “South.” Each region consists of several countries. “North” countries are symmetric. Each Northern country produces one non-traded good, which uses skilled and unskilled labor, and one variety of a traded, differentiated good, which uses human capital and an intermediate good. Only the North has human capital so that the differentiated good can be produced only in that region. The intermediate good uses skilled labor and can be produced anywhere. A key feature, which drives many of the results, is the presence of an international external economy in the production of the intermediate input. Southern countries have skilled labor and could produce the intermediate input, trading it for the differentiated good with the North, but they face resistance to openness. Initially, this resistance is sufficiently strong that even the country with the least resistance is in autarky. Each Southern country produces and consumes a rudimentary good, which is a poor substitute for the North’s differentiated good. Northern countries trade initially but impose the Nash optimum tariff on the imports of the differentiated good from other countries. Because the countries are symmetric, the tariff is the same for all of them.

Suppose now that multilateral cooperation leads to a reduction in the Northern tariff. This leads to an expansion of the intermediated input and differentiated goods sectors in each Northern country. The international externality lowers the production



cost for intermediate input and allows some Southern countries to overcome resistance to openness. The production of the intermediate input moves partially to the reforming Southern countries. This opening up itself creates opportunities for North-South regional arrangements. Some Northern countries give a tariff preference to the intermediate input produced in the Southern partner in return for exclusive access to the Southern partner's market for the differentiated good.

By using this model, Ethier (1998: 1242) evaluates the role of foreign direct investment (FDI) and policy reform to the success of postwar multilateralism in many countries as follows:

- a. The small-country participants in regional arrangements have embarked on programs of policy reform intended, at least in part, to enhance the role of international trade.
- b. Direct investment has been surging since the late 1980s.
- c. Reforming countries anxious to join the multilateral trading system as soon as possible see the attraction of FDI as a key step.
- d. Attracting FDI requires making the country attractive relative to other, similar potential hosts, not relative to source countries.
- e. Regional arrangements can give a small country a marginal advantage – over other, similar, small countries – in attracting FDI because they obtain marginally more favorable access to a large market than other nonparticipating small countries.
- f. The regional arrangements, by in effect internalizing a critical externality, help spread the benefits of the multilateral trading system around the globe and enhance its value to all participants, thereby reinforcing, rather than undermining, support for multilateralism.

#### **IV. Theoretical Development and the Limitations**

In this chapter, I point out the methodological/theoretical limitations of international economies, and then, I outline the necessity of political analysis for studying the relationship between multilateralism and regionalism.

##### **IV-1. Theoretical Understandings**

Before discussing the trend of the theoretical development, we have to clarify and list up the theoretical tacit understandings shared among international economists:

- U1: International economists have assumed the political context (arena) of games as anarchy, which means players (nations) can choose any strategies as long as

the strategies are rational.<sup>22</sup>

- U2: International economists basically have defined governments as economical profit-maximizers when defining them as players in international economy, in other words, they have excluded non-economic elements from the utility functions.
- U3: International economists have assumed the global free trade system maximizes the international economic welfare, which means it is the first best choice by the criteria of social rationality.

Based on these understandings, their pure theories have been constructed and have given some theoretical implications to empirical and normative studies.

In the first stage (1940s-1980s), FTAs and customs unions were evaluated in the framework of static-comparative analysis (area *A* of table 1). In this discussion, although Kemp and Wan showed that the formation of FTAs/customs unions might improve the international economic welfare, scholars agree that it was no better than second best in economic welfare. What needs to be emphasized here is that multilateralism in this period was only a normative theory highly dependent on conventional liberalism such as the Heckscher-Ohlin theory.

In the second stage (1990s-), the debates focused on the time-path question, whether the effect of the FTAs or customs unions accelerate or decelerate the continued reduction of trade barriers towards global free trade (area *C* of table 1). In this discussion, most of the dynamic analysis concludes that the formation of a FTA may be a stumbling block, pointing to the following reason: If the economic scale of the regional bloc by two countries is fully large, they two may found it, reject the entry of non-members, and put high tariffs on the rest of the world (Riezman 1985; Kennan and Riezman 1988; Krishna 1998). In other words, the more a FTA benefits from trade diversion, the more likely it will turn into a stumbling bloc to global free trade (Grossman and Helpman 1995; Freund 1998).

