UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNCTAD

COOPERATION IN THE TARIFF WATERS OF THE WORLD TRADE ORGANIZATION

POLICY ISSUES IN INTERNATIONAL TRADE AND COMMODITIES
STUDY SERIES No. 62

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

POLICY ISSUES IN INTERNATIONAL TRADE AND COMMODITIES
STUDY SERIES No. 62

COOPERATION IN THE TARIFF WATERS OF THE WORLD TRADE ORGANIZATION

by

Alessandro Nicita
UNCTAD, Geneva

Marcelo Olarreaga
University of Geneva and Centre for Economic Policy Research

Peri Silva
Kansas State University and Centro Studi Luca d'Agliano

UNITED NATIONS
New York and Geneva, 2014

Note

The purpose of this series of studies is to analyse policy issues and to stimulate discussions in the area of international trade and development. The series includes studies by UNCTAD staff and by distinguished researchers from other organizations and academia. This paper represents the personal views of the authors only, and not the views of the UNCTAD secretariat or its member States.

This publication has not been formally edited.

The designations employed and the presentation of the material do not imply the expression of any opinion on the part of the United Nations concerning the legal status of any country, territory, city or area, or of authorities or concerning the delimitation of its frontiers or boundaries.

Material in this publication may be freely quoted or reprinted, but acknowledgement is requested, together with a copy of the publication containing the quotation or reprint to be sent to the UNCTAD secretariat at the following address:

Alessandro Nicita
Trade Analysis Branch
Division on International Trade in Goods and Services, and Commodities
United Nations Conference on Trade and Development
Palais des Nations, CH-1211 Geneva 10, Switzerland
Tel: +41 22 917 5772; Fax: +41 22 917 0044
E-mail: alessandro.nicita@unctad.org

Series editor:
Victor Ognivtsev
Officer-in-Charge
Trade Analysis Branch
Division on International Trade in Goods and Services, and Commodities
United Nations Conference on Trade and Development

UNCTAD/ITCD/TAB/62

UNITED NATIONS PUBLICATION

ISSN 1607-8291

Abstract

It has been long recognized that in the presence of market power, positive import tariffs can be optimal. The rationale is that higher tariffs reduce import demand, which in the presence of inelastic export supply from the rest of the world allows the importing country to increase its terms of trade. Indeed, there is empirical evidence suggesting that countries often set tariffs to exploit their market power when they have policy space to do so. However, optimal tariff-setting often results in a negative externality for trading partners. Such externalities create incentives for trading partners to cooperate within a negotiating framework such as the World Trade Organization (WTO) or regional trade agreements. Indeed, there is large empirical evidence suggesting that WTO negotiations do facilitate cooperation in tariff-setting by providing a negotiating table to internalize terms-of-trade externalities.

This paper empirically explores whether any cooperative behaviour in tariff-setting extends beyond the WTO accession process. In principle, the possibility of further cooperation is provided by the presence of policy space in regard to tariffs within the WTO framework. Indeed, a key aspect of the WTO process is the negotiation of bound tariffs, rather than applied tariff levels. WTO members can apply tariffs below the bound, if they choose to do so. The difference between the tariff that a country applies at the border and the country's commitments to other WTO members is referred to as "tariff water", or "binding overhang". In principle, tariff waters provide the policy space for country to set their tariff at non-cooperative levels.

The findings of this paper suggest that countries do cooperate both during the accession process and beyond it. However, non-cooperative tariff-setting is observed in the presence of sufficiently large amounts of tariff water. We find that in the absence of tariff water, importing countries' market power tends to be negatively correlated with applied tariffs, which is consistent with a cooperative tariff-setting. On the other hand, in the presence of tariff water, the relationship between importers' market power and tariffs tends to become positive, suggesting a tendency towards non-cooperative tariffs. However, the positive correlation between importers' market power and tariffs is only observed when levels of tariff water are above 20 percentage points. In the presence of moderate levels of tariff water, WTO members tend to set their tariffs cooperatively. One possible explanation for setting tariffs at non-optimal levels in the absence of legal constraints is the fear of retaliation from trading partners. We show that WTO members that have little to lose from retaliation tend to set tariffs non-cooperatively within their tariff waters, while WTO members that may have more to lose in case of retaliation are more likely to set tariffs cooperatively within their tariff waters.

Keywords: Export supply elasticities, WTO cooperation, tariff water

JEL Classification: F1

Acknowledgements

We are grateful to Matthieu Crozet, Anne-Célia Disdier, Michael Gasiorek, Sajal Lahiri, Jaime de Melo, Christoph Moser, Patrick Low, Subhash Sharmaand, José de Sousa, Akiko Suwa, Alan Winters, and seminar participants at ETH Zurich, the Paris School of Economics, Southern Illinois University and Sussex University for helpful comments and discussions.

The views expressed here are those of the authors and do not necessarily reflect those of the institutions with which they are affiliated.

Contents

List of figures

List of tables

1. INTRODUCTION

It has been long recognized that in the presence of market power, positive import tariffs can be optimal (Edgeworth, 1894). Higher tariffs reduce import demand, and the more inelastic is export supply, the larger is the improvement in the terms-of-trade of the importer. There is empirical evidence suggesting that non-members of WTO set tariffs to exploit their market power (Broda et al., 2008). However, by definition, these optimal tariffs generate a negative externality to other trading partners, which creates incentives for cooperation within a negotiating framework such as the WTO (Bagwell and Staiger, 1999). Indeed, recent empirical evidence suggests that WTO negotiations do facilitate cooperation in tariff-setting by providing the means to internalize terms-of-trade externalities, resulting in new members' tariff schedules that no longer not their market power in international markets (Bagwell and Staiger, 2011).

A key aspect of the WTO process is the negotiation of tariff caps, or bound tariffs, rather than applied tariff levels. WTO members can apply tariffs below bound rates if they choose to do so. The difference between the tariff that a country applies at the border and the country's commitments to other WTO members is referred to as "tariff water", or "binding overhang". In principle, the absence of tariff water indicates cooperation in tariff-setting, as the importing country is bound by its commitments to other trading partners. On the other hand, the presence of tariff water provides WTO members with the opportunity to set tariffs that reflect their market power.[1]

In this paper we empirically explore the extent of tariff cooperation to internalize terms-of-trade externalities in the presence and absence of tariff water. To guide our empirical work, we consider a two-country model in which tariffs are driven by a terms-of-trade rationale, as well as political economy forces. Governments put an extra-weight on the profits of firms in import-competing sectors, but also on exporters' profits. Countries can set tariffs cooperatively depending on the trade-off between the benefits and costs of cooperation. When the costs of cooperation are relatively high in a specific tariff line of a WTO member, we assume that a sufficiently high exogenous tariff bound is imposed, allowing the importing country to implement a non-cooperative tariff within its tariff waters. In the presence of cooperation, the negotiated tariff maximizes the joint political function of the two countries, and no tariff water will be observed. This dichotomy seems to fit well with the different manners in which developed and developing countries have so far participated in multilateral agreements as discussed in Croome (1995) and Hoekman and Kostechi (2009).

The model predicts that in the absence of cooperation, one should observe the positive textbook relationship between the importers' market power and tariffs. On the other hand, in the presence of cooperation, the importing country's tariffs are inversely related to its market power. To understand the latter, note that exporters' profits have an extra weight in the government's politically motivated objective function. Thus, the incentives for exporters to negotiate tariff reductions are stronger the larger the importer's market power. Indeed, the tariff reduction will have a larger impact on the exporter's profits the more inelastic is its export supply.

This second prediction is new, and we use it to identify the presence of cooperation in WTO's member tariff schedules. In the absence of tariff water, we should observe a negative relationship between importers' market power and tariffs. In the presence of tariff water, there is room to set non-cooperative tariffs; therefore, the relationship between importers' market power and tariffs should be positive.

We can empirically test these predictions by explaining applied most favoured nations (MFN) tariffs with the degree of market power enjoyed by the importer (i.e. the inverse of the export supply elasticity of the rest of the world), as well as the interaction of market power with a measure of the importer's tariff water. The model predicts a negative coefficient on importers' market power and a positive coefficient on the interaction.

[1] The literature offers several explanations for the presence of tariff water. Amador and Bagwell (2012) explain its presence with a model where uncertainty and private information are present. Horn, Maggi and Staiger (2010) explain its presence in a model with uncertainty and contract costs. In practice, the rationale why countries often set their applied tariffs to levels below the bound tariffs remains an open question.

To implement the empirical test, we first need estimates of rest of the world's export supply elasticities. These are obtained building on the Kee et al. (2008) adaptation of Kohli's (1991) revenue function approach to the estimation of trade elasticities. In short, we estimate the revenue function of the rest of the world for each WTO member as a function of the rest of the world factor endowments and the price they face in the import market. The price parameter of the revenue function of the rest of the world can then be used to calculate the export supply elasticity of the rest of the world in the WTO member's market as in Kee et al. (2008).

We estimated more than 260,000 export supply elasticities of the rest of the world faced by 100 importing countries at the six-digit level of the Harmonized System (HS) classification. The median of the inverse of the export supply elasticity is 0.044, suggesting a 4.4 per cent optimal tariff if countries were to set tariffs non-cooperatively. This is smaller than the 5 per cent median tariff we observe in our sample. If part of the terms-of-trade rationale vanishes through cooperation in trade agreements, forces other than terms of trade are needed to explain the tariff levels observed, which provides indirect support for a government objective function that is not only driven by terms-of-trade motives, but also political economy forces.

