Centre for Economic Performance

Discussion Paper ISSN 2042-2695

No. 2043
October 2024

Political competition and the strategic adoption of free trade agreements

Emanuel Ornelas

LSE THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

UKRI Economic and Social Research Council

Abstract
I study how political competition affects the feasibility of free trade agreements (FTAs). I show that the possibility of political turnover creates strategic motivations for the formation of FTAs. Specifically, a government facing a high enough probability of losing power will have an incentive to form a trading bloc to "tie the hands" of its successor. This incentive mitigates inefficiencies in the incumbent's decision to form FTAs, regardless of its bias toward special interests. An FTA can affect the likelihood of political turnover as well. Accounting for that effect, I show that an incumbent party with a known bias toward special interests could seek an FTA as a commitment device toward less distortionary policies, thereby enhancing its own electoral prospects. Overall, the analysis reveals the importance of considering the time horizon of policymakers when studying their decision to enter in FTAs.

Keywords: regionalism, free trade agreements, political competition, lobbying
JEL codes: F15; F13; D72

This paper was produced as part of the Centre's Trade Programme. The Centre for Economic Performance is financed by the Economic and Social Research Council.

I thank Emily Blanchard, Monika Mrazova, Torsten Persson, Lorenzo Rotunno, Scott Taylor, Bob Staiger, the editor Scott Baier, and two anonymous referees for helpful comments. I acknowledge financial support from the Brazilian Council of Science and Technology (CNPq).

Emanuel Ornelas, Sao Paulo School of Economics, FGV, CEPR, CESifo, London School of Economics and Centre for Economic Performance at London School of Economics.

Published by
Centre for Economic Performance
London School of Economic and Political Science
Houghton Street
London WC2A 2AE

1. INTRODUCTION

As of 1 August 2024, the World Trade Organization reported 369 regional trade agreements in force. If one counts agreements on goods and services separately, the figure reaches impressive 608 agreements. As these numbers suggest, in the last 30 years membership in these agreements has been the main form of trade liberalization worldwide. It is therefore critical to understand why countries form and participate in free trade agreements (FTAs).

The reasons are surely diverse, but many analysts associate the formation of FTA with "politics," in particular electoral disputes and electoral outcomes. In the United States, this link was probably clearest during the 1992 presidential campaign, when Ross Perrot's platform relied heavily on his opposition to NAFTA, which he suggested would generate a "giant sucking sound" of American jobs and investment heading south to Mexico. Simultaneously, several observers associated the decision of Mexico to join NAFTA as "strategic," as a way to lock in domestic liberalizing reforms (Fernandez and Portes 1998; Whalley 1998). More recently, in 2017, President Trump withdrew the U.S. from advanced negotiations of the Trans-Pacific Partnership, a bloc with 11 other countries, on his first day in office, as he had promised during the electoral campaign. Still, and despite all the attention given to the issue of preferential integration by the press, by policymakers, and by economists, there is hardly any theoretical research linking the formation of free trade agreements to political competition. In this paper, I make this connection explicit by analyzing how the prospect of political turnover affects the political viability of an FTA.

The common approach to the analysis of the formation of an FTA assumes (usually implicitly) that the governments that decide the fate of the agreement keep power indefinitely. This assumption is inconsequential once it is also assumed that governments behave as "social (welfare-maximizer) planners." However, it becomes highly restrictive whenever the policies of the current policymakers can affect the actions of its successors. Indeed, I show in this paper that, in contrast to the relatively common view that FTAs can play a role in solving time inconsistency problems by tying the hands of incumbent governments, these arrangements can play a role in tying the hands of one's *opponents* in the future.[1] And instead of a benevolent government employing an FTA to tie its own hands in the future, I find that a government very biased towards special interests has a strong incentive to adopt an FTA to ensure a continuation of its political rents.

[1] It should be pointed out that the notion that a government may seek to form an FTA as a commitment to a liberal policy when it may be replaced in the future by a government with different policy preferences is not entirely new, having been discussed by Fernandez and Portes (1998), for example. However, it has not been formalized before.

When countries form a free trade agreement, they lower the tariffs on each other's exports, but their duties on imports from outside the bloc remain largely unconstrained. For that reason, it is conceivable that, rather than reducing protectionist rents, the bloc may increase them. Indeed, much of the earlier literature on the topic focuses precisely on the possibility that governments may use FTAs as a device to raise rents (e.g., Grossman and Helpman 1995 and Krishna 1998). Ornelas (2005a) shows, however, that FTAs actually diminish the rents available to governments. The central reason is that governments have an incentive to lower the tariffs on non-members subsequent to the formation of an FTA—otherwise, inefficient rent-creating trade diversion would be generated, but with such rents being partially captured by the exporters from bloc partners. With lower external tariffs, protectionist rents are then partly destroyed. The direct implications of this destruction of rents is that governments will tend to implement only the agreements that are "substantially" welfare improving, and that only those governments weakly attached to rents will tend to engage their countries in FTAs. The analysis of Ornelas (2005a) is static, however, and therefore cannot account for the possibility of political turnover, which alters the workings and consequences of the rent destruction effect of FTAs. In this paper, I take the rent destruction effect to its logical consequences in a setting where governments are not permanently in power.[2]

First, I examine the implications of political turnover for the viability of free trade agreements by extending Ornelas' model to a 2-period setting where the incumbent faces a fixed probability of being replaced in office. In that context, I show that the prospect of political turnover may turn an otherwise unviable FTA into a politically viable one. This possibility arises because the incumbent government does not acquire any rents generated in the political process when it is out of office, but its constituency is still harmed by the welfare consequences of protectionist policies. Accordingly, it wants to constrain the ability of future administrations to create rents through inefficient policies. This logic seems to fit well the contemporaneous justifications for Mexico's decision to join NAFTA in the 1990s, given that most-favored-nation tariffs in Canada and the U.S. were already quite low, and therefore there was relatively little to gain in terms of additional market access (Fernandez and Portes 1998; Whalley 1998). The rent destruction effect ensures that an FTA is an effective tool to constrain the adoption of such rent-creating inefficient policies. The upshot is that

[2] The model in Ornelas (2005a) assumes large countries (and therefore a country's optimal tariff is strictly positive) and the most standard type of market structure – perfect competition. The latter may seem restrictive, but Ornelas (2005b) shows that the key elements of the rent destruction effect of FTAs carry over to an environment with imperfect competition (specifically, an oligopolistic setting with a generic number of firms). This implies that the findings of the current paper, which hinge on the rent destruction effect, do not depend on the assumption of perfect competition.

in polities where political competition is intense, decisions about participation in FTAs are more efficient, no matter how biased to special interests the political parties may be.

This rationale parallels the line of analysis pursued by Liu and Ornelas (2014), who consider the complementary issue of regime transitions between democracy and autocracy. Here I adapt their model to a democratic polity, but similar forces apply in both settings. In particular, just like the possibility of political turnover can turn an FTA politically viable in the current model, the possibility of a coup d'état has an analogous effect in Liu and Ornelas (2014). The analysis is related as well to those of Maggi and Rodríguez-Clare (1998, 2007) and Mitra (2002), who also assess the value of trade agreements as a commitment device against time-inconsistent political problems. However, while those authors focus on circumstances in which governments want to constrain their own future choices, I consider time inconsistency created by the possibility of political turnover.

The reasoning developed here also parallels that demonstrated in the macroeconomic political economy literature. As shown there, political competition can induce governments to act strategically to constrain the policy options available to their successors.[3] Similarly, I show here that an incumbent government can use an FTA to ensure that policies will broadly conform to its own preferences even if it is replaced in office. Yet, as I explain in Section 3, the welfare implications of political competition in the present setting and in the macro political economy literature are quite distinct. Specifically, we show here that FTAs made possible because of the possibility of political turnover are welfare-improving.

Now, the implementation of an FTA may not only reflect the realities of political turnover; it can also determine the likelihood of turnover. Accordingly, in Section 4 I endogenize the incumbent's probability of remaining in office. Conceptually, this is the main departure from the theoretical analysis of Liu and Ornelas (2014). In that context, I demonstrate how an FTA may be used to "steal the election platform" of challengers. In particular, I show that a party with a known strong bias toward special interests can credibly commit to less distortionary policies by entering an FTA. This, in turn, reduces the relative importance of welfare issues on voters' decisions and raises the probability of the incumbent's staying in office. The reason is, again, linked to the rent destruction effect: by reducing the incentives for lobbying, an FTA mitigates the electoral disadvantage of a party known to favor special interests.