Even after the dynamic approach was introduced, multilateralism still was the theory that gained ground among economists. On the other hand, around 1995 the new

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<sup>22</sup> Bagwell and Staiger (1998: 1162) express this point as follows: “Introductory references are typically made to the GATT/WTO, but the analysis is often carried out with little or no reference to the structure of this multilateral institution.”

type of regionalism appeared and began to attract scholars' attention. Their theoretical feature is to add international institutions restricting the freedom of players' choice into the model (Yi 1996), to assume the government's strategies and efforts in domestic politics (Wei and Frankel 1996; Either 1998), or to focus on dynamic effects such as the FDI (Either 1998) or non-economic factors (Baldwin 1995). These models depict the grand customs unions (global free trade) as an equilibrium outcome, as the consequence of interaction by rational players. Using these exogenous factors, some scholars began to illustrate the possibility of dilemma resolutions.

#### **IV-2. Theoretical Implication from the Debate**

Research on international economics has given much theoretical implication to the political scientists who inquire on this issue. And many research programs of international political economists have employed the theories of international economics in the formation of their research programs.

Now, let us summarize the theoretical implications extracted from the debate in international economics. Basically, many theories, which do not stand on the same premises in modeling, accommodate the same issue. Some of them build a model consisting of a two-sector, two-factor, and multi-country situation, on the other hand, others set a single-sector and three-country model. Due to this theoretical situation, it is difficult to compare propositions and to point out comprehensive implications in this field.<sup>23</sup> However, there exist some common implications even in different theories. Therefore, we can share, at least, the following implications:

I1: Under anarchical conditions where players can do anything they want, regional economic blocs tend to be a stumbling block for multilateral liberalization.

I2-1: If the economic scale of the regional bloc by two countries is fully large, they may found it, reject the entry of non-members, and put high tariffs on the rest of the world. This has been the basic dilemma on this issue.

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<sup>23</sup> In the interview with Dr. Ross Garnaut (2001.12.6), he expressed that it was important for model-builders to set appropriate premises in formulations, moreover, the evaluation with the model largely depends on its appropriateness. On the other hand, Milton Friedman states that what is important is whether these assumptions lead to fruitful propositions that can be tested empirically and thereby be shown to be valid or invalid (Friedman, 1953: 3-43).

I2-2: (From the above implication, we can say that) if the international distribution of economic resources (factor endowments) is unequal, customs unions will be stumbling blocks to global free trade.<sup>24</sup>

I3: If a country can specialize in an industrial sector corresponding to regional liberalization, regional blocs may work as stepping stones to global free trade.

I4: In cases in which international institutions limit the freedom of players' to some degree, regional blocs may be stepping stones toward global free trade.

Considering the above implications heavily related to one another, we can conclude that any regional movement may give negative impacts on multilateralization (social rationality) as long as the individual rationality of countries is respected under anarchy.

For example, Riezman (1985) criticizes the famous proposition by Kemp and Wan that there exists a set of transfers that makes everyone better off at free trade given any initial tariff equilibrium (I1). Riezman clearly explains the irrationality of their theoretical outcome using the case that initially the {2, 3} customs union forms (U2, I2) as follows:

If transfers are allowed then country 1 could bribe 2 and 3 to move to free trade. Is this an equilibrium? No, because country 1 could pay a smaller bribe to country 2 to join in a customs union against 3. It is clear that free trade with transfers is not an equilibrium because no country would be willing to be the net transferor at free trade. This follows from symmetry and the fact that all countries do better in a customs union than at free trade. (Riezman, 1985; 362-364)

Likewise, Hallett and Braga (1994) have shown the limitations of their side payments theory in another aspect: side payments require intra-bloc explicit co-operation which is not always possible, even with such a co-operation, the expansion of the bloc does not guarantee the final outcome of free trade, since there is a strong incentive to exploit the market power of the bloc.

Baldwin (1995), who employs the dynamic approach for analyzing the bloc expanding phenomena, also assumes that members in an existing bloc have no incentive

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<sup>24</sup> As Riezman shows in his article (Riezman, 1985), if the economic scale of one country is fully large, the country may not have incentives to liberalize its trade, and the rest of the world will build a regional blocs with high tariff.

to block entry, and finally the bloc expands into a global bloc as Kemp=Wan implied. Opposing this proposition, Soamiley Andriamananjara (1999) shows that as the customs union expands, profits of the members first rise, reach a maximum, and then decline. Moreover, the maximum-profit point is reached before the customs union comes to encompass all countries. Bond and Syropoulos (1996) ask this same question, and, with the help of simulations, show that as the bloc expands, the welfare of its members peaks before it absorbs all members of other blocs.<sup>25</sup>

To overcome this dilemma, some scholars reconsider the theoretical context, and try to resolve this problem through the viewpoint of institutional comparative analysis. Although few of these types of studies exist now, this will be a leading approach in this issue area according to Ohyama (2001).