We then test our theoretical predictions and find evidence that in the absence of tariff water, tariffs are set cooperatively, as the importer's market power has a negative impact on tariffs. We also find that in the presence of tariff water the relationship between the importer's market power and tariffs tends to become positive. However, this is only observed for sufficiently large levels of tariff water. Below 20 percentage points of tariff water, which includes more than two thirds of our sample, the correlation between market power and applied tariffs remains negative, suggesting that cooperation for terms-of-trade motives in the WTO extends far beyond the negotiation of tariff bounds.

The presence of cooperation within moderate amounts of tariff waters calls for an explanation. A likely candidate is the fear that trade partners will retaliate. Indeed, Blonigen and Bown (2003) show that retaliation threats reduce the likelihood of antidumping measures by the United States of America. Similarly, Bown (2004) shows that the fear of retaliation makes the WTO's dispute settlement defendants more likely to comply with their WTO commitments. WTO members with tariff water in their schedules may refrain from using their market power from fear of having other WTO members, who also have tariff water and market power, retaliate by increasing their tariffs.

To investigate whether retaliatory concerns play a role in tariff-setting, we build an indicator capturing the trading partners' market power and the scope for tariff increases within their tariff schedules. We find that non-cooperative behaviour within WTO tariff waters is only observed for those members who face little retaliatory threat form their trading partners. Countries who suffer from strong retaliatory threats from their partners tend to behave cooperatively, even in the presence of large amounts of tariff water.

The remainder of the paper is organized as follows. Section 2 provides the theoretical framework and describes our empirical strategy. Section 3 focuses on the estimation of the rest of the world's export supply elasticities faced by each importer. Section 4 presents the empirical results regarding the extent of cooperation in tariff-setting in WTO tariff waters. Section 5 contains concluding remarks.

2. OPTIMAL TARIFFS AND THE WORLD TRADE ORGANIZATION

In a set-up where tariffs are determined by both market power and political economy forces, non-cooperative tariffs reflect both the terms-of-trade rationale and lobbying forces in the importing country.[2] In principle, in the presence of cooperation, the market power rationale vanishes as it captures inefficient transfers from the exporting country to the importing country that are internalized through cooperation. We should, therefore, expect no relationship between cooperative tariffs and the market power of the importer.

However, this does not take into account that the government in the exporting country can also be politically motivated and have an objective function that gives additional weight to the profits of importers, but also exporters. If this is the case, then the cooperative tariff will be negatively correlated with the market power of the importing country, as a stronger market power for the importer increases the incentives for the exporter to negotiate harder to prevent a sharp drop in prices.

We first develop a simple model to illustrate how the presence of cooperation changes the relationship between an importer's market power and tariffs. We then develop an empirical strategy to test the predictions of the model. We identify cooperative and non-cooperative tariff-setting by the extent of tariff water in the importer's schedule. Indeed, the absence of tariff water signals that tariffs are set at the negotiated bound reflecting cooperation among WTO members. The presence of tariff water opens the door to non-cooperative tariff-setting among WTO members, which could legally increase their tariffs to exploit their market power.

Note that this assumes that all tariffs are bound in the agreement, while only some are set through cooperative negotiations. The tariff bound is endogenously set when countries cooperate, but is exogenous in the absence of cooperation. The latter describes well the setting of WTO tariff bounds in many developing countries. As described in Croome (1995), an Australian proposal was adopted during the Uruguay Round to ensure that most countries would bind their tariffs by allowing each member to follow its own approach to tariff binding. This led many developing countries, in particular the smaller and poorer countries, to bind almost all of their previously unbound tariffs at arbitrarily high levels.[3] On the other hand, it is clear that the United States, the European Union, and Japan play a prominent role in negotiating tariffs under WTO. The available data (see table 1) indicate that they have very little tariff water in their schedules, which suggests that their applied MFN tariffs are the outcome of trade negotiations.

[2] See Grossman and Helpman (1995) and Bagwell and Staiger (1999).

[3] For example, 19 of the 36 least developed countries at the time, bound their tariffs at levels above 100 per cent, whereas their applied average tariffs were close to 10 per cent. The binding levels were also taken arbitrarily. According to interviews with Mauritanian participants in the final Ministerial meeting of the Uruguay Round in Marrakech, their delegation was briefed by the GATT secretariat's staff in a meeting that lasted a couple of hours in a hotel room in Marrakech. The delegation reviewed the last eight years of negotiations in Geneva, where Mauritania did not have a negotiating team, before making a decision on the level at which agriculture and manufacturing tariffs would be bound. More importantly, while most developed countries had locked in their offers before the Marrakech meeting that concluded the Uruguay Round, many developing countries were still drafting their offers during the Marrakech meeting, and least developed countries had an extra year to submit their goods and services tariff schedules. Thus, negotiations with other WTO members were impossible, and it is therefore not surprising that today many developing countries have very large levels of water in their tariff schedules.

Table 1. Descriptive statistics

Country or entity	Statistics	Tariff bound	MFN applied	Tariff water	Vapour water	Import demand elasticity	Export supply elasticity	*Rest-of-the-world supply elasticity*
Antigua and Barbuda	Mean	0.720	0.149	0.571	0.013	1.65	24.3	694
	SD	0.323	0.093	0.301	0.057	2.13	54.7	1 931
Argentina	Mean	0.319	0.127	0.193	0.014	1.52	27.0	99
	SD	0.063	0.071	0.083	0.048	1.97	103.4	1 082
Australia	Mean	0.110	0.042	0.068	0.003	1.64	27.0	35
	SD	0.116	0.053	0.077	0.020	2.26	101.9	141
Bahrain	Mean	0.344	0.067	0.280	0.004	1.53	23.7	324
	SD	0.143	0.109	0.076	0.026	1.84	63.3	733
Bangladesh	Mean	1.465	0.167	1.300	0.499	1.55	52.6	157
	SD	0.776	0.118	0.744	0.578	2.08	151.6	468
Barbados	Mean	0.810	0.158	0.654	0.030	1.51	22.9	692
	SD	0.273	0.219	0.262	0.159	1.83	56.8	2 260
Belize	Mean	0.603	0.127	0.476	0.004	1.63	22.5	775
	SD	0.200	0.119	0.198	0.032	1.96	56.6	2 376
Benin	Mean	0.229	0.135	0.128	0.004	1.71	29.5	1 135
	SD	0.239	0.067	0.200	0.033	2.19	56.9	3 942
Bolivia (Plurnational State of)	Mean	0.399	0.087	0.313	0.005	1.54	22.8	463
	SD	0.009	0.034	0.034	0.031	2.00	87.4	1 619
Botswana	Mean	0.224	0.103	0.121	0.008	1.61	25.5	462
	SD	0.240	0.122	0.224	0.130	2.08	93.6	1 775
Brazil	Mean	0.312	0.139	0.174	0.018	1.58	26.7	51
	SD	0.076	0.065	0.081	0.053	2.14	100.2	144
Brunei	Mean	0.254	0.028	0.226	0.002	1.59	26.2	363
	SD	0.084	0.058	0.071	0.015	2.14	82.2	1 853
Bulgaria	Mean	0.254	0.079	0.175	0.003	1.54	22.3	155
	SD	0.160	0.082	0.137	0.028	1.97	72.0	515
Burkina Faso	Mean	0.306	0.119	0.216	0.008	1.81	22.4	683
	SD	0.391	0.066	0.359	0.055	2.27	53.2	1 743
Burundi	Mean	0.555	0.218	0.404	0.022	1.89	39.0	1 569
	SD	0.444	0.130	0.392	0.110	3.14	84.6	5 562
Côte d’Ivoire	Mean	0.097	0.121	0.015	0.001	1.54	27.9	494
	SD	0.068	0.068	0.045	0.021	2.07	79.0	1 494
Cameroon	Mean	0.800	0.216	0.584	0.050	1.73	42.6	224
	SD	0.000	0.099	0.099	0.124	2.11	90.1	371
Canada	Mean	0.052	0.040	0.013	0.000	1.68	27.0	16
	SD	0.053	0.054	0.022	0.002	2.38	108.5	63
Central African Republic	Mean	0.372	0.168	0.204	0.000	1.52	30.8	906
	SD	0.103	0.088	0.119	0.000	2.00	55.1	3 325
Chile	Mean	0.252	0.066	0.186	0.005	1.61	25.6	124
	SD	0.029	0.010	0.031	0.027	2.15	92.0	1 097
China	Mean	0.099	0.116	0.002	0.000	1.62	26.4	29
	SD	0.073	0.092	0.014	0.002	2.27	99.9	106
Colombia	Mean	0.414	0.126	0.288	0.022	1.58	23.4	136
	SD	0.209	0.068	0.202	0.112	2.12	84.1	784
Costa Rica	Mean	0.425	0.059	0.366	0.009	1.53	26.9	239
	SD	0.120	0.079	0.119	0.048	1.98	102.1	791
Croatia	Mean	0.064	0.068	0.011	0.000	1.64	26.9	176
	SD	0.054	0.066	0.024	0.001	2.20	100.3	1 856
Czeck Republic	Mean	0.048	0.047	0.002	0.000	1.64	25.7	53
	SD	0.062	0.062	0.011	0.000	2.26	98.0	206
Democratic Republic of the Congo	Mean	0.231	0.191	0.040	0.000	0.84	70.7	367
	SD	0.102	0.103	0.078	0.000	0.29	109.4	591
Dominica	Mean	0.705	0.141	0.565	0.012	1.59	26.9	1 053
	SD	0.327	0.168	0.275	0.078	1.70	63.0	4 084
Egypt	Mean	0.296	0.138	0.168	0.012	1.54	23.1	128
	SD	0.673	0.612	0.307	0.249	2.00	89.8	341
El Salvador	Mean	0.359	0.070	0.289	0.007	1.56	25.5	274
	SD	0.128	0.085	0.123	0.040	2.11	89.9	901
Estonia	Mean	0.091	0.030	0.063	0.000	1.64	26.7	238
	SD	0.077	0.062	0.062	0.007	2.30	96.3	1 661

/...