This result is important to reveal how the intuition of Ornelas (2005a)—that only governments weakly attached to rents tend to form FTAs—can be reversed when electoral outcomes

[3] See Persson and Svensson (1989) and Alesina and Tabellini (1990) for some of the seminal contributions in that line of research.

are endogenous. Albeit at the cost of fewer rents generated in the subsequent FTA equilibrium, a very rent-seeking incumbent could adopt an FTA to benefit electorally from "tying its own hands." I show that such a "reelection bias" could be strong enough to make a welfare-reducing FTA politically viable, thus more than offsetting the rent-destructing effect. This result is related to those of Aghion and Bolton (1990) and Milesi-Ferretti (1995), who have employed similar reasoning to analyze the strategic use of debt policies and the choice of exchange-rate regimes, respectively. The key difference is that here rent destruction is the cause, and the vehicle for commitment is an FTA.[4]

To the best of my knowledge, besides Liu and Ornelas (2014), McLaren (2004) is the only other theoretical paper that accounts for the possibility of political turnover in the literature of regionalism, but he emphasizes the choice of the type of agreement to be formed (whether a free trade area or a customs union).[5] All other political-economy analyses of the viability of FTAs are in settings without political competition. See, for example, Grossman and Helpman (1995), Levy (1997), Krishna (1998), Cadot et al. (1999), McLaren (2002) and Ornelas (2005a, b). Indeed, as can be inferred from the lack of discussion in the reviews of the literature by Maggi (2014), Grossman (2016) and Limao (2016), we know next to nothing about how dynamic political incentives shape the decision to form FTAs.[6] The surveys by Freund and Ornelas (2010) and by Lake and Krishna (2019) do discuss dynamic incentives to form FTAs, but only from the perspective of long-lasting governments (or "countries") that consider dynamic motives to sign agreements.

Despite the scarcity of theoretical analyses of how political turnover affects the desirability of FTAs, Rotunno (2016) provides persuasive empirical evidence for the mechanism developed in this paper. A key empirical difficulty is that, as the theoretical results stress, the relationship between political competition and formation of FTAs is bidirectional. Rotunno (2016) gets around that difficulty by relying on unexpected events that increase the probability of turnover and on term limits. He confirms that, in line with the version of our model with an exogenous probability of turnover, FTAs are more likely to be signed when the probability of turnover increases. Conconi et al. (2014) obtain a similar result. They find that U.S. legislators are more likely to support trade

[4] This result is also related to some findings in the literature on strategic delegation, as discussed in Section 4. I thank Torsten Persson for pointing out this parallel.

[5] Conconi and Sahuguet (2009) also model policymakers' limited horizon, but to study the enforceability of multilateral trade agreements.

[6] For the *economic* determinants of FTAs, see the seminal contributions of Baier and Bergstrand (2004) and of Egger et al. (2008). Egger and Larch (2008) and Baier and Bergstrand (2014) further study how previous FTAs affect the likelihood of new agreements.

agreements when they are in their last term in office (and therefore the probability of turnover is nearly one).

Finally, there is also an empirical literature that provides indirect empirical support for the rent-destructing effect, which is key for the results of the paper. Essentially, that literature shows that external tariffs tend to fall upon the formation of FTAs, along the lines of Ornelas' (2005a) model.[7] While falling external tariffs are not sufficient for the rent-destructing effect, they are necessary for it to hold.

2. MODEL

The static model mimics the one in Ornelas (2005a), which is extended to a 2-period setting by Liu and Ornelas (2014). The key difference is that in Liu and Ornelas (2014) we consider the possible alternation between democracy and autocracy, whereas here we study political turnover within a democracy.

2.A. The economic structure

I consider a 3-country, N-sector competitive economy where in each sector there is a "natural importer" country that would import the good from the other two countries under free trade. Goods are produced under constant returns to scale. One unit of the numeraire good 0 is produced with one unit of labor. All other goods $j = 1…N-1$ are produced with labor and a sector-specific factor. This implies that, whenever good 0 is produced in equilibrium, the wage rate equals unity and general equilibrium forces are absorbed by that sector.

The analysis is carried out from the perspective of a "Home" country, whose population consists of a continuum of agents with measure L. Each agent is endowed with one unit of labor, and specific factors are owned by a negligible fraction of the population. They have quasi-linear utilities of the form $U = q^0 + \sum_{j=1}^{N-1}\left[Aq^j - (q^j)^2/2\right]$, which generates demand $D^j = A - p^j$ for good j.

Home is the natural importer of goods $m = 1…M$, country Y is the natural importer of a subset E of the remaining goods, and country Z is the natural importer of the other $(N - M - E - 1)$ products. Home's owners of the specific factor used in sector j earn $\pi^j(p^j)$, where p^j denotes the price of good j in Home's market. The domestic supply of each imported good m is $S^m(p^m) = d^m p^m$ and the supply of each exported good x is $S^x(p^x) = d^x p^x$, where $d^x > d^m > 0$. An analogous specification applies

[7] See Estevadeordal et al. (2008), Calvo-Pardo et al. (2010), Crivelli (2014), Ketterer et al. (2014), Fugazza and Robert-Nicoud (2014), and May and Stoyanov (2015).

for the supply and demand conditions in countries Y and Z. Home can use specific import tariffs in each import sector; other policy instruments are assumed unavailable. Let Home's tariff on imports from country j be denoted by t_j, $j = Y, Z$. Because all import sectors are identical, I write prices and tariffs without sector-identifying superscripts.

Prices in the three countries are linked by arbitrage conditions. For a generic product imported by Home, this condition is

(1) $$p = p_Y + t_Y = p_Z + t_Z,$$

provided that tariffs are not prohibitive. Using this arbitrage condition, market-clearing requires

(2) $$D(p) - S^m(p) = S^x(p - t_Y) - D(p - t_Y) + S^x(p - t_Z) - D(p - t_Z).$$

Using the expressions for demand and supplies defined above, condition (2) becomes

(3) $$\hat{p}(t_Z, t_Y) = \gamma + (t_Z + t_Y)\rho,$$

where $\gamma \equiv 3A/(3+d^m+2d^x)$ and $\rho \equiv (1+d^x)/(3+d^m+2d^x)$.

When Home is not in a free trade agreement, it follows GATT's requirement of non-discrimination. In that case, I denote its uniform tariff simply by t. When Home is in an FTA, imports from the FTA partner are duty free. In that case, I represent Home's external tariff on imports from the excluded country by t_F.

2.B. The political structure

I consider that political parties seek power because there are rents for holding office, created by transfers from the private sector whose only purpose is to influence policies. Thus, rents are specific to incumbency.

This perspective differs from the approach that interprets transfers as campaign contributions that can be acquired by incumbents and contenders alike, as assumed for instance by Grossman and Helpman (1996). In that case, transfers are not beneficial *per se*, but because they enhance the electoral prospects of politicians, whose gains from being elected correspond to intangible benefits that are unrelated to the contributions received. By contrast, while recognizing the importance of campaign financing, several authors acknowledge that those in office, in a position to actually enact policies, usually obtain additional benefits from their interaction with lobbies. This is the view taken, for example, by Besley and Coate (2001), who find "office rents" as an equilibrium result. See also the pioneering analysis of Magee et al. (1989) on how lobbying by organized groups shapes trade policy.

Political parties also care about national welfare. As in the literature of strategic debt issuance, I consider that a party's welfare concerns reflect the links with its "constituency," where

the constituency of a political party is represented by the fraction $s \leq 1$ of the population that supports the party unconditionally. The relative weight attached to social welfare in the party's objective function is a strictly increasing function f(s) of this share, satisfying lim f($s \to 0$) = 0 and lim f($s \to 1$) = ∞. Thus, if the government represents the whole population, it will care only about welfare issues; in turn, if the government has no real link with its electorate, it will simply seek rents. As a consequence, a given distortionary policy will be more costly for a party, the larger its constituency, which induces it to internalize a larger part of the distortions created by its policies. This specification therefore presumes that the welfare concerns of a political party, stemming from the party's link with its constituency, are unrelated with incumbency, whereas the rents obtained through interactions with the private sector are specific to incumbents.

Welfare generated in an import sector is denoted by $W^m(t)$, whereas W^x represents welfare generated in an export sector. The former is defined as the sum of consumers' surplus, tariff revenue and producers' surplus in that sector; the latter corresponds to the sum of consumers' and producers' surplus in the sector.[8] Welfare aggregated across all non-numeraire import and export sectors is $W^M(t) \equiv MW^m(t)$ and $W^X \equiv (N - M - 1)W^x$, respectively. National welfare, $W(t)$, aggregates welfare across all sectors:

$$W(t) \equiv L + W^M(t) + W^X = L + \sum_{m=1}^{M} W^m(t) + \sum_{x=M+1}^{N-1} W^x.$$

The preference of a political party in office—the government—is specified as

$$G(t,T) \equiv \sum_{m=1}^{M} G^m(t,T^m) + \sum_{x=M+1}^{N-1} G^x, \tag{4}$$

with $G^x \equiv W^x/b$ and

$$G^m(t,T^m) \equiv \frac{1}{b} W^m(t) + T^m, \tag{5}$$

where T^m denotes the transfer from import-competing sector m to the government and $b \equiv 1/\text{f}(s)$. I refer to b as the "political bias" of a party. Thus, the smaller the constituency of the party in power, the larger its political bias.