As I noted before, Yi (1996) expresses the dilemma, which Riezman (1985) points out, as a rational outcome in his model.<sup>26</sup> It is of great significance that in his work he accepts criticisms from multilateralists, and furthermore, tries to get over the dilemma by assuming the open membership rule, which is a counterfactual institution, into his conventional model.

More recently, Bagwell and Staiger (1998; 2000) define the game of FTA and customs union formation, introducing the pillars of the GATT architecture, in other words, the principles of *reciprocity* and *non-discrimination*. Consequently, Bagwell and Staiger (2000) show that if any WTO members respect both principles, nobody will have incentives to form FTAs and customs unions. Even though the former provides the measure for bloc expansion, while the latter shows the institutional conditions for multilateral liberalization, both models imply that international institutions in effect may move existing equilibriums to the ideal one.

On the other hand, some scholars focus on the dynamics of domestic politics, especially the strategy of the government to render the eventual global free trade feasible. As I mentioned, Wei and Frankel (1996) model the sector-specialization process of Ricardo's theory in the dynamic context, and explain regional blocs as an intermediate step that could divide the original opposition force so that a sequence of liberalization becomes possible. In this set, the optimal and unique strategy of the government is to form a regional bloc first, and then to accept the entry of the third

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<sup>25</sup> These two studies play as the lemma of *proposition 2*.

<sup>26</sup> See, Yi's *proposition 7* and *8* in this paper.

country (I3). This is a good example of a contribution from the viewpoint of political science to the purely economic considerations. As Wei and Frankel (1996: 345) already pointed out in their paper, there exists a case in which it will not work. For example, in the case that the comparative advantage (international competitiveness) of the rest of the world (the 3rd country) is absolutely high (strong) in more than two sectors, a regional bloc will be a stumbling block. In such a case, other countries may not have any incentive to develop free trade with the advantageous country (I2-2). In this connection, it should be stressed that Riezman (1985) also points out this situation by hypothetical example in a similar setting.<sup>27</sup>

When we consider the reality, to say nothing of the inappropriateness of hypothesizing the ideal distribution in domestic and international endowments that makes multilateral liberalization feasible naturally, it is unrealistic to assume that international institutions are effective (I1).

In sum, we conclude the theoretical development and theoretical implications of international economics on this issue are as follows: whereas international economists attempt to find the way of resolving the dilemma by putting counterfactual premises into their models, they have never referred to the feasibility of actualizing these premises yet.

### **IV-3. Insights from Political Science**

The results of this survey make clear that the bloc-expansion theories are constructed by some unrealistic assumptions for traditional economists' theories. Because of this difference in theoretical premises, we need to evaluate the political feasibility of these assumptions.

Therefore, from the standpoint of political science, we verify the theoretical contexts of these new economic theories on the international level and domestic level separately, and point out there is the room and necessity for contributions from political science to this issue.

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<sup>27</sup> See, Table 3 in Riezman (1985).

#### *IV-3-(1). The International Level*

Through introducing the studies of Yi (1996) or Bagwell and Staiger (1998; 2000), we can see that they have assumed the institutional (political) environment as a given, and have shown the mechanism toward multilateral trade liberalization. In short, they imply that the feasibility of multilateral liberalization is a function of the degree of institutionalization (effectiveness) of international rules. However, this type of new study does not teach us how to actualize such institutions in an anarchical society. Thus, if there is not room for actualization completely in the political sense, their theories may be meaningless not only as political theory, but also as economic theory. In this sense, the present trend of international economics concerning this issue potentially requires the research of political science.

Contrary to economics, in the field of international politics and IR, international institution has been one of the main research targets for a long time. As a result, many theories and empirical studies concerning international institutions have accommodated, for example, federalism, (neo)functionalism, (neo)institutionalism, regime theory, or constructivism (Gilpin 2001: 348-361).