Country or entity	Statistics	Tariff bound	MFN applied	Tariff water	Vapour water	Import demand elasticity	Export supply elasticity	*Rest-of-the-world supply elasticity*
European Union	Mean	0.044	0.044	0.001	0.000	5.51	47.0	5
	SD	0.044	0.044	0.008	0.002	7.84	228.0	11
Gabon	Mean	0.224	0.182	0.084	0.001	1.54	23.6	498
	SD	0.167	0.095	0.128	0.012	1.93	87.0	1 463
Georgia	Mean	0.064	0.053	0.020	0.000	1.74	26.4	420
	SD	0.058	0.056	0.039	0.002	2.51	70.8	1 460
Ghana	Mean	0.845	0.164	0.681	0.053	1.76	45.4	153
	SD	0.264	0.094	0.244	0.160	2.47	90.3	347
Grenada	Mean	0.599	0.138	0.461	0.006	1.80	24.6	1 346
	SD	0.229	0.093	0.231	0.047	2.28	49.7	5 870
Guatemala	Mean	0.415	0.063	0.352	0.015	1.58	25.9	240
	SD	0.171	0.069	0.169	0.076	2.13	101.3	765
Guinea	Mean	0.164	0.129	0.067	0.000	1.59	29.3	869
	SD	0.143	0.069	0.108	0.004	1.90	69.1	2 786
Guyana	Mean	0.555	0.096	0.460	0.001	1.55	20.7	579
	SD	0.157	0.083	0.159	0.007	1.71	52.2	1 771
Honduras	Mean	0.309	0.067	0.242	0.002	1.63	27.3	383
	SD	0.088	0.071	0.096	0.018	2.24	97.8	1 477
Hungary	Mean	0.067	0.063	0.005	0.000	1.61	26.0	63
	SD	0.082	0.077	0.023	0.004	2.19	94.7	243
Iceland	Mean	0.168	0.040	0.128	0.007	1.56	31.0	345
	SD	0.205	0.063	0.187	0.064	2.21	116.7	1 736
India	Mean	0.441	0.222	0.225	0.039	1.61	24.8	50
	SD	0.353	0.172	0.292	0.174	2.22	101.8	165
Indonesia	Mean	0.372	0.067	0.306	0.024	1.65	26.4	77
	SD	0.123	0.086	0.123	0.081	2.27	106.7	289
Israel	Mean	0.204	0.042	0.162	0.033	1.59	26.5	90
	SD	0.400	0.104	0.381	0.225	2.33	100.2	611
Jamaica	Mean	0.525	0.087	0.439	0.014	1.61	23.7	346
	SD	0.224	0.111	0.205	0.067	2.10	83.9	1 189
Japan	Mean	0.031	0.032	0.001	0.000	1.59	24.5	13
	SD	0.048	0.047	0.009	0.000	2.27	90.0	37
Jordan	Mean	0.169	0.151	0.040	0.000	1.60	24.5	265
	SD	0.152	0.154	0.073	0.007	2.06	87.2	716
Kenya	Mean	0.941	0.209	0.733	0.064	1.68	59.3	226
	SD	0.188	0.166	0.207	0.172	2.09	142.9	541
Kyrgyzstan	Mean	0.064	0.038	0.029	0.000	1.64	26.8	461
	SD	0.047	0.049	0.037	0.000	1.88	80.4	2 022
Latvia	Mean	0.078	0.038	0.041	0.000	1.62	25.6	229
	SD	0.095	0.056	0.082	0.010	2.24	83.2	740
Lesotho	Mean	0.996	0.118	0.878	0.208	1.81	25.2	305
	SD	0.631	0.119	0.642	0.385	2.14	53.7	793
Lithuania	Mean	0.066	0.038	0.031	0.000	1.62	28.0	180
	SD	0.067	0.060	0.051	0.007	2.18	107.4	638
Madagascar	Mean	0.246	0.105	0.144	0.001	1.58	27.0	574
	SD	0.066	0.068	0.078	0.008	2.13	71.8	1 384
Malawi	Mean	0.772	0.105	0.666	0.036	1.82	40.8	415
	SD	0.397	0.099	0.356	0.103	2.65	96.2	1 180
Malaysia	Mean	0.150	0.086	0.067	0.002	1.69	24.5	63
	SD	0.123	0.102	0.098	0.034	2.42	88.0	243
Mali	Mean	0.201	0.120	0.112	0.001	1.73	22.9	532
	SD	0.214	0.065	0.185	0.016	2.01	50.8	1 272
Malta	Mean	0.493	0.057	0.435	0.005	1.54	25.0	415
	SD	0.095	0.041	0.100	0.036	2.01	95.4	1 194
Mauritius	Mean	0.865	0.099	0.776	0.110	1.60	32.9	337
	SD	0.491	0.166	0.465	0.197	2.11	67.6	1 427
Mexico	Mean	0.351	0.152	0.200	0.010	1.64	26.3	29
	SD	0.046	0.094	0.090	0.041	2.32	99.7	92
Mongolia	Mean	0.184	0.044	0.141	0.000	1.68	23.7	531
	SD	0.050	0.018	0.052	0.003	2.07	105.9	1 560
Morocco	Mean	0.403	0.248	0.178	0.007	1.61	25.4	152
	SD	0.139	0.204	0.173	0.052	2.19	93.9	428
Namibia	Mean	0.255	0.111	0.144	0.012	1.55	27.9	381
	SD	0.293	0.129	0.283	0.179	2.02	97.6	973

/…

Country or entity	Statistics	Tariff bound	MFN applied	Tariff water	Vapour water	Import demand elasticity	Export supply elasticity	*Rest-of-the-world supply elasticity*
New Zealand	Mean	0.117	0.034	0.083	0.002	1.61	28.1	100
	SD	0.116	0.044	0.080	0.014	2.16	102.4	574
Nicaragua	Mean	0.423	0.058	0.365	0.002	1.52	24.1	475
	SD	0.099	0.074	0.096	0.026	1.89	87.7	1 131
Niger	Mean	0.428	0.130	0.316	0.023	1.65	23.7	830
	SD	0.437	0.069	0.413	0.126	2.03	47.3	2 713
Nigeria	Mean	0.949	0.152	0.797	0.168	1.97	39.4	66
	SD	0.516	0.210	0.459	0.311	3.01	125.0	123
Oman	Mean	0.135	0.061	0.077	0.003	1.63	23.0	236
	SD	0.172	0.085	0.116	0.046	2.15	69.1	758
Panama	Mean	0.232	0.081	0.153	0.002	1.51	24.4	301
	SD	0.115	0.085	0.101	0.018	1.84	81.5	1 440
Papua New Guinea	Mean	0.333	0.040	0.293	0.003	1.59	21.8	480
	SD	0.145	0.094	0.132	0.027	2.02	59.2	1 373
Paraguay	Mean	0.326	0.117	0.210	0.003	1.52	21.2	352
	SD	0.067	0.068	0.086	0.022	2.01	56.5	1 239
Peru	Mean	0.302	0.096	0.206	0.007	1.53	24.7	214
	SD	0.026	0.058	0.061	0.031	2.02	91.4	1 977
Philippines	Mean	0.248	0.055	0.194	0.009	1.68	27.7	115
	SD	0.114	0.061	0.099	0.043	2.39	101.6	621
Poland	Mean	0.075	0.075	0.001	0.000	1.62	25.8	39
	SD	0.112	0.113	0.008	0.000	2.21	102.0	183
Rep. of Korea	Mean	0.153	0.109	0.048	0.003	1.63	25.7	28
	SD	0.356	0.336	0.081	0.045	2.28	95.1	94
Romania	Mean	0.044	0.084	0.002	0.000	1.62	26.6	79
	SD	0.046	0.090	0.009	0.000	2.20	105.3	235
Rwanda	Mean	0.873	0.177	0.709	0.044	1.66	26.6	826
	SD	0.283	0.111	0.280	0.132	2.06	74.5	2 774
Saint Kits	Mean	0.818	0.141	0.677	0.011	1.68	23.1	858
	SD	0.243	0.103	0.230	0.057	1.96	55.2	2 683
Saint Lucia	Mean	0.746	0.136	0.610	0.024	1.52	24.7	771
	SD	0.350	0.121	0.328	0.082	1.64	53.4	2 168
Saudi Arabia	Mean	0.107	0.063	0.051	0.001	1.69	26.1	64
	SD	0.062	0.040	0.047	0.009	2.40	102.4	176
Senegal	Mean	0.299	0.125	0.174	0.001	1.65	20.8	457
	SD	0.009	0.068	0.068	0.011	2.00	53.6	1 274
Singapore	Mean	0.070	0.000	0.070	0.001	1.62	31.0	42
	SD	0.040	0.000	0.040	0.007	2.38	116.3	280
Slovakia	Mean	0.055	0.120	0.014	0.000	1.59	25.3	93
	SD	0.070	0.151	0.048	0.014	2.15	87.0	337
Slovenia	Mean	0.123	0.073	0.058	0.001	1.60	27.8	151
	SD	0.112	0.063	0.082	0.013	2.15	102.1	1 361
South Africa	Mean	0.195	0.085	0.110	0.012	1.60	24.1	67
	SD	0.234	0.116	0.216	0.132	2.13	88.3	273
Sri Lanka	Mean	0.224	0.087	0.142	0.003	1.72	34.1	208
	SD	0.193	0.133	0.134	0.029	2.21	92.5	784
Swaziland	Mean	0.242	0.115	0.127	0.004	1.60	23.8	608
	SD	0.205	0.125	0.184	0.057	1.89	65.5	2 031
Thailand	Mean	0.255	0.131	0.139	0.006	1.59	30.5	79
	SD	0.139	0.145	0.119	0.042	2.10	120.2	448
Togo	Mean	0.800	0.169	0.631	0.006	1.53	41.7	341
	SD	0.000	0.053	0.053	0.051	1.98	67.3	706
Trinidad and Tobago	Mean	0.577	0.085	0.492	0.015	1.56	24.2	415
	SD	0.193	0.104	0.172	0.072	2.01	96.3	1 893
Tunisia	Mean	0.495	0.255	0.241	0.009	1.65	26.8	131
	SD	0.317	0.246	0.235	0.075	2.30	78.3	356
Uganda	Mean	0.698	0.140	0.559	0.044	1.97	41.5	330
	SD	0.158	0.145	0.154	0.129	2.86	79.3	789
United Arab Emirates	Mean	0.158	0.049	0.109	0.015	1.72	22.8	55
	SD	0.240	0.057	0.213	0.139	2.57	78.9	134
United Republic of Tanzania	Mean	1.200	0.233	0.967	0.140	2.00	51.1	182
	SD	0.000	0.160	0.160	0.254	3.10	99.2	327
United States	Mean	0.040	0.042	0.000	0.000	1.41	28.7	3
	SD	0.122	0.122	0.003	0.000	1.95	155.2	11