Thus, as in Grossman and Helpman (1994), this is a context in which the domestic industry, through lobbying, compensates the government for using a technology to transform a "public good" (welfare) into a "private good" (protection). This transformation distorts the economy and reduces

[8] Note that I denote welfare in import-competing sectors as a function of the tariff, but not in export sectors. In reality, W^x also depends on tariffs, but on those imposed by foreign countries Y and Z. Since those tariffs are given from the perspective of the Home government under any trade regime, I use this more concise representation for notational ease.

general welfare, but benefits the politically active actors—the party in power and the domestic industry.

In line with previous literature, I assume that producers within each industry can overcome free-riding problems and act jointly in their lobbying activities. Because of the symmetry and independence across sectors, I focus on a single import-competing sector. The net payoff of producers in such a sector corresponds to the industry's aggregate profits, $\pi^m(t)$, subtracted of the transfers it gives to the local government, T^m.

As in Maggi and Rodríguez-Clare (1998, 2007), I model the interaction between government and each domestic industry as a bargaining game, with the "bargaining powers" of the government and of the producers given by parameters α and $1 - \alpha$, respectively. If $\alpha \to 0$, all the surplus from the lobbying interaction is kept by the government, while the industry gains nothing beyond what it would already obtain without lobbying. If $\alpha \to 1$, the opposite happens. For interior α, government and industry share the surplus from lobbying. Regardless, assuming that the outcome of the bargaining process is jointly efficient, the "political tariff" resulting from this interaction is independent of α, which determines only the distribution of the lobbying surplus. Instead, the political tariff satisfies

(6) $$t^p = argmax[W^m(t) + b\pi^m(t)],$$

where the function $[W^m(t) + b\pi^m(t)]$ can be interpreted as the joint payoff of the government and the industry in a representative import-competing sector. Thus, in equilibrium, policies will be more distortionary, the greater the government's political bias – or equivalently, the smaller its constituency. To simplify exposition, I restrict the analysis to the case where the solution of problem (6) is interior. This corresponds to assuming that $b < b_{max} \equiv (1+d^m)(d^x - d^m)/(1+d^x)d^m$. Notice that, because of the transferability of utility between government and producers through contributions, the bargaining parameter α does not affect t^p.

2.C. Equilibrium payoffs

In this context, Ornelas (2005a) shows that the government's equilibrium payoff in a representative import sector corresponds to

(7) $$G^m = \frac{1}{b} W^m(b = 0) + \alpha PR^m,$$

where

(8) $$PR^m \equiv \frac{1}{b}[(W^m(b) + b\pi^m(b)) - (W^m(b = 0) + b\pi^m(b = 0))]$$

denotes the "political rents" created in the lobbying process in an import-competing sector. In expressions (7) and (8), functions W^m and π^m are evaluated at the political tariff when they are represented as a function of b; when they are represented as a function of $b = 0$, they are evaluated at the tariff that maximizes national *welfare*. Thus, the expression in the first parenthesis of (8) corresponds to the maximized joint payoff of government and industry, while the expression in the second parenthesis corresponds to the value of the same function in the absence of lobbying. The difference between these two expressions represents the surplus that the lobbying process adds to the combined payoff of government and industry (normalized by $1/b$).

Aggregating across all sectors and using (7), we can write (4) evaluated at the equilibrium as

$$G = \frac{1}{b}W^M(b=0) + \frac{1}{b}W^X + \alpha PR, \tag{9}$$

where $PR \equiv \sum_{m=1}^{M} PR^m$. Hence, the political party holding office obtains in equilibrium its reservation utility, $[W^M(b=0) + W^X]/b$, added by a fraction of the political rents determined by its bargaining power. This implies that, when in power, a political party does not internalize the welfare distortions due to its use of the political tariff.

On the other hand, a party is not compensated by the private sector if it cannot enact policies.[9] Hence, if a party is out of power, it receives none of the current political rents, and in equilibrium its payoff H reflects only the concerns for its constituency:

$$H \equiv G(t^P, 0) = \frac{1}{b}W^M(b_{off}) + \frac{1}{b}W^X, \tag{10}$$

where b_{off} denotes the political bias *of the party in office*.

2.D. Political turnover

I consider a 2-period, 2-party model of political competition. Initially, I take the probability of reelection of the current government as given, indicated by a fixed parameter $\sigma \in [0, 1]$. In Section 4, I allow this probability to be determined endogenously. In either case, if the incumbent party loses power, its rival party takes office. The two competing political parties are labeled A and B. Without loss of generality, let A be the incumbent government in period 1. Party B takes over the government in period 2 with probability $1 - \sigma$.

[9] There would be no qualitative change in the results of the paper if one allowed parties out of power to receive money from the private sector, say to finance political campaigns. What is necessary for the results is that the incumbent party receives some compensation tied to what only it can accomplish, which is to implement policies.

Political parties discount future payoffs; the (common) discount factor is denoted by δ, where $\delta \in [0, 1]$. Hence, if δ is very low, the future matters little for the parties; in the limit where $\delta \to 0$, we are back to the static case. In contrast, with a high δ, intertemporal strategic considerations become more relevant. The present value payoff of incumbent party *A* and of its rival political party *B* are represented, respectively, as

(11) $$\Gamma^A = G^A + \delta[\sigma G^A + (1-\sigma)H^A]$$

and

(12) $$\Gamma^B = H^B + \delta[\sigma H^B + (1-\sigma)G^B],$$

where superscripts identify the political party. Notice that, since the political parameter *b* and the bargaining power α are both idiosyncratic, the values *G* and *H* are also specific to each party.

It should be noted that an FTA can be used to affect future policies only if its reversal is costly enough to inhibit withdrawal from the arrangement by future governments. In the main text I simply assume that FTAs are irreversible. However, I present in the Appendix an extension of the model in which, paralleling McLaren (2002), governments incur in "negotiating costs" when forming (or withdrawing from) an FTA.[10] That extension, which treats irreversibility as an equilibrium result, shows that the rationale developed in this paper requires only the existence of *a* cost to reverse established FTAs, with the strategic issues driven by political turnover becoming more important as the costs to form/renege an FTA increase.[11]

2.E. The decision to form a free trade agreement

The equilibrium under an FTA is entirely analogous to the one described above, the only difference being the constraint imposed on the imports from the FTA partner. Without loss of generality, I let Home's potential FTA partner be country *Y*.

The political party in office determines its decision regarding the formation of a free trade agreement on the anticipated impact of the agreement, implementing it if and only if the FTA increases its present value payoff. Attaching subscript "*F*" to all variables when they are evaluated under the agreement, the equilibrium payoff of political party *A* under the FTA corresponds to

[10] McLaren (2002) argues forcefully that negotiating frictions are significant in actual negotiations of international trade agreements. Nevertheless, all that is required in the extension is the existence of one-time costs to implement and/or undo the FTA. These costs could be interpreted alternatively as arising from the need to specialize towards the FTA partners (as in Maggi and Rodríguez-Clare 1998 and Freund 2000a) or from possible retaliation by the FTA partners (as in Bond, Syropoulos and Winters 2001 and Freund 2000b).

[11] It is worth pointing out that irreversibility is coherent with history, as preferential trading arrangements de facto implemented are seldom turned down later on. The most salient exception to this rule is BREXIT, although it was motivated mainly by features of the European Union that go well beyond the internal free trade of goods.