In classical theories of international politics related to institutions, normative theories had been the main school, however, present theories such as regime theories and constructivism are highly concerned with political developments or the political decay of international institutions. Regime theories, which have explained many cases of institution-building, tend to consider that the institutionalization of norms relies on the degree of convergence of countries' preferences (Krasner 1983). On the other hand, constructivism is a meta-theory, which tries to explain social phenomenon from the viewpoint of agent-structure relations. Hence, constructivists have paid attention to and have tried to explain unintended (social) consequences by analyzing the historical change of players' preferences and norms of international society as a result of interactions among them.<sup>28</sup>

In general, political scientists define a country's preference as decided by not only economic elements, but also by non-economic elements. Therefore, these types of political theories might extend the possibility of institution-building, which is not

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<sup>28</sup> In international political science, the typical work is Wendt (1987, 1999), and in international economics, it is North (1990).

rational in economics, but is in politics. Even though international economists have a pessimistic view concerning unselfish actions of countries, international cooperation involving side payments from developed countries to developing countries has sometimes been observed in international politics. A typical one is the economic and technical cooperation (ECOTECH) in APEC or similar activities in the EU. This kind of action, which is a sort of a side payment in a sense, had not been imagined in economics.

Another typical example is the dispute settlement procedure built into the WTO when this international organization was founded in 1995 (Staiger 1995; Maggi 1999). Although, to begin with, this proposal was strongly opposed by the United States which had been afraid of being restricted in the exercise of superiority in economic power, its implementation was supported by other countries and now works effectively.

Like the above phenomenon, there are many instances in which countries seem to act unselfishly so that it is not trivial to define a country as an economic rational player. For instance, although the choice of a country may seem to be irrational in economics, it may be rational in political sense. In reality, many countries take part in FTAs because they are now afraid of failing to keep up with the new wave of the “FTA movement”.<sup>29</sup> Therefore, we have to consider factors of utility or the expectations of countries as much as possible in pursuing the possibility of institution building and states’ cooperation in the international political arena.

#### *IV-3-(2). The Domestic Level*

Although the study of Wei and Frankel (1996) illustrates the possibility of political path to multilateral free trade, they put some strong assumptions on the model of domestic politics.

One of the most prominent assumptions is to define the stage game as a two-period game. In their article, after providing a positive result with the formation of a FTA, they prove that it still holds in the two-period variation, however, this outcome demands the finiteness of the game. In other words, this consequence cannot hold

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<sup>29</sup> According to an interview with Mr. Rajan Venkataraman, who belongs to WTO Regional & Free Trade Agreements Section of Trade Negotiation Division of Foreign Affairs and Trade in Australia (2001,12.5), the incentive to form FTAs is very political in most cases.



without this strong assumption, which is the finiteness. In reality, the game of politics continues infinitely.

And this model assumes that each sector has equal political power, however, it is usual that the structure of political power is unequal in reality. In this sense, this assumption is overdrawn, in other words, it is too idealistic.

Thinking about these gaps between the assumptions made and reality, we can understand that the path to multilateralism, which Wei and Frankel (1996) found, is not to the extent that they thought always feasible in reality. And it is easy to imagine that to actualize these stories it needs some political assistance of third players such as government.

In political science, there are some theories which solve such problems like Rogowski's theory named neocooperatism (1989). This shows the possibility to control, in other words, to calm down the opposition of political groups in a country by the government's side-payment policies. By assuming such political techniques or efforts in each country, we can expect to solve the dilemma which most of the international economists studying this issue would encounter.

## **V. Conclusion**

As discussed above, although studies of political science may not directly provide a comprehensive solution, these could become a "side-study" for this issue in the sense of providing interdisciplinary context.

The theme of our research project is so abstract that international economists have used the rational choice approaches and defined this as a tariff problem when tackling this issue. It is not clear whether this traditional methodology in international economics is appropriate or not. However, we cannot neglect the methodology choice because global free trade has never been observed and it is only international economics that has studied this vague issue.

Compared with this approach, the reality regarding this issue is very complicated in the sense that many kinds of social forces coexist, affect, and interact. Hence, the theoretical implications from international economics are limited in nature. Note that

this fact does not mean that the intellectual achievements of international economics are meaningless, however, we have to take notice of the limitations.

It follows from this survey and discussion that there are several prescriptions for multilateralization tacitly shared by multilateralists and regionalists. The first one is to build some appropriate international institutions in effect. The second one is to promote international cooperation. The third one is political efforts of a government for promoting the specialization process in a country.

**These prescriptions are not related to one another directly. However, some international economists have paid attention to these political factors and treated them as important variables in the framework of institutional comparative analysis, in order to get over the conventional dilemma. In this intellectual situation, what is required of political science on this issue may be to investigate the political incentive (structure) concerning the above three points for multilateral trade liberalization.**

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