/…

Country or entity	Statistics	Tariff bound	MFN applied	Tariff water	Vapour water	Import demand elasticity	Export supply elasticity	*Rest-of-the-world supply elasticity*
Uruguay	Mean	0.315	0.128	0.188	0.004	1.49	26.7	290
	SD	0.065	0.068	0.086	0.027	1.81	91.2	659
Venezuela (Bolivarian Republic of)	Mean	0.358	0.134	0.223	0.012	1.59	23.9	125
	SD	0.133	0.070	0.136	0.057	2.19	86.4	860
Zambia	Mean	0.886	0.130	0.756	0.065	1.95	39.4	236
	SD	0.411	0.109	0.353	0.169	2.65	71.9	631
Zimbabwe	Mean	0.633	0.186	0.485	0.106	1.48	36.2	365
	SD	0.680	0.186	0.596	0.264	1.71	82.8	953

Abbreviations: SD, standard deviation

2.1 THEORETICAL PREDICTIONS

We consider a home country and a foreign country where the foreign country's variables are identified by superscript "*". These countries trade three goods labeled 0, 1 and 2, where good 0 represents a numeraire good that is freely traded. Consumer preferences are the same across countries and are described by the following additive quasilinear utility function:

$$U(c_0, c_1, c_2) = c_0 + u_1(c_1) + u_2(c_2) \tag{1}$$

which describes the preference structure in the home country while a similar expression describes the preference structure in the foreign country. We assume that sub-utility functions are increasing on consumption and concave, i.e. $u_i^{'}(.) > 0$ and $u_i^{''}(.) < 0$.

On the production side, we assume that the numeraire good is produced using labour under constant returns to scale, keeping the wage rate constant, regardless of the trade policy imposed on imports of goods 1 and 2. Moreover, we assume that goods 1 and 2 are produced using labour and a specific factor needed to produce each good using a constant return to scale technology. Perfect competition prevails. Thus, the assumptions on the supply side and on the demand side of the model allow us to conclude that the market equilibrium for good 1 is not affected by the market equilibrium for good 2.[4]

We assume that the differences in the relative endowments of sector-specific capital in sectors 1 and 2 is sufficiently large so that the home country imports good 1 and exports good 2. This implies $x_1(p) < x_1^*(p)$, where x_1 and x_1^* are the supply of good 1 in the home and foreign country, respectively. The reverse happens for good 2. As a result, a tariff on good 1 (2) may be imposed by country 1 (2), as we only consider tariffs and disregard export-related trade instruments. The relationship between the price in the home and foreign country is then described by $p_1 = p_1^* + t_1$ and $p_2^* = p_2 + t_2$. Without loss of generality, units are chosen so that initially export prices of good 1 and 2 are equal to 1, i.e. $p_1^* = p_2 = 1$. The cost of negotiating each tariff between these two countries is described by the parameter α, which is assumed to be positive. If negotiation costs are high relative to the benefits of negotiation, the importing country imposes a non-cooperative tariff.

We consider that the home country's government objective function $G(p_1, p_2)$ is defined by a weighted average between profits and social welfare. In this case, parameter $\beta > 0$ describes the extra weight given to profits relative to consumer surplus and tariff revenue in this government's

[4] This rules out counterlobbying by exporters within the same country as in Gawande et al. (2012).

objective function. A similar approach applies to the foreign country's government, where the extra weight to profits is captured by parameter $\beta^{å}$. Then, the home country's government objective function is described, with the assistance of expression (1), by the following expression:

$$G(p_1, p_2) = u_1(d_1(p_1)) - p_1 d_1(p_1) + u_2(d_2(p_2)) - p_2 d_2(p_2) \\ + t_1 m_1(p_1) + (1+\beta)[\pi_1(p_1) + \pi_2(p_2)] \tag{2}$$

where d_i is the demand for good i, $m_1 = d_1 - x_1$ stands for imports of good 1, and π_1 stands for home firms' profits in sector 1.

The choice of assumptions on the supply and demand sides, along with separate costs to negotiate each tariff, allows us to independently consider the choice of whether to negotiate tariffs on goods 1 and 2. Thus, we focus on the decision to negotiate a the tariff imposed by the home country on good 1, but a similar logic applies for the tariff imposed by the foreign country on imports of good 2.

We first investigate the tariff for good 1 that emerges with and without negotiation between the countries. Later, we use the equilibrium tariffs under the two scenarios to consider the role played by market power and political influence in determining the benefits of negotiation.

The optimal non-cooperative tariff on imports of good 1 is obtained by differentiating expression (2) with respect to tariffs to obtain the first-order condition of the home country maximization problem:

$$\frac{dG}{dt_1} = -d_1\left[\frac{dp_1^*}{dt_1} + 1\right] + m_1 + t_1 m_1'\left[\frac{dp_1^*}{dt_1} + 1\right] \\ + (1+\beta)x_1\left[\frac{dp_1^*}{dt_1} + 1\right] \tag{3}$$

which can be arranged as follows:

$$\frac{dG}{dt_1} = -m_1\frac{dp_1^*}{dt_1} + t_1 m_1'\frac{dp_1}{dt_1} + \beta x_1\frac{dp_1}{dt_1} \tag{4}$$

Note that $\frac{dp_1}{dt_1} = \frac{dp_1^*}{dt_1} + 1$. We can solve for the non-cooperative tariff by setting expression (4) equal to zero. As usual, we can use the market-clearing condition to solve for the non-cooperative tariff using (4) and express the non-cooperative tariff as a function of the importing country's market power. Since imports equal exports, we can express the marketing clearing condition as follows:

$$m_1(p_1) + m_1^*(p_1^*) = 0 \tag{5}$$

and total differentiation of the market clearing conditions yields

$$m_1^{'} \frac{dp_1}{dt_1} = -m_1^{*'} \frac{dp_1^*}{dt_1} \tag{6}$$

We can apply relationship (6) to solve for the non-cooperative tariff using (4) to obtain:

$$t_1^N = \frac{\beta z_1 p_1}{e_1} + \frac{1}{e_1^*} \tag{7}$$

where t_1^N is the non-cooperative optimal tariff, z_1 stands for the inverse of the import penetration ratio expressed in monetary units, e_1 represents the import demand elasticity, and e_1^* stands for the export supply elasticity faced by the importing country. Expression (7) displays the usual two motives for deviations from free trade under perfect competition. The political economy motive is represented by the first term on the right-hand side of (7), while the market power motive, also known as the terms-of-trade motivation, is described in the second term on the right-hand side. As Bagwell and Staiger (1999) explain in detail, the latter motivation corresponds to a negative externality of the importing country's trade policy on the exporting country. Negotiations between countries should internalize this motivation by design, while respecting the political economy forces in each negotiating party.

We can now investigate the equilibrium tariff on good 1 that emerges when the two countries cooperate. We adopt the usual assumption that negotiated tariffs maximize the sum of the governments' political functions.[5] In this case, we represent the sum of the political functions by the global political function, which is represented by $G^w = G + G^*$.[6] Focusing on the equilibrium tariff for good 1, we can totally differentiate G^w to obtain:

$$\begin{aligned} \frac{dG^w}{dt_1} &= -d_1\left[\frac{dp_1^*}{dt_1}+1\right] + m_1 + t_1 m_1^{'}\left[\frac{dp_1^*}{dt_1}+1\right] \\ &+ (1+\beta)x_1\left[\frac{dp_1^*}{dt_1}+1\right] \\ &- d_1^*\frac{dp_1^*}{dt_1} + (1+\beta^*)x_1^*\frac{dp_1^*}{dt_1} \end{aligned} \tag{8}$$

where the first and second lines can be found in expression (3) and the third line comes from calculating $\frac{dG^*}{dt_1}$. Rearranging equation (8) yields:

$$\frac{dG^w}{dt_1} = t_1 m_1^{'} \frac{dp_1}{dt_1} + \beta x_1 \frac{dp_1}{dt_1} + \beta^* x_1^* \frac{dp_1^*}{dt_1} \tag{9}$$

[5] This follows other papers in the literature such as Bagwell and Staiger (1999), Horn, Maggi and Staiger (2010) and Beshkar, Bond and Rho (2012), among others.