(13) $$\Gamma_F^A = G_F^A + \delta[\sigma G_F^A + (1-\sigma)H_F^A].$$

Now, for notational ease, let subscript "ΔF" represent the equilibrium change in any variable due to the FTA. Thus, for example, $W_{\Delta F}^X$ denotes the aggregate welfare change in the export sectors with the agreement, whereas $W_{\Delta F}^M(b_A)$ and $W_{\Delta F}^M(b=0)$ denote, respectively, the aggregate welfare impact of the FTA on the import sectors under a party A ruling and under an administration whose only concern is national welfare. The condition under which party A supports the FTA is then

$$\Gamma_{\Delta F}^A = \Gamma_F^A - \Gamma_{\Delta F}^A > 0.$$

Using equations (11) and (13), $\Gamma_{\Delta F}^A$ can be rewritten as

$$\Gamma_{\Delta F}^A = G_{\Delta F}^A + \delta[\sigma G_{\Delta F}^A + (1-\sigma)H_{\Delta F}^A],$$

where the second term within the square brackets indicates that, in the event party A loses power, it values the FTA in period 2 only to the extent that the arrangement affects national welfare. Using (9) and (10) and manipulating, this expression becomes

(14) $$\Gamma_{\Delta F}^A = \frac{1}{b_A}[(1+\delta\sigma)W_{\Delta F}^M(b=0) + \delta(1-\sigma)W_{\Delta F}^M(b_B) + (1+\delta)W_{\Delta F}^X + (1+\delta\sigma)b_A\alpha_A PR_{\Delta F}^A].$$

Thus, the incumbent party A supports the FTA if and only if

(15) $$(1+\delta\sigma)W_{\Delta F}^M(b=0) + \delta(1-\sigma)W_{\Delta F}^M(b_B) + (1+\delta)W_{\Delta F}^X + (1+\delta\sigma)b_A\alpha_A PR_{\Delta F}^A > 0.$$

Naturally, it takes two to tango: to form an FTA the Home government also needs to find a willing partner country Y. Henceforth, I assume that there is such a country. This amounts, essentially, to assuming that there is *a* country such that condition (15) holds for its government when it forms an FTA with Home – if there is not such a country, then the questions I answer in this paper would be mute.[12] One may also wonder about Home's choice of partner country among those satisfying the condition. In fact, the choice of partner does matter for $W_{\Delta F}^M(b_A)$ and $\Gamma_{\Delta F}^A$. It is intuitive to consider that, within the set of FTAs with willing partners, Home's incumbent will focus on either (1) the FTA that yields the highest $\Gamma_{\Delta F}^A$, or (2) all FTAs that yield $\Gamma_{\Delta F}^A > 0$. Regardless, the subsequent analysis, which is qualitative, would remain identical. Hence, I keep the assumption that there is at least *a* willing partner country throughout the rest of the paper.

[12] Observe that, in my setup, a government is unconcerned with what happens in other countries as long as domestic variables are not affected. Thus, the FTA partner matters for the Home government only to the extent that improved market access to its market raises Home exporters' surplus and that domestic tariff preferences affect Home's welfare and political rents, but not to the extent that those variables affect the partner country. In future research, it would be interesting to consider a setting where the Home government may care about other countries' variables *per se*, for example because they may affect national security.

3. RENT DESTRUCTION AND THE POLITICAL VIABILITY OF FTAS

I now describe the effects of an FTA on the level of available political rents and the role of the political parameter b in shaping the welfare effects of an FTA. These results set the basis for the analysis of the political viability of FTAs.

Ornelas (2005a) shows that an FTA moderates the role of political economy forces in the determination of tariffs, and that the mitigation of the politically driven distortions corresponds to a source of welfare gain that is more relevant, the more far-reaching the government's political motivations. Furthermore, an FTA diminishes the rents created in the lobbying process. The reason is that, because the arrangement provides free access to the partner's exporters, the market share of the domestic industry shrinks, at any given external tariff. As a result, the FTA makes any price increase due to a marginal increase in the external tariff less valuable for the import-competing industries, lowering their incentives to lobby for higher external tariffs. In equilibrium, these lower incentives imply less lobbying and fewer rents for the government. The following lemma summarizes these effects.

Lemma 1. The rent destruction effect of FTAs (Ornelas 2005a)

Everything else constant, an FTA

(a) improves Home's welfare by more (or reduces it by less), the higher its government's political bias; and

(b) reduces the rents generated in the political process ($PR_{\Delta F} < 0$), this reduction being larger, the higher the government's political bias.

The results in Lemma 1 allow us to analyze the conditions under which the Home government would choose to form an FTA.[13] It has, in particular, strong implications for the case where the incumbent government faces no political competition.

When there is no political turnover, $\sigma = 1$ and criterion (15) reduces to

$$W^{M}_{\Delta F}(b=0) + W^{X}_{\Delta F} + b_{A}\alpha_{A} PR^{A}_{\Delta F} > 0 . \tag{16}$$

We know that $W^{X}_{\Delta F} > 0$, since the preferential treatment under the FTA improves Home's terms of trade vis-à-vis the two other countries in the E sectors where Home exports to country Y. On the

[13] Naturally, an FTA is formed only if all prospective members endorse it. I conduct the discussion from the perspective of the Home country, but exactly the same type of analysis applies also for country Y.

other hand, $W_{\Delta F}^{M}(b=0) < 0$ [14] and $PR_{\Delta F} < 0$ by Lemma 1. In turn, the condition under which the FTA is welfare-improving when σ = 1 is

(17) $$W_{\Delta F}^{M}(b_A) + W_{\Delta F}^{X} > 0 .$$

The next lemma describes the relationship between these two conditions.

Lemma 2. The static political viability of an FTA (Ornelas 2005a)

A political party that is sure to remain permanently in office does not endorse a welfare-reducing FTA, but may obstruct a welfare-improving FTA.

Lemma 2 shows that, when we abstract from the possibility of political turnover, the set of politically viable FTAs is a proper subset of the welfare-enhancing FTAs. The reason is two-fold. First, the lower political rents available under FTAs reduce the attractiveness of those arrangements for the party in power. Furthermore, since governments are compensated by the distortions introduced by their policies, they do not internalize the welfare benefits of FTAs due to the mitigation of the politically motivated distortions. For these two reasons, political parties that expect to hold power indefinitely sponsor an FTA only if its impact on national welfare is sufficiently large. FTAs that improve welfare, but not enough to compensate the government for the lower rents, are inefficiently blocked.

I now show how the prospects of political turnover alter the political feasibility of an FTA.[15]

Proposition 1. The possibility of political turnover can turn an otherwise politically unfeasible FTA into a viable one. By contrast, the possibility of turnover cannot render unfeasible an otherwise feasible FTA.

Proof: I need to show first that $\Gamma_{\Delta F}^{A}$ decreases with σ. Using (14), we have that

(18) $$\frac{d\Gamma_{\Delta F}^{A}}{d\sigma} = \frac{\delta}{b_A}\left[W_{\Delta F}^{M}(b=0) - W_{\Delta F}^{M}(b_B) + b_A \alpha_A PR_{\Delta F}^{A}\right].$$

[14] When $b = 0$, the government chooses tariffs to maximize welfare in the import sectors. Since the FTA constrains the tariffs on imports from Y to zero, it must reduce welfare in import sectors when $b = 0$.

[15] This result is analogous to Proposition 1 of Liu and Ornelas (2014). In the context of the proposition, when the possibility of political turnover is determined by a fixed probability, it does not make a difference whether the change is through the ballot box or through a coup.

We know from Lemma 1 that $PR_{\Delta F} < 0$ regardless of the identity of the party in power. Lemma 1 tells us also that the welfare impact of an FTA is increasing in the political bias of the party in power, so that $W^M_{\Delta F}(b=0) - W^M_{\Delta F}(b_B) < 0.$ Accordingly, the expression in (18) is unambiguously negative and $\Gamma^A_{\Delta F}$ increases as the probability of turnover rises. As a result, an FTA that is politically unfeasible when there is no chance of political turnover can become viable if the likelihood of turnover is sufficiently large. That is, an FTA that does not satisfy condition (16) can satisfy criterion (15) for sufficiently high σ. On the other hand, the reverse cannot happen: if an FTA is politically viable when there is no chance of political turnover, it remains viable if a possibility of change in government arises. That is, an FTA that satisfies condition (16) also satisfies criterion (15) for any $\sigma < 1$. ■

This result shows that the possibility of political turnover creates "strategic" motivations for the adoption of FTAs, thereby increasing their political feasibility. Strategically supported FTAs arise when condition (15) is satisfied but condition (16) is not:

(19) $$\Gamma^A_{\Delta F}(\sigma = 1) < 0 < \Gamma^A_{\Delta F}(\sigma < 1).$$

FTAs can be implemented because of strategic reasons because the incumbent government, when out of power, does not receive any of the lobbying-related rents. In that instance, it would benefit from a decline in the trade distortions, since the volume of rents falls because FTAs help constrain welfare-distorting political activities. Thus, a government that believes reelection is unlikely may establish an FTA only to constrain the policies of the succeeding ruling party. Since these strategic motivations are more relevant when the incumbent is less likely to hold office, it follows that high political turnover tends to incite the formation of free trade agreements.

It is interesting to contrast the strategic use of a trade agreement here and in Maggi and Rodríguez-Clare (1998, 2007) and Mitra (2002). As in those papers, the government wants to use a trade agreement to foreclose future inefficient outcomes. In Maggi and Rodríguez-Clare's models, these harmful outcomes are due to distortions in investment decisions that take place under a protectionist regime, while in Mitra's model they come from fixed lobby formation costs. Here, the government's motivation comes from the fact that lobbies generate rents only for those actually in charge of enacting policies. Thus, if the FTA has no effect on electoral probabilities, the current government will not want to "tie its own hands," as Maggi and Rodríguez-Clare and Mitra argue. In

contrast, it may want to "tie its successor's hands," provided that there is a sufficiently high probability of political turnover.[16]

The political biases of the incumbent party and that of its rival, as well as the incumbent's bargaining power vis-à-vis the private sector and the common discount factor, affect the possibility of strategically supported FTAs. In particular, higher political biases, a higher α_A, and a higher δ enlarge the scope for such arrangements.

Proposition 2. The set of parameters under which the possibility of political turnover can turn an FTA politically viable increases with b_B, b_A, α_A, and δ.

Proof: To prove these results, it suffices to show that the cross-derivative of the function $b_A\Gamma^A_{\Delta F}$, which gives the criterion for the political viability of FTAs, with respect to the probability of reelection, σ, and each of the parameters b_B, b_A and α_A, is negative. This would imply that an increase in (1 - σ) would have a greater impact on the viability of the FTA when b_B, b_A, α_A, and δ are higher. The $b_A\Gamma^A_{\Delta F}$, function is represented in the left-hand side of (15). We have that

$$\frac{d^2(b_A\Gamma^A_{\Delta F})}{d\sigma db_B} = -\delta\frac{dW^M_{\Delta F}(b_B)}{db_B} < 0,$$

$$\frac{d^2(b_A\Gamma^A_{\Delta F})}{d\sigma d\delta} = W^M_{\Delta F}(b=0) - W^M_{\Delta F}(b_B) + b_A\alpha_A PR^A_{\Delta F} < 0,$$

$$\frac{d^2(b_A\Gamma^A_{\Delta F})}{d\sigma db_A} = \delta\alpha_A\left(PR^A_{\Delta F} + b_A\frac{aPR^A_{\Delta F}}{db_A}\right) < 0, \text{ and}$$

$$\frac{d^2(b_A\Gamma^A_{\Delta F})}{d\sigma d\alpha_A} = \delta b_A PR^A_{\Delta F} < 0,$$

where all inequalities follow from Lemma 1. Thus, if any of these parameters rises, an increase in the probability of turnover (i.e., a reduction in σ) enlarges the set of parameters under which criterion (15) is satisfied. ■

The intuition behind Proposition 2 is as follows. The more biased toward special interests party *B* is, the larger the distortions it would create if it held power. In that case, the role of FTAs in moderating distortions and enhancing welfare is magnified (Lemma 1), so a larger b_B makes the incumbent more inclined to use an FTA to limit the rent-seeking activities of its potential successor

[16] I show in the next section, however, that if an FTA can alter the reelection probability, the incumbent government may want to form an agreement to "tie its own hands" as well.

as the probability of turnover increases (σ falls). Similarly, as δ rises and future payoffs become more valuable, curbing distortionary policies of one's successor becomes more important as σ decreases. Now, if the incumbent government is itself very receptive to the politically generated rents, or if it has a strong bargaining power vis-à-vis the private sector in the division of rents, the incumbent will in general be unwilling to forgo the possibility to obtain rents. This effect is diminished, however, when the incumbent's probability of keeping power falls, since in that case the loss of rents will be borne mainly by the future government.

An important implication of the strategically supported FTAs identified in Proposition 1 is that, as those endorsed for non-strategic reasons (when σ = 1), they too enhance (expected) national welfare. Hence, if FTAs do not alter the probability of reelection, political competition unambiguously enhances efficiency in the decision to adopt FTAs.

Proposition 3. For given σ, all FTAs that are made viable by the possibility of political turnover enhance expected national welfare.

Proof**:** The expected present value of the welfare impact of an FTA is

$$\Omega_{\Delta F} = (1+\delta\sigma)W^{M}_{\Delta F}(b_A) + \delta(1-\sigma)W^{M}_{\Delta F}(b_B) + (1+\delta)W^{X}_{\Delta F}.$$

This expression differs from the left-hand side of (15) in two ways: it does not have the term containing $PR^{A}_{\Delta F}$ in (15), and it replaces $W^{M}_{\Delta F}(b=0)$ with $W^{M}_{\Delta F}(b_A)$. Now, since Lemma 1 tells us that $PR^{A}_{\Delta F} < 0$ and that $W^{M}_{\Delta F}(b=0) < W^{M}_{\Delta F}(b_A)$, it follows that condition (15) $\Rightarrow \Omega_{\Delta F} > 0$. Therefore, for given σ, a strategically adopted FTA necessarily enhances expected national welfare. ■

Thus, some of the socially desirable FTAs that would not be politically viable because of the rent destruction effect can become politically feasible if the incumbent perceives a large enough chance of losing power. The intuition for this result is clear. A welfare-improving FTA can be politically infeasible because of the rents it takes away from policymakers. But if the incumbent believes reelection is unlikely, the loss of rents would be incurred mainly by its successor. This would make the gains from less distortion relatively more important in the incumbent's assessment, and could compel it to implement the agreement. On the other hand, welfare-reducing FTAs that are not feasible with σ = 1 remain infeasible also when reelection is not guaranteed. The upshot is that polities characterized by strong political competition make their decisions about participation in FTAs more efficiently. This result is consistent with the empirical findings of Anderson and Yotov

(2016), who estimate large efficiency gains for most countries forming FTAs during the 1990s, and only small losses for the few countries that lose with FTAs. Baier et al. (2008) deliver a similar message.

As indicated in the Introduction, the idea that governments can manipulate state variables to constrain their successors' choices was first advanced in the macroeconomics political economy literature. Prominent examples in that line of research are the pioneering contributions of Alesina and Tabellini (1990) and Persson and Svensson (1989), who employ such a rationale to study the politics of debt issuance. A similar reasoning is employed here to show that a government faced with the prospect of being replaced might want to limit the ability of its successor to create rents through interactions with the domestic industry. I show that an FTA can be an effective tool for that purpose.

There are also important differences between the approaches pursued here and in the macro political economy literature. For instance, whereas heterogeneous preferences for the competing political groups/parties are typically central for the results in that line of research,[17] I require no heterogeneity in the preferences of distinct political groups.[18] Instead, the strategic motive for the establishment of an FTA relies on the capacity of an incumbent party to use an FTA to constrain the ability of future governments to pursue distortionary rent-creating policies.

There is also a fundamental distinction regarding the welfare consequences of "binding the successor's hands" here and in the macro literature. A key insight from the latter is that political competition introduces "strategic inefficiencies" in the policymaking process, because it prevents governments from fully internalizing the welfare impact of their policies.[19] By contrast, I show that political competition compels governments to internalize a *larger* part of the welfare consequences of a trade agreement. Thus, here political competition creates instead "strategic efficiencies," being helpful from a social standpoint.

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

[18] I do allow the two political parties to have distinct preferences, characterizing them with possibly distinct parameters b and α. But while this provides additional flexibility to the model, it is not required for the results.

[19] In Alesina and Tabellini (1990), e.g., the incumbent government tends to accumulate debt beyond the socially optimal level in order to raise the cost of the funds necessary to finance the successor's preferred public spending policy.

4. FTAs WITH ENDOGENOUS PROBABILITY OF REELECTION

The formation of an FTA can influence also the likelihood of turnover. To show how this can happen and its consequences, I now add a probabilistic voting mechanism to the previous setting.

To highlight the distinct forces that arise with endogenous electoral outcomes, I focus on situations where the incumbent party has a smaller constituency than its rival (the analysis would nevertheless proceed analogously if one reversed this assumption). Thus, let the incumbent party A have a constituency made up of a fraction $s_A < ½$ of the electorate, while its rival party B is supported by a fraction $s_B \in (s_A, ½)$ of the electorate. Following Milesi-Ferretti and Spolaore (1994), I assume there is also a fraction $(1 - s_A - s_B) > 0$ of voters who are "unattached" to political parties and need to be persuaded before each election.

All voters are rational, forward-looking, and aware of the economic positions of the two parties. Since b_j is an inverse function of s_j, the party with broader representation (B) selects a policy more in conformity with the interests of the population at large than the more narrowly represented party (A). Neither party can commit to any platform that is inconsistent with its type. The loyal voters have objectives identical to the parties they support. The unattached voters, by contrast, base their choices on two dimensions: (1) "welfare prospects," which depend on the (fully anticipated) welfare impact of the economic policies to be enacted by each party; and (2) "non-economic issues," representing exogenous or non-economic aspects of public policy that are relevant to those voters. I allow the preferences of the unattached voters to differ with respect to the latter, so they vote heterogeneously.