[6] The usual rationale for focusing on the joint political pay-off is the presence of similar countries in economic and political power or the presence of cross-country transfers. We follow suit in line with the literature.

where it is clear that the political economy forces in each country are driving forces in determining the negotiated tariff. The equilibrium cooperative tariff can be calculated by setting expression (9) to zero, and with assistance of expression (6), we can rearrange the equation to obtain:

$$t_1^C = \frac{\beta z_1 p_1}{e_1} - \frac{\beta^* z_1^*}{e_1^*} \tag{10}$$

Where (10) is the optimal cooperative tariff, and z_1^* is the inverse of the export penetration ratio in the foreign country. It is clear from expression (10) that a cooperative tariff differs from zero due to the political forces present in each negotiating party ($\beta \neq 0$ and $\beta^{å} \neq 0$). Otherwise, free trade would prevail. Note that politically important exporters ($\beta^{å} > 0$) influence the cooperative tariff in a very intuitive way. If the importing country market power is high (low e_1^*), then the equilibrium cooperative tariff is lower, as a high tariff would cause a significant decrease in the exporting country's price, which obviously has a negative effect on the politically influential producers in the foreign economy. This suggests that when moving from a non-cooperative to a cooperative set-up, market power is more than fully internalized when the foreign country cares about their exporter's profits. Indeed, the cooperative is lower the higher the market power of the importing country. This is the opposite of the prediction we obtained for non-cooperative tariffs.

Whether countries cooperate in tariff-setting depends entirely on whether the gains from cooperation are larger than its costs, i.e. $(G^w(t_1^C) - G^w(t_1^N))$ needs to be greater than α. We follow Horn, Maggi and Staiger (2010) to obtain the sufficient condition for obtaining sufficiently large gains from cooperation. By definition, the function G^w is concave, and $\frac{dG^w(t_1^C)}{dt_1} = 0$ since the cooperative tariff maximizes the global political function. Thus, a sufficient condition for large gains from cooperation is to have $\left|\frac{dG^w(t_1^N)}{dt_1}\right|$ large, but this boils down to have $\left|\frac{dG^*(t_1^N)}{dt_1}\right|$ large, since $\frac{dG(t_1^N)}{dt_1} = 0$ by definition of the non-cooperative solution. Using the definition of the foreign country's objective function we can obtain:

$$\left|\frac{dG^*(t_1^N)}{dt_1}\right| = \left(d_1^* - x_1^*\right)\frac{dp_1^*}{dt_1} - \beta^* x_1^* \frac{dp_1^*}{dt_1} \tag{11}$$

Expression (11) can be rearranged with the assistance of expression (6) to yield the following sufficient condition:

$$\left|\frac{dG^*(t_1^N)}{dt_1}\right| = \frac{\left(m_1 + \beta^* x_1^*\right)m_1'}{\left(m_1' + m_1^{*'}\right)} \tag{12}$$

which can be rewritten to display the relevant elasticities as follows:

$$\left|\frac{dG^*(t_1^N)}{dt_1}\right| = \frac{\left(m_1+\beta^* x_1^*\right)}{\left(1+\frac{e_1^*}{e_1}p_1\right)} \qquad (13)$$

We can relate expression (13) to the discussion above about the equilibrium tariffs. This sufficient condition indicates that countries are more likely to cooperate when the importing country has significant market power (low e_1^*), or a tariff creates significant distortions in the importing country (high e_1), or foreign exporters are politically influential(high β^*), or the countries trade a great deal with each other (high m_1). If these conditions apply, then countries cooperate, and tariff water is not present since the bound and applied tariff are described by the cooperative tariff (10). Otherwise, countries do not cooperate, water is present and tariffs reflect the market power of the importing country. This is summarized in the following prediction:

Prediction 1. *If gains from cooperation described by expression (13) are relatively large (small) compared with negotiation costs, then tariff water is absent (present) and tariffs are negatively (positively) related to market power.*

Our identification strategy in the empirical section relies on this prediction. In the presence of cooperation, i.e. when there is no tariff water, we should observe a negative relationship between market power and applied tariffs, whereas if tariffs are set non-cooperatively, and tariff water is present, then the relationship between tariffs and market power should be positive.

2.2 EMPIRICAL STRATEGY

In order to empirically test the prediction developed in the previous section, we will use tariff data for 100 WTO members at the six-digit level of the HS classification[7] and investigate the extent to which the importer's market power (the inverse of the export supply elasticity of the rest of the world) can explain the variation in tariffs, in particular in the presence of tariff water:

$$t_{p,c,t} = \alpha_1 \times \frac{1}{e^*_{p,c}} + \alpha_2 \times W_{p,c,t} + \alpha_3 \times \frac{1}{e^*_{p,c}} \times W_{p,c,t} + \alpha_p + \alpha_{c,2HS,t} + \mu_{p,c,t} \qquad (14)$$

where $t_{p,c,t}$ is the applied tariff in product p (defined at the six-digit level of the HS classification) in country c at time t, W captures tariff water that is measured as the difference between bound and applied tariffs, α_p is a product fixed effect defined at the six-digit level of the HS classification, and $\alpha_{c,2HS,t}$ is a two-digit HS fixed effect that varies by country and year, which serves as a control for political economy determinants of tariffs, such as firm concentration and capital/labour intensity.[8] Our prediction will therefore be identified using the variation across HS six-digit tariff lines within HS two-digit aggregates for each country and year, while checking for HS six-digit common effects. We expect $\alpha_1 < 0$, as the relationship between market power and tariffs is negative in the absence of

[7] For a list of countries, see table 1.

[8] Ideally, we would like to have these types of controls varying at the six-digit level of the HS classification, but such data do not exist across countries, so a good compromise is to use fixed effects at the two-digit level of the HS classification.

tariff water, $\alpha_3 > 0$, suggesting that as a non-cooperative tariff-setting is possible within WTO's tariff waters, the relationship between applied tariffs and market power becomes positive.

There are several issues regarding the estimation of (14). First, export supply elasticities of the rest of the world are measured with a lot of noise as suggested by Broda et al. (2008).[9] We follow their strategy and use as an alternative the log of $1/e^{â}$, as well as dummy variables that split the sample into high, medium and low levels of market power across all countries, products and time. This alternative fits our analytical set-up better, since it implies a discontinuity in the relationship between tariffs and market power above a certain level of market power that would yield cooperation gains larger than the negotiation costs.

The second issue has to do with the endogeneity of our measure of tariff water and market power. We solve the endogeneity of tariff water by instrumenting it with what Foletti et al. (2011) labelled as water vapour:

$$Watervapor_{p,c,t} = \max\{0, t^{b}_{p,c} - t^{pr}_{p,c,t}\} \tag{15}$$

where $t^{b}_{p,c}$ stands for the bound tariff, and $t^{pr}_{p,c,t}$ for the prohibitive tariff. So water vapour is tariff water above the prohibitive tariff.[10] Arguably, this instrument satisfies the exclusion and the inclusion restrictions, as the level of the applied tariff should not depend on how much water vapour exists, and by construction, water vapour is correlated with tariff water as it is part of it.

To construct water vapour, we need a measure of prohibitive tariffs for every tariff line. These are not observable, but we use the approximation in Foletti et al. (2011), which with the help of import demand elasticities calculates the prohibitive tariff as the one that will lead to zero imports using a linear approximation around the observed level of imports. The prohibitive tariff is then given by:

$$t^{pr}_{p,c,t} = t_{p,c,t} + \frac{(1 + t_{p,c,t})}{e^{m}_{p,c}} \tag{16}$$

where $e^{m}_{p,c}$ represents the import demand elasticity that varies by country and by product. Table 1 provides summary statistics by country of tariff water and water vapour, applied tariffs and bound tariffs, as well as the various elasticities.

The endogeneity of market power is addressed by using a some theory. Olarreaga et al. (1999) show that two determinants of the export supply elasticity of the rest of the world are an average of the export supply elasticity across all countries measured from the exporters' point of view and an average of the import demand elasticities across all countries in the rest of the world.[11]

---

[9] We also do not have estimates that vary across time; therefore, the only variation in these elasticities is across products and countries.

[10] Note that tariff bounds do not vary by time, given that they were the outcome of the Uruguay Round negotiations.

[11] For a given product, let us define world export supply as $x_w = \sum_c x_c$ (the sum of each country's export supply). The rest of the world export supply faced by country i is then given by $x_i = x_w - \sum_{c \neq i} m_c$ where m_c are imports of country c. Differentiate both sides by the world price p and multiply by p/x_w and rearrange the expression to obtain:

$$e^{*}_{i} = \frac{1}{m_i/x_w}\left(e^{x*} + \sum_{c \neq i} e^{m}_{c} \frac{m_c}{x_w}\right)$$

where e^{x*} is the export supply of the world, and e_c is the absolute value of the import demand elasticity of country c.

We have estimates of import demand elasticities at the six-digit level of the HS classification from Kee et al. (2008), and we adapt their methodology to estimate export supply elasticities for each country in our sample at the six-digit of the HS classification. The methodology employed to measure the export supply elasticities of the rest of the world from the point of view of the importers is discussed in section 3. We then take averages of these elasticities and use them as instruments for market power (the inverse of the export supply elasticity of the rest of the world from the point of view of the importer). Below, we provide more details on this issue. In principle, these two averages satisfy the exclusion restriction. We instrument the interaction term with the interaction of these averages with water vapour. We perform over-identification and weak instrumental variables' tests to check the validity of our instruments.