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

$$\mu_i + \eta > [W^M(b_B) + W^X] - [W^M(b_A) + W^X], \tag{20}$$

where η denotes the relative popularity of party A in terms of the non-economic issues and μ_i is an idiosyncratic parameter representing the bias of elector i toward party A. The two parties observe neither η nor μ_i, but know their distributions. I denote the distribution of η by $F(\eta)$, assuming only that it is non-constant in the neighborhood of the initial equilibrium. For concreteness, I assume that the subject-specific parameter μ_i is uniformly distributed in the range $[\frac{-1}{2\phi}, \frac{1}{2\phi}]$, with $\phi > 0$.

Provided that not all unattached electors vote for the same party, there will be a "swing voter," i^*, whose parameter μ_{i^*} is such that

$$\mu_{i^*} = W^M(b_B) - W^M(b_A) - \eta. \tag{21}$$

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

(22) $$\int_{\mu_{i^*}}^{1/2\phi} \phi dv = \phi\left[\frac{1}{2\phi} - \mu_{i^*}\right] = \tfrac{1}{2} - \phi[\Delta - \eta],$$

where $\Delta \equiv [W^M(b_B) - W^M(b_A)]$. The total fraction of voters supporting party *A* corresponds then to

(23) $$\nu^A = s_A + (1 - s_A - s_B)[\tfrac{1}{2} - \phi(\Delta - \eta)].$$

Party *B*, in turn, captures a share of voters equal to $\nu^B = 1 - \nu^A$. Party *A*'s probability of reelection is thus given by $\sigma = \text{prob}\{\nu^A > \tfrac{1}{2}\}$. After some rearranging, this probability can be rewritten as:

(24) $$\sigma = prob\left\{\eta > \Delta + \frac{(s_B - s_A)}{2\phi(1 - s_A - s_B)}\right\} = 1 - F\left(\Delta + \frac{(s_B - s_A)}{2\phi(1 - s_A - s_B)}\right).$$

Expression (24) clarifies the factors that would improve party *A*'s reelection prospects: a smaller difference between the constituencies of the two parties, ($s_B - s_A$); a larger fraction and/or more dense distribution of unattached voters, $\phi(1 - s_B - s_A)$; and a greater advantage in the non-economic issues, η.[20] However, in this probabilistic voting model with rational and informed voters, these are all fixed parameters from the perspective of the political parties. Accordingly, the incumbent party cannot alter its reelection prospects unless it credibly commits to implement distinct policies. I now show that an FTA can play the role of such a credible commitment device.

An FTA alters σ through its effect on Δ. By reducing the incentives of any government to distort the economy, the arrangement reduces party *A*'s disadvantage in that respect. This shifts the election's probabilistic outcome toward party *A*. Proposition 4 proves this claim.

Proposition 4. By engaging the country in an FTA, party *A* lowers Δ, thereby enhancing its own electoral chances.

Proof: It follows directly from (24) that a reduction in Δ improves σ. Hence, it remains to be shown only that an FTA decreases Δ. This happens if and only if

$$[W_F^M(b_B) + W_F^X] - [W_F^M(b_A) + W_F^X] < [W^M(b_B) + W^X] - [W^M(b_A) + W^X],$$

which is equivalent to $W_{\Delta F}^M(b_B) < W_{\Delta F}^M(b_A)$. Since $b_B < b_A$ by construction, this inequality follows from Lemma 1. ■

Proposition 4 illustrates a commitment role played by an FTA that is distinct from the one analyzed in the previous section. Rather than "tying its successor's hands," the incumbent

[20] Note that, since party *B* has a larger constituency by assumption, the argument of *F*(.) in equation (24) is always positive.

government may now form an FTA to "tie its *own* hands," since that would improve its likelihood of electoral success. The argument relies essentially on the voters viewing the incumbent party as relatively weak in one of the electorally relevant dimensions. If the incumbent is able to credibly reduce its disadvantage on that issue, it improves its own electoral prospects. The proposition shows that an FTA can be an effective instrument for such a commitment.

Now, despite the electoral benefits, the incumbent party *A* may still not find it worthwhile to implement the FTA. This can happen if party *A* were sufficiently opposed to the arrangement in the absence of strategic motivations. In such a case, it would need to weight the gain from an increased prospect of reelection against the loss from having the FTA in place. The condition under which party *A* supports the arrangement in this case is

$$G_F^A + \delta[\sigma_F G_F^A + (1-\sigma_F)H_F^A] > G^A + \delta[\sigma G^A + (1-\sigma)H^A], \tag{25}$$

where σ_F denotes party *A*'s probability of reelection with the FTA in place. The left-hand (right-hand) side of (25) represents the incumbent's expected utility with (without) the FTA.

Denote the increase in the reelection probability due to the FTA by $\sigma_{\Delta F} \equiv \sigma_F - \sigma > 0$. Then, subtracting $\delta[\sigma G_F^A + (1-\sigma)H_F^A]$ from both sides of (25) and re-organizing, the condition can be rewritten as

$$\begin{aligned} G_{\Delta F}^A + \delta[\sigma G_{\Delta F}^A + (1-\sigma_F)H_{\Delta F}^A] &> \delta\sigma_{\Delta F}(H_F^A - G_F^A) \\ &= \frac{\delta\sigma_{\Delta F}}{b_A}[W_F^M(b_B) - W_F^M(b=0) - b_A\alpha_A PR_F^A], \end{aligned} \tag{26}$$

where the equality follows from definitions (9) and (10) under an FTA. The left-hand side of (26) represents the impact the FTA would have on party *A*'s expected payoff if the arrangement did not affect σ, as assumed in the previous section. But party *A*'s incentives to adopt the FTA are now enhanced by the arrangement's effect on its probability of reelection. Accordingly, even if the FTA reduces party *A*'s expected payoff under a fixed σ, party *A* may still benefit with the agreement if its chance of keeping office increases enough. This can be seen by noting that the right-hand side of (26) is unambiguously negative, since $W_F^M(b_B) < W_F^M(b=0)$ and $PR_F^A > 0$.

The possibility to use FTAs to improve reelection prospects can, however, generate an "excess of incentives" for integration. That is, in contrast with the results from the previous section, welfare-reducing arrangements can now become politically feasible. The next proposition demonstrates this possibility.

Proposition 5. When FTAs improve the government's probability of reelection, the government can endorse arrangements that would reduce expected national welfare.

Proof: Using definition (10), the condition under which the government supports the FTA, given in (25), can be rewritten as

$$b_A G^A_{\Delta F} + b_A \delta[\sigma_F G^A_F - \sigma G^A] > \delta[(1-\sigma)(W^M(b_B) + W^X) - (1-\sigma_F)(W^M_F(b_B) + W^X_F)], \tag{27}$$

whereas the condition under which the FTA improves welfare (in expected terms) is equivalent to

$$\begin{aligned} W^M_{\Delta F}(b_A) + W^X_{\Delta F} + \delta[\sigma_F(W^M_F(b_A) + W^X_F) - \sigma(W^M(b_A) + W^X)] \\ > \delta[(1-\sigma)(W^M(b_B) + W^X) - (1-\sigma_F)(W^M_F(b_B) + W^X_F)]. \end{aligned} \tag{28}$$

Note that the right-hand sides of expressions (27) and (28) are identical. Suppose then that, as before, the FTA enhances welfare whenever the incumbent government supports it. If so, the left-hand side of (28) would need to be unambiguously greater than the left-hand side of (27):

$$W^M_{\Delta F}(b_A) + W^X_{\Delta F} + \delta[\sigma_F(W^M_F(b_A) + W^X_F) - \sigma(W^M(b_A) + W^X)] > b_A G^A_{\Delta F} + b_A \delta[\sigma_F G^A_F - \sigma G^A].$$

Using definition (9), this inequality can be rearranged as

$$\begin{aligned} W^M_{\Delta F}(b_A) - [W^M_{\Delta F}(b=0) + \alpha_A b_A PR^A_{\Delta F}] \\ > \delta[\sigma_F(W^M_F(b=0) + \alpha_A b_A PR^A_F) - \sigma_F W^M_F(b_A) + \sigma W^M(b_A) - \sigma((W^M(b=0) + \alpha_A b_A PR^A)]. \end{aligned}$$

Now, adding $\sigma[W^M_F(b=0) - W^M_F(b_A) + \alpha_A b_A PR^A_F]$ to both sides of this inequality and manipulating, it can be rewritten as

$$(1+\delta\sigma)[W^M_{\Delta F}(b_A) - W^M_{\Delta F}(b=0) - \alpha_A b_A PR^A_{\Delta F}] > \delta\sigma_{\Delta F}[W^M_F(b=0) - W^M_F(b_A) + \alpha_A b_A PR^A_F].$$

Lemma 1 ensures that the left-hand side of this expression is positive, but the right-hand side is also positive. Thus, if $\sigma_{\Delta F}$ is sufficiently large, this inequality will not hold, contradicting the assumption that the arrangement enhances welfare whenever the government supports it. ■

The intuition behind Proposition 5 is as follows. Governments value incumbency because of its associated "office rents." We know from Lemma 1 that an FTA reduces such rents. Therefore, this rent destruction effect diminishes governments' willingness to enter in FTAs, generating a bias against the formation of these agreements, relative to the socially optimum. Now, if an FTA enhances the probability by which a party will acquire those rents in the future, it creates a bias in the opposite direction, making that party excessively eager to adopt the arrangement, vis-à-vis the socially optimal decision. The net effect will depend on the relative magnitudes, with the "reelection bias" prevailing if the increase in the probability of reelection ($\sigma_{\Delta F}$) is high enough.[21] In that case,

[21] It is worth noting that an "excess of incentives" to institute FTAs relies on the incumbent being more rent-seeker than its contender. This case highlights the role of endogenous electoral outcomes in (possibly) turning welfare-reducing FTAs into politically viable ones. Yet it should be clear that if the assumption regarding the sizes of

agreements that lower both national welfare and rents can be politically viable, because they make it more likely that the incumbent will acquire (some) rents in the future.

As pointed out in the outset, this rationale relates to the line of research that focuses on the manipulation of state variables for electoral purposes, as well as to the literature on "strategic delegation." The latter emphasizes that agents can delegate responsibilities to another party to circumvent time inconsistent policy problems. This reasoning has been applied for example to monetary policies (Rogoff 1985) and to the capital levy problem (Persson and Tabellini 1994).[22] Interestingly, the welfare implications of "tying your own hands" here and in that line of research are entirely distinct. While the strategic delegation literature shows that a government's commitment to tie its own hands can solve inefficiency problems, I show that it can turn an otherwise politically infeasible welfare-reducing FTA into a politically feasible one.

5. CONCLUDING REMARKS

This paper shows how the "economics of politics," and in particular the possibility of political turnover, shapes the political viability of free trade agreements. Political turnover is a central characteristic of democratic systems. Nevertheless, little is known about its relationship with the viability of free trade agreements. Relying on the "rent destruction" effect of FTAs identified in Ornelas (2005a) and carrying through its logical implications in an environment marked by political uncertainty, I show how political competition, by altering the implications of the rent destruction effect, can help to explain the timing and the consequences of free trade agreements. I find, in particular, that political instability creates strategic incentives for the adoption of FTAs. Overall, the analysis indicates that one must account for such an uncertainty to fully understand the political determinants of FTAs, as well as its welfare consequences.

The results of the paper are presented primarily as a contribution to the theory of preferential trade agreements, but they are also closely related to the broader literature that studies the consequences of political uncertainty. Previous authors have evaluated the impact of political instability on, e.g., the management of debt, the timing of tax reforms and the viability of stabilization programs. The present analysis indicates that, in contrast with the typical findings in

---

the two parties' relative constituencies were reversed, the bias toward too little incentives to form FTAs introduced by the rent destruction effect would be reinforced, and again only welfare-improving FTAs would become politically viable.

[22] In the context of the regionalism literature, Facchini et al. (2013) consider how strategic delegation in customs unions affects the desirability of FTAs vis-à-vis customs unions. Their key point is that, under the latter, the need to coordinate external tariffs induce voters to delegate power to more protectionist representatives.

the macroeconomic applications, the effects of political uncertainty on the viability of FTAs can be benign, as the possibility of turnover can induce the formation of otherwise unfeasible welfare-enhancing FTAs. Yet the goal of this paper is not to provide an exhaustive examination of the relationship between political uncertainty and the viability of free trade agreements, but rather to offer the initial step toward such understanding. The need of further theoretical research to investigate these links in more detail is warranted.

On the empirical side, recent research by Rotunno (2016) has shown that higher political turnover induces more participation in FTAs, as the model predicts. Assessment of whether participation in FTAs affects political turnover, as the model also predicts, is still in need of empirical scrutiny.[23]

[23] The exception is Liu and Ornelas (2014), who find that FTAs make democracy last longer. However, there is no such evidence for political turnover within democracies.

Appendix – FTAs with Political Turnover and Endogenous Irreversibility

In this Appendix, I extend the analysis of Section 3 to show that the irreversibility of an FTA can be viewed as an equilibrium outcome. The extension is simple and maintains all the results of that section unaltered. An analogous development could be carried out for the results of Section 4 as well.

McLaren (2002) argues forcefully that negotiating frictions constitute an important element defining the political feasibility of trade agreements. Accordingly, I assume that any government has to incur in "negotiating costs" to either establish/join an FTA or to withdraw a country from a previously established FTA. Letting λ (λ^u) denote the negotiating costs that a government would have to incur to have its country participating in (withdrawing from) an FTA, where both λ and λ^u are positive constants measured in terms of the numeraire good, the first condition required for "strategically adopted" FTAs becomes

(A1) $$\Gamma^A_{\Delta F}(\sigma = 1) - \lambda < 0 < \Gamma^A_{\Delta F}(\sigma < 1) - \lambda$$

$$\Leftrightarrow \Gamma^A_{\Delta F}(\sigma = 1) < \lambda < \Gamma^A_{\Delta F}(\sigma < 1).$$

This condition simply generalizes condition (19) for cases when $\lambda > 0$.

But the successful establishment of an FTA requires also that party *B* does not undo the FTA, if it gets in office. This non-reversibility condition corresponds to

(A2) $$G^B_F > G^B_{\square} - \lambda^u \Leftrightarrow G^B_{\Delta F} > -\lambda^u.$$

Under (A1), if condition (A2) does not hold, party *A* would suffer a payoff loss with the agreement in period 1 while not having the FTA in place when it wants, in period 2. In addition, party *A* would also have wasted resources worth λ of the numeraire good when creating the FTA. Clearly, in this case party *A* would not establish the agreement. The complete irreversibility assumed in the main text corresponds to the limiting case in which $\lambda^u \to \infty$. When λ^u is strictly positive but finite, the incumbent government engages the country in an FTA for strictly strategic reasons if and only if conditions (A1) and (A2) hold. That is, requirement (19) is replaced by the more restrictive (A1) and by the additional requirement (A2).

Note also that, while both λ and λ^u can be significant, non-reversibility could arise in equilibrium even if either $\lambda = 0$ or $\lambda^u = 0$. Moreover, and more importantly, while this extension makes the simple point that negotiating costs reduce the general attractiveness of FTAs, it also indicates that the rationale behind an arrangement established for strategic reasons remains virtually unaltered by such costs. In particular, none of the forces behind the results in the paper are qualitatively altered.

REFERENCES

Aghion, P. and P. Bolton (1990). "Government Domestic Debt and the Risk of Default: a Political-Economic Model of the Strategic Role of Debt." In R. Dornbusch and M. Draghi (eds.), *Public Debt Management: Theory and History*. Cambridge: Cambridge University Press.

Alesina, A. and G. Tabellini (1990). "A Positive Theory of Fiscal Deficits and Government Debt." *Review of Economic Studies* 57(3), 403-14.

Anderson, J. and Y. Yotov (2016). "Terms of trade and global efficiency effects of free trade agreements, 1990–2002." *Journal of International Economics* 99, 279-298.

Baier, S. and J. Bergstrand (2004). "Economic determinants of free trade agreements." *Journal of International Economics* 64 (1), 29–63.

Baier, S. and J. Bergstrand (2014). "Economic Determinants of Free Trade Agreements Revisited: Distinguishing Sources of Interdependence." *Review of International Economics* 22 (1), 31-58.

Baier, S., J. Bergstrand, P. Egger, and P. McLaughlin (2008). "Do Economic Integration Agreements Actually Work? Issues in Understanding the Causes and Consequences of the Growth of Regionalism." *The World Economy* 31(4), 461-497.

Besley, T. and S. Coate (2001). "Lobbying and welfare in a representative democracy," *Review of Economic Studies* 68(1), 67-82.

Bond, E., C. Syropoulos and L. A. Winters (2001). "Deepening of Regional Integration and Multilateral Trade Agreements." *Journal of International Economics* 53, 335-361.

Cadot, O., J. de Melo and M. Olarreaga (1999). "Regional Integration and Lobbying for Tariffs Against Non-Members." *International Economic Review* 40, 635-57.

Calvo-Pardo, H., C. Freund, C. and E. Ornelas (2011). "The ASEAN free trade agreement: impact of intra-bloc liberalization on external trade flows and external trade barriers." In: Barro, R., Lee, J. (Eds.), *Costs and Benefits of Regional Economic Integration in Asia*. Oxford University Press, New York.