3. ESTIMATING THE EXPORT SUPPLY ELASTICITIES OF THE REST OF THE WORLD

We start by describing our adaptation of the methodology used in Kee et al. (2008) to estimate the export supply elasticities of the rest of the world faced by each importing country ($e_{nn}^{å}$). We then discuss the adaptation of their methodology to estimate export supply elasticities of each exporting country at the six-digit level of the HS classification that will be used jointly with the estimates in Kee et al. (2008) to instrument the export supply elasticities of the rest of the world faced by each importer. We then describe the data used to estimate the elasticities and provide some descriptive statistics of these estimates, as well as some external tests.

3.1 ESTIMATING REST-OF-THE-WORLD EXPORT SUPPLY ELASTICITIES

In this section, we describe the methodology employed to estimate the rest-of-the-world supply elasticities faced by each importer. They correspond to our measure of market power in international markets and capture the ability of countries in changing their terms of trade by using trade policy instruments, for instance. The empirical model is based on the adaptation by Kee et al. (2008) of Kohli's (1991) gross domestic product (GDP) function approach for the estimation of trade elasticities at the tariff-line level. Kee et al. (2008) provides estimates of import demand elasticities at the six-digit HS level, whereas our focus here is the export supply of the rest of the world, so we need to model the GDP function of the rest of the world for each importing country.

We assume that the GDP function is common across all countries up to a constant term that accounts for productivity differences. The GDP function of each country, denoted $G^t\left(p^t, v^t\right)$ is a function of prices and endowments. Without loss of generality, we assume that this GDP function has a flexible translog functional form, where n and k are index goods, and m and l are index factor endowments, as follows:

$$\begin{aligned}\ln G^t\left(p^t, v^t\right) &= a_{00}^t + \sum_{n=1}^{N} a_{0n}^t \ln p_n^t + \frac{1}{2}\sum_{n=1}^{N}\sum_{k=1}^{N} a_{nk} \ln p_n^t \ln p_k^t \\ &+ \sum_{m=1}^{M} b_{0m}^t \ln v_m^t + \frac{1}{2}\sum_{m=1}^{M}\sum_{l=1}^{M} b_{ml}^t \ln v_m^t \ln v_l^t \\ &+ \sum_{n=1}^{N}\sum_{m=1}^{M} c_{nm} \ln p_n^t \ln v_m^t \qquad (17)\end{aligned}$$

where all the translog parameters a, b and c_{nm} when indexed by t allow for changes over time.[12] We also impose the necessary restrictions so that the GDP function satisfies the homogeneity and symmetry properties of a GDP function. For each country c we can then construct the GDP function of the rest of the world by summing the GDP functions of each country given by (17). Then, taking the derivative of $\ln G^t\left(p^t, v^t\right)$ with respect to $\ln p_n^t$ and summing across each country c in the rest of the world, we obtain the equilibrium share of exported good n in the rest of the world's GDP at period t,[13]

$$s_n^t\left(p^t, v^t\right) \equiv \frac{p_n^t q_n^t\left(p^t, v^t\right)}{G^t\left(p^t, v^t\right)} = (C_w - 1)a_{0n}^t + (C_w - 1)\sum_{k=1}^{N} a_{nk} \ln p_k^t + \sum_{m=1}^{M} c_{nm} \sum_{c=1}^{C_w - 1} \left(\ln v_m^t\right)_c$$
$$= (C_w - 1)\left(a_{0n}^t + a_{nn} \ln p_n^t + a_{nk} \sum_{k \neq n} \ln p_k^t \right) + \sum_{m=1}^{M} c_{nm} \sum_{c=1}^{C_w - 1} \left(\ln v_m^t\right)_c \qquad (18)$$

where s_n^t is the share of export good n in the rest-of-the-world GDP, C_w is the total number of countries in the world, and $\sum_{c=1}^{C_w - 1}\left(\ln v_m^t\right)_c$ is the sum of the log of factor endowment m across all countries in the rest of the world.

The rest-of-the-world export supply elasticity of good n is then given by:[14]

$$e_{nn}^* \equiv \frac{\partial q_n^t\left(p^t, v^t\right)}{\partial p_n^t} \frac{p_n^t}{q_n^t} = \frac{(C_w - 1)a_{nn}}{s_n^t} + s_n^t - 10 \qquad (19)$$

Thus we can calculate the export supply elasticities once a_{nn} is properly estimated. Note that the size of the export supply elasticities e_{nn}^* positively depends on the size of a_{nn}, which captures the changes in the share of good n in each country's GDP when the price of good n increases.

With data on export shares, unit values and factor endowments, equation (18) is the basis for our estimation of export elasticities. There are, however, several problems with the estimation of a_{nn} using (18). First, there are thousands of goods traded among the countries in any given year. Moreover, there is also a large number of non-traded commodities that compete for scarce factor endowments and contribute to GDP in each country. Thus, we do not have enough degrees of freedom to estimate all a_{nk} s.

We follow Kee et al. (2008) to solve this problem by transforming the N-good economy problem into a collection of N sets of two-good economies. This is done by constructing a price index of the remaining goods in the economy (including imported and non-traded goods) for each n exported good. For this we use information on GDP deflators, a price index for each of the n exported goods as well as Caves, Christensen and Diewert's (1982) result that if the GDP function follows a translog functional form and the translog parameters are time-invariant, then a Tornquist price index is the exact price index of the GDP function. Using the definition of the Tornquist price

[12] We assume some parameters to be time-invariant so that we can estimate them using the variation over time.

[13] This assumes that goods exported by the rest of the world are differentiated by destination, and the price of goods to other destinations are included in the second term of the right-hand side on the top line of (18).

[14] Cross-price elasticities of export supply are given by: $\varepsilon_{nk}^t \equiv \frac{\partial q_n^t\left(p^t, v^t\right)}{\partial p_k^t} \frac{p_k^t}{q_n^t} = \frac{a_{nk}^t}{s_n^t} + s_k^t, \forall n \neq k.$

index, it is then easy to compute for each good n a price index for all other goods in the economy, denoted p_{-n}. Equation (18) becomes:

$$s_n^t\left(p_n^t, p_{-n}^t, v^t\right) = (C_w - 1)a_{0n} + (C_w - 1)a_{nn} \ln\frac{p_n^t}{p_{-n}^t} + \sum_{m \neq l, m=1}^{M} c_{nm} \sum_{c=1}^{C_w - 1} \ln\left(\frac{v_m^t}{v_l^t}\right)_c + \mu_n^t, \forall n. \tag{20}$$

With an additive stochastic error term, μ_n^t, to capture measurement errors, equation (20) is the basis used for the estimation of own price effect, a_{nn}, and hence the export price elasticity of the rest of the world, e_{nn}^*.

The second problem is that we do not have enough time variation to estimate these parameters by country. Therefore,0. given that we assume that the GDP functions are common up to a constant, we pool the data together and estimate the common a_{nn} using both cross-country and time variations and introducing year- and country-specific fixed effects that are all specific to each good n. The country-specific fixed effects (for each good n) will control, for example, for the level of trade restrictiveness in each importing country that may be correlated with the price received by exporters, as long as trade restrictiveness does not vary significantly across time. The year fixed effects (for each good n) will capture general shocks to good n's world market.

There are also several econometric problems. Unit prices can be endogenous or measured with error. There may also be selection bias due to the fact that some products may not be exported by the rest of the world to a particular country. Finally, there may be partial adjustments of exported quantities to changes in prices which may lead to serial correlation in the error term.

To address all the econometric problems, we follow the procedure in Kee et al. (2008). We instrumented unit values using the simple and inverse-distance weighted averages of the unit values of the rest of the world, as well as the trade-weighted average distance of country c to all the exporting countries of good n. We corrected for selection bias by introducing the Mills ratio of probit equation that determines whether or not the good was exported by the rest of the world using the procedure in Semykina and Wooldridge (2010), but only when the test they propose suggests that selection bias is a problem. We also test for serial correlation in the error term, and, when serial correlation is present, we then estimate a dynamic model by introducing a lagged dependent variable using the generalized method of moments (GMM) system estimators developed by Arellano and Bover (1995). This estimation strategy corresponds to the Arellano and Bond (1991) difference GMM estimators, with a level equation added to the system to improve efficiency.[15]

Finally, for equation (18) to be the solution of the GDP maximization problem, the second order necessary conditions need to be satisfied (i.e. the Hessian matrix needs to be negative semi-definite). This implies that the estimated export elasticities of the rest of the world are not negative. For this to be true for all observations:

$$a_{nn} \geq \bar{s}_n\left(1 - \bar{s}_n\right) \tag{21}$$

where $\bar{s}_n$ is the maximum share in the sample for good n. Thus, when the estimated a_{nn} does not satisfy the curvature condition described by expression (21), we impose the estimated $a_{nn} \equiv \bar{s}_n$, which ensures that all elasticities are positive.

[15] See Kee et al. (2008) for further details.

3.2 ESTIMATING EXPORT SUPPLY ELASTICITIES FROM THE POINT OF VIEW OF THE EXPORTER

The export supply elasticities from the the exporter's point of view are used as instruments for the export supply elasticity of the rest of the world from the point of view of the importer. The estimation procedure is identical to the one followed above, except that we are not summing the GDP functions of rest of the world's countries. We then take the derivative of the GDP function with respect to prices and rearrange to obtain the share equation that will be estimated:

$$s_n^t\left(p_n^t, p_{-n}^t, v^t\right) = b_{0n} + b_{nn} \ln \frac{p_n^t}{p_{-n}^t} + \sum_{m \neq l, m=1}^{M} d_{nm} \left(\frac{v_m^t}{v_l^t} \right) + u_n^t, \ \forall n \qquad (22)$$

where b and d s are parameters to be estimated after pooling observations across countries for each good n. The export supply elasticity of good n in each exporting country is then given by:

$$e_{nn}^x \equiv \frac{\partial q_n^t(p^t, v^t)}{\partial p_n^t} \frac{p_n^t}{q_n^t} = \frac{b_{nn}}{s_n^t} + s_n^t - 10 \qquad (23)$$

We are facing the same econometric problems and data constraints as when estimating the export supply elasticities of the rest of the world, and we therefore follow the procedure described in the previous section.

3.3 DATA

The dataset used to estimate export supply elasticities consists of export values and quantities reported by different countries to the United Nations Comtrade system at the six-digit level of the HS classification (around 4,600 products).[16] The HS classification was introduced in 1988. The basic data set consists of an unbalanced panel of exports for 100 countries at the six-digit level of the HS classification for the period 1988–2009. The number of countries obviously varies across products, depending on the presence of export flows and on the availability of trade statistics using the HS classification.

There are three factor endowments included in the regression: labour, capital stock and agricultural land. Data on labour force and agricultural land are from the World Bank World Development Indicators (WDI). Data on capital endowments are constructed using the perpetual inventory method based on real investment data in WDI.

The estimation sample did not include goods where the recorded trade value at the six-digit level of the HS classification represented less than 0.01 per cent of exports (or it had an absolute value of less than $50,000). This eliminated less than 1 per cent of the value of exports in the sample, and it is necessary in order to avoid biasing our results with economically meaningless exports. The elasticities are constructed following equation (19), where the export share is the sample average (i.e. we constrained the elasticities to be time-invariant). We also purged the reported results from extreme values by dropping from the sample the top and bottom 1 per cent of the estimates.

[16] Available at the World Bank through the World Integrated Trade Solution.

3.4 EMPIRICAL RESULTS

We have estimated a total of 268,240 rest-of-the-world export supply elasticities corresponding to 100 importers at the six-digit level of the HS classification.[17] Figure 1 provides a plot of the distribution of the inverse of these rest-of-the-world supply elasticities, which captures the importer's market power when facing exports from the rest of the world. The inverse of these export supply elasticities is also equal to the level of the optimal tariff if the importer were to use its market power. The median of the inverse of the export supply elasticity of the rest of the world is equal to 0.044, which implies that the median optimal tariff in the world should be around 4.4 per cent.

Figure 1. Distribution of the inverse of export supply elasticities faced by importers

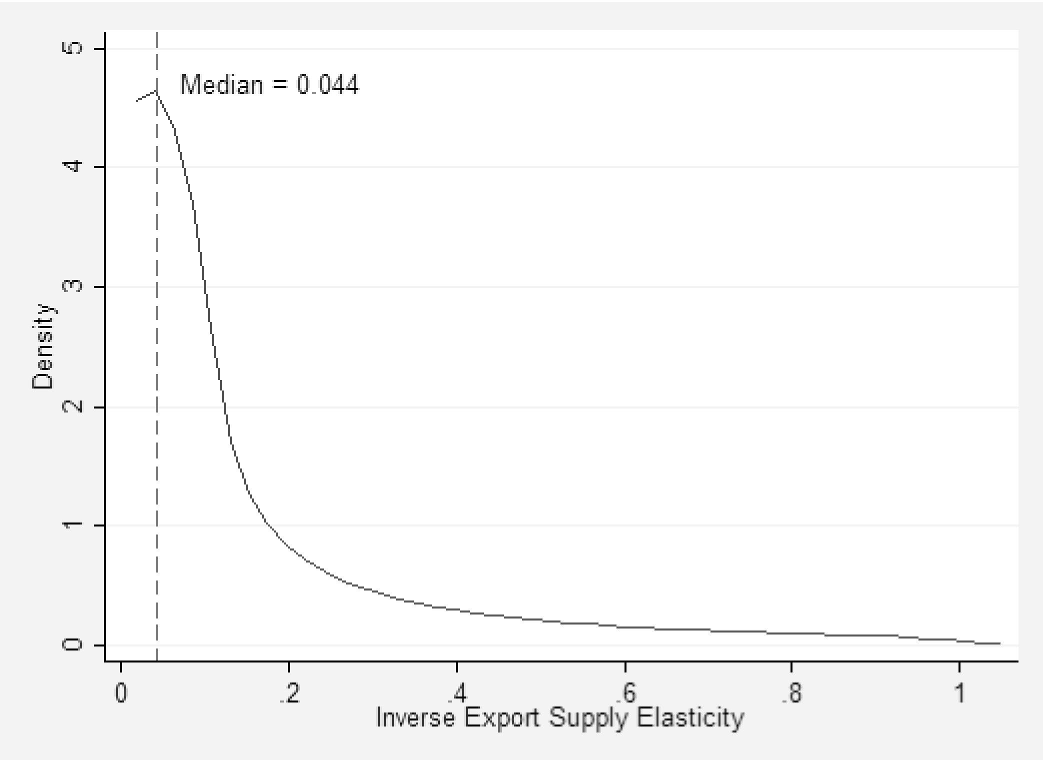


Table 1 also provides the mean and standard deviation of export supply elasticities faced by each importer in the sample used to estimate equation (14), so it excludes some countries for which we do not have applied or bound tariffs. Moreover, these elasticities do not take into account information about individual members of the European Union, given that this preferential trade agreement represents a single decision-making unity for trade policy purposes.[18] The economies facing the lowest export supply elasticities, and therefore having the strongest market power, are the United States and the European Union, with average optimal tariffs above 15 per cent. The countries facing the highest export supply elasticity, and therefore being close to price-taking behaviour in international markets are Burundi, Grenada and Benin, all with average optimal tariffs below 0.001 per cent.

[17] We have also estimated rest-of-the-world export supply elasticities for individual members of the European Union. If we count individual European members, we reach a total number of 317,348 rest-of-the-world export supply elasticities corresponding to 127 importers at the six-digit level of the HS classification.

[18] We perform the same analysis using data for individual members of the European Union instead. The results are very similar economically and statistically and are available upon request. In order to calculate the market power of the European Union, we followed a procedure similar to the one described in section 3: We first estimate parameter a_{nn} using equation (20) and then, using aggregated data for members of the European Union where we purged intra-European Union trade flows, we calculate market power using expression (19).

We provide a few external tests of these estimates. First, with information on import demand elasticities and export supply elasticities for each esporter, the rest of the world export supply epasticity faced by importer *i* can be approximated by:

$$e_i^* = \frac{1}{m_i/x_w}\left(e^{x^*} + \sum_{c \neq i} e_c^m \frac{m_c}{x_w}\right) \tag{24}$$

where e^{x^*} is the export supply of the entire world, which can be approximated by the weighted sum of export supply elasticities estimated from the exporter's point of view, and e_c^m is the absolute value of the import demand elasticity of country c, which has been estimated by Kee et al. (2008). The average and standard deviation of export supply elasticities estimated for each exporting country are given in table 1. The average could seem high, but it is important to remember that these export supply elasticities are estimated at the six-digit level of the HS classification keeping all prices constant, and among these prices that are kept constant there are some that are very close substitutes. For example, HS 010511 is the product code for live chickens under 185 grams, and HS 010512, for live turkeys under 185 grams. Note that in order to derive equation (24), we assumed that the export supplies were not differentiated by importer, whereas our estimates of e_i^* described in section 3.1 assume that the export supply elasticities of the rest of the world are differentiated by destination. Thus, we do not expect the estimates in section 3.1 to be equal to the ones in obtained using equation (24).

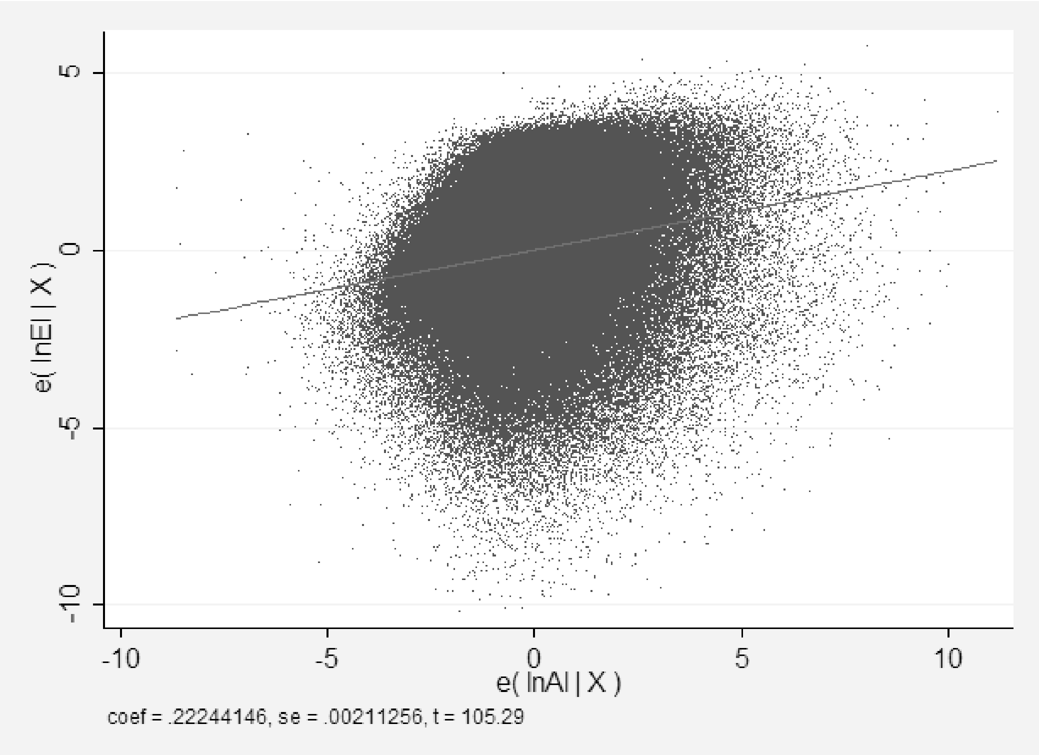
Table 2. External tests of the estimates of export supply elasticities faced by importers

	(1)	(2)	(3)	(4)
Log of export supply elasticity of rest of the world	0.222**			
(left-hand side of equation (24))	(0.002)			
Log of world's export supply elasticity		0.024**		
(right-hand side of equation (24))		(0.003)		
Log of import demand elasticity of rest of the world		0.09**		
(right-hand side of equation (24))		(0.004)		
Log of import share		-0.37**		-0.421**
(right-hand side of equation (24))		(0.002)		(0.003)
Log of Export supply elasticity of rest of the world			0.029	
(Broda et al. (2008) estimates)			(0.006)	
Log of GDP				-0.05**
				(0.002)
Log of remoteness				-0.179**
(inverse of distance-weigthed GDP of rest of the world)				(0.012)
R2 adjusted	0.139	0.164	0.249	0.505
Number of observations	2 68 240	268 225	9 378	196 185
Number of countries	119	119	13	119
HS six-digit fixed effects	No	No	No	Yes
Country fixed effects	Yes	Yes	Yes	No

Note: Robust standard errors are in parenthesis; ** stands for 5 per cent statistical significance and * stands for 10 per cent statistical significance.

In the first column of table 2, we provide estimates of the correlation between our estimate of the export supply elasticity faced by each importer and its proxy using equation (24).[19] In the second column we split equation (24) into its three elements: the world's export supply elasticity for each good, which is proxied by the weighted average export supply elasticity of each exporter; the import-weighted import demand elasticity in the rest of the world and the import share of the importer in world's markets. As expected, there is a positive correlation in the first column, and figure 2 provides a partial plot of our estimate of the export supply elasticity faced by each importer, against the one calculated using the right-hand side of equation (24). The positive correlation is clearly illustrated in figure 2. In the second column of table 2, as expected, when decomposing equation (24) into its three elements, we find that both average elasticities have a positive sign (the import demand elasticities are measured in absolute value), and the import share has a negative sign.

Figure 2. Correlation between the export supply elasticities faced by importers and those calculated using equation (24)



The second external test uses the estimates by Broda et al. (2008) of export supply elasticities faced by importers at the six-digit level of the HS classification for 13 countries that were not WTO members. Thus, the third column in table 2 provides the correlation between the estimates of Broda et al. and our estimates. There is a positive and statistically significant correlation for these 13 countries, which again confirms the validity of our estimates. Note again that their estimates and ours vary in the assumptions made to obtain them, as they impose a constant elasticity of scale structure on the demand side, whereas our elasticities are derived from the supply side (the GDP function) and we make no assumptions on the demand side. Thus, we should not expect the elasticities to be equal, but positively correlated as they both capture the export supply elasticities faced by importers.

[19] Note that in order to provide estimates of the proxy using equation (24) for all six-digit level HS goods, we replaced some missing average export supply elasticities with the four-digit HS average (or the two-digit HS average when the four-digit HS average was also missing). The reason is that it was impossible to estimate some export supply elasticities from the point of view of the exporter for some products using equation (23) because there was not enough variation in the data (not enough exporters). This was not a problem when estimating the export supply elasticity faced by importers using equation (19) because there was always a sufficiently large number of importers.

Finally, Broda et al. (2008) provides as an external test a regression of the export supply elasticities faced by the importer on the GDP of each importing country, the importer's share in world markets and a measure of the remoteness of each importing country. Remoteness is defined as the inverse of the distance-weighted GDP of all the other countries in the world. In the fourth column of table 2 we found, as in Broda et al. (2008), a negative correlation between the rest of the world's export supply elasticities and the GDP of the importer, the share of the importer's in world markets and its remoteness. The first two results suggest that larger countries are likely to face smaller elasticities, and therefore have more market power. The third results suggest that countries located far from world markets are more likely to have market power. Broda et al (2008) explains this negative correlation by the fact that isolated markets are likely to absorb a larger share of regional demand due to higher trade costs with the rest of the world.

4. EVIDENCE OF COOPERATIVE BEHAVIOUR IN THE TARIFF WATERS OF THE WORLD TRADE ORGANIZATION

To empirically assess the degree to which WTO member countries cooperate in WTO tariff waters, we rely on the estimation of equation (14). We use data on applied MFN tariffs and tariff bounds for the period 2000–2009.[20]

Table 1 provides the average and standard deviation applied MFN and bound tariffs, as well as information on tariff water across countries. It is clear that among developed nations only Australia and New Zealand have significant amounts of tariff water, with 7 percentage points and an average difference of 9 percentage points between their bound and applied tariffs, respectively. On the other hand, most developing countries have more than 10 percentage points of tariff water in their tariff schedules, reaching over 40 percentage points in several cases.

We also need data on rest-of-the-world export supply elasticities, which are used to measure importers' market power, as well as the export supply elasticity from the point of view of exporters, which are used as an instrument of market power, as discussed in section 2. The estimation of these elasticities was discussed in the previous section. Finally, we need import demand elasticities, which are borrowed from Kee et al. (2008).

To test our two predictions, we estimate equation (14) using six different measures of market power. In the first specification we use our estimate of market power ($1/e^*$). However, it is clear that the elasticities are measured with errors, since they are the outcome of the econometric strategy described in section 3. Moreover, the data described in table 1 show that there are important outliers given that the standard deviation is often several times larger than the average elasticity. For these reasons, we follow Broda et al. (2008) in considering alternative nonlinear measures of market power. The second specification uses the log of $1/e^*$. The third specification uses a dummy that takes a value of 1 for goods that are in the top and middle thirds of the distribution of market power within each country. The fourth column uses separate dummies for the top third and the middle third of goods in terms of market power within each country. Broda et al. (2008) builds these dummies using the elasticity distribution within each country, but one could argue that the top third of goods in terms of market power in Burundi may well be at the bottom of the market power distribution when considering all countries and goods. Thus, the fifth specification uses a dummy that takes a value of 1 when the market power of a country in a particular good is at the top or middle thirds of the world distribution of market power. The last specification splits this dummy into two dummies that capture the top third and the middle third separately, as in the fourth specification.

Table 3 presents the ordinary least squares (OLS) results of equation (14), which broadly confirm the prediction that in the absence of water, i.e. in the presence of tariff cooperation, the

[20] This circumvents the problem that bound tariffs negotiated during the Uruguay Round were allowed a transition period until 2000, which may artificially create negative or positive tariff water. The applied MFN tariffs were obtained using the World Integrated Trade Solution, while tariff bounds negotiated during the Uruguay Round were provided by WTO.

importer's market power is negatively correlated with applied tariffs in the absence of water. With the exception of the specification in the first column, all coefficients on the importer's market power are statistically significant.

Table 3. Is market power used within tariff waters? OLS estimates

	(1)	(2)	(3)	(4)	(5)	(6)
Import market power	-6.88E-07 (0.0001)					
Log of import market power		-0.0019** (0.0001)				
Dummy for high and medium power (within)			-0.0047** (0.0007)			
Dummy for high power (within)				-0.007** (0.001)		
Dummy for medium power (within)				-0.0028** (0.0003)		
Dummy for high and medium power (across)					-0.0071** (0.0009)	
Dummy for high power (across)						-0.0129** (0.0018)
Dummy for medium power (medium)						-0.0049** (0.0004)
Water	-0.062** (0.0097)	-0.0481** (0.0132)	-0.0749** (0.0063)	-0.0753** (0.0061)	-0.0777** (0.0061)	-0.0789** (0.0057)
Power*water (high in (4) and (6))	0.0001** (0.0000)	0.0047** (0.0010)	0.0182** (0.0051)	0.0311** (0.0104)	0.0239** (0.0061)	0.0443** (0.0129)
Medium market power*water				0.0061** (0.0015)		0.0073** (0.0016)
Uses power when water is large (high)	-2.02p.p. (2.06)	40.42p.p.** (7.09)	25.82p.p.** (3.92)	19.35p.p.** (2.37)	29.71p.p** (4.35)	29.12p.p.** (4.6)
Uses power when water is large (medium)				46.67p.p.** (8.52)		67.12p.p.** (11.45)

Note: All columns include year, HS six-digit and country x year x HS two-digit fixed effects. Robust standard errors are in parenthesis; ** stands for 5 per cent statistical significance and * stands for 10 per cent statistical significance. F-statistics indicate all regressions are significant at the 1 per cent level. Number of observations in each specification is 1,690,909.

Results also tend to confirm that this relationship tends to become positive in the presence of tariff water, as the interaction term between water and the importer's market power is positive and statistically significant, with the exception of the specification in the first column. This suggests that in the presence of tariff water, countries tend to set non-cooperative tariffs.

However, the degree of tariff water needed for the derivative of tariffs with respect to market power to become positive is between between 19 percentage points and 67 percentage points, depending on the specification, as can be seen from the bottom panel of table 3. Thus, very large amounts of tariff water are needed to start observing non-cooperative tariffs. Less than a third of the observations in the sample used in table 3 have tariff water