Conconi, P., G. Facchini and M. Zanardi (2014). "Policymakers' horizon and trade reforms: The protectionist effect of elections." *Journal of International Economics* 94 (1), 102-118.

Conconi, P. and N. Sahuguet (2009). "Policymakers' horizon and the sustainability of international cooperation." *Journal of Public Economics* 93 (3-4), 549-558.

Crivelli, P. (2016). "Regionalism and falling external protection in high and low tariff members." *Journal of International Economics* 102, 70–84.

Egger, H., P. Egger and D. Greenaway (2008). "The trade structure effects of endogenous regional trade agreements." *Journal of International Economics* 74(2), 278-298.

Egger, P. and M. Larch (2008). "Interdependent preferential trade agreement memberships: An empirical analysis." *Journal of International Economics* 76(2), 384-399.

Estevadeordal, A., C. Freund and E. Ornelas (2008). "Does regionalism affect trade liberalization toward nonmembers?" *Quarterly Journal of Economics* 123, 1531–1575.

Facchini, G., P. Silva and G. Willmann (2013). "The customs union issue: Why do we observe so few of them?" *Journal of International Economics* 90, 136-147.

Fernández, R. and J. Portes (1998). "Returns to Regionalism: An Analysis of Nontraditional Gains from Regional Trade Agreements." *The World Bank Economic Review*, 12(2), 197-220.

Freund, C. (2000a). "Different Paths to Free Trade: The Gains from Regionalism." *Quarterly Journal of Economics* 115(4), 1317-41.

Freund, C. (2000b). "Multilateralism and the Endogenous Formation of Preferential Trade Agreements." *Journal of International Economics* 52(2), 359-76.

Freund, C. and E. Ornelas (2010). "Regional trade agreements." *Annual Review of Economics* 2, 139–166.

Fugazza, M. and F. Robert-Nicoud (2014). "The "emulator effect" of the Uruguay round on US regionalism." *Review of International Economics* 22 (5), 1049–1078.

Grossman, G. (2016). "The Purpose of Trade Agreements." In K. Bagwell & R. Staiger (eds.), *Handbook of Commercial Policy*, Elsevier/North Holland, chapter 7.

Grossman, G. and E. Helpman (1994). "Protection for Sale." *American Economic Review* 84(4), 833-50.

Grossman, G. and E. Helpman (1995). "The Politics of Free-Trade Agreements." *American Economic Review* 85, 667-90.

Grossman, G. and E. Helpman (1996). "Electoral Competition and Special Interest Politics." *Review of Economic Studies* 63(2), 265-86.

Ketterer, T., D. Bernhofen and C. Milner (2014). "Preferences, rent destruction and multilateral liberalization: the building block effect of CUSFTA." *Journal of International Economics* 92, 63–77.

Krishna, P. (1998). "Regionalism and Multilateralism: A Political Economy Approach." *Quarterly Journal of Economics* 113, 227-52.

Lake, J. and P. Krishna (2019). "Preferential trade agreements: Recent theoretical and empirical developments." *Oxford Research Encyclopedia of Economics and Finance*.

Levy, P. (1997). "A Political-Economic Analysis of Free-Trade Agreements." *American Economic Review* 87(4), 506-19.

Limao, N. (2016). "Preferential trade agreements." In K. Bagwell & R. Staiger (eds.), *Handbook of Commercial Policy*, Elsevier/North Holland, chapter 6.

Liu, P. and E. Ornelas (2014). "Free Trade Agreements and the Consolidation of Democracy." *American Economic Journal: Macroeconomics* 6(2), 29-70.

Magee, S. W. Brock and L. Young (1989). "Black Hole Tariffs and Endogenous Policy Theory." Cambridge University Press.

Maggi, G. and A. Rodríguez-Clare (1998). "The Value of Trade Agreements in the Presence of Political Pressures." *Journal of Political Economy* 106(3), 574-601.

Maggi, G. and A. Rodríguez-Clare (2007). "A Political Economy Theory of Trade Agreements." *American Economic Review* 97, 1374–1406.

Maggi, G. (2014). "International Trade Agreements." In E. Helpman, K. Rogoff and G. Gopinath (eds.), *Handbook of International Economics* v.4, Elsevier: North Holland, chapter 6.

Mai, J. and A. Stoyanov (2015). "The effect of the Canada-US free trade agreement on Canadian multilateral trade liberalization." *Canadian Journal of Economics* 48 (3), 1067–1098.

McLaren, J. (2002). "A Theory of Insidious Regionalism." *Quarterly Journal of Economics* 117, 571-608.

McLaren, J. (2004). "Free Trade Agreements, Customs Unions, and the Dynamics of Political Influence." Mimeo.

Milesi-Ferretti, G. (1995). "The Disadvantage of Tying Their Hands: On the Political Economy of Policy Commitments." *Economic Journal* 105(433), 1381-1402.

Milesi-Ferretti, G. and E. Spolaore (1994). "How Cynical Can an Incumbent Be? Strategic Policy in a Model of Government Spending." *Journal of Public Economics* 55(1), 121-40.

Mitra, D. (2002). "Endogenous Political Organization and the Value of Trade Agreements." *Journal of International Economics* 57(2), 473-85.

Ornelas, E. (2005a). "Rent Destruction and the Political Viability of Free Trade Agreements." *Quarterly Journal of Economics* 120(4), 1475-506.

Ornelas, E. (2005b). "Endogenous Free Trade Agreements and the Multilateral Trading System." *Journal of International Economics* 67(2), 471-97.

Persson, T. and L. Svensson (1989). "Why a Stubborn Conservative Would Run a Deficit: Policy with Time-Inconsistent Preferences." *Quarterly Journal of Economics* 104(2), 325-45.

Persson, T. and G. Tabellini (1994). "Representative Democracy and Capital Taxation." *Journal of Public Economics* 55(1), 53-70.

Rogoff, K. (1985). "The Optimal Degree of Commitment to an Intermediate Monetary Target." *Quarterly Journal of Economics* 100(4), 1169-89.

Rotunno, L. (2016). "Political stability and trade agreements: Evidence for 'endgame FTAs'." *European Journal of Political Economy* 45 133–148.

Whalley, J. (1998). "Why do Countries Seek Regional Trade Agreements?" In J. Frenkel (ed.), *The Regionalization of the World Economy*, Chicago: The University of Chicago Press.

CENTRE FOR ECONOMIC PERFORMANCE
Recent Discussion Papers

2042	Max Nathan Henry G. Overman Capucine Riom Maria Sanchez-Vidal	Multipliers from a major public sector relocation: The BBC moves to Salford
2041	Paolo Conconi Florin Cucu Federico Gallina Mattia Nardotto	A political disconnect? Evidence from voting on EU trade agreements
2040	Mirko Draca Max Nathan Viet Nguyen-Tien Juliana Oliveira-Cunha Anna Rosso Anna Valero	The new wave? The role of human capital and STEM skills in technology adoption in the UK
2039	Nikhil Datta	Why do flexible work arrangements exist?
2038	Jennifer Hunt Iain Cockburn intelligence	Is distance from innovation a barrier to the adoption of artificial intelligence
2037	Giuseppe Berlingieri Filippo Boeri Danial Lashkari Jonathan Vogel	Capital-skill complementarity in firms and in the aggregate economy
2036	Alessandra Fenizia Tom Kirchmaier	Not incentivized yet efficient: Working from home in the public sector
2035	Elodie Andrieu John Morrow	Can firm subsidies spread growth?
2034	Miquel-Àngel Garcia López Luz Yadira Gómez-Hernández Rosa Sanchis-Guarner	Highway traffic in Britain: The effect of road capacity changes

2033	Stephan Heblich Stephen J. Redding Yanos Zylberberg	The distributional consequences of trade: Evidence from the Grain Invasion
2032	Brian Bell Philip Johnson	Immigrant downgrading: New evidence from UK panel data
2031	Ying Chen Paul Cheshire Xiangqing Wang You-Sin Wang	Valuing consumption services as technology transforms accessibility: Evidence from Beijing
2030	Johannes Boehm Thomas Chaney	Trade and the end of antiquity
2029	Jay Euijung Lee Martina Zanella	Learning about women's competence: The dynamic response of political parties to gender quotes in South Korea
2028	Christos Genakos Blair Yuan Lyu Mario Pagliero	Asymmetric pass-through and competition
2027	Fabrice Defever Alejandro Riaño Gonzalo Varela	Evaluating the impact of export finance support on firm-level export performance: Evidence from Pakistan
2026	Andrés Barrios-Fernández Christopher Neilson Seth Zimmerman	Elite universities and the intergenerational transmission of human and social capital
2025	Agnes Norris Keiller	Brexit and investment
2024	Lídia Farré Libertad González Claudia Hupkau Jenifer Ruiz-Valenzuela	Paternity leave and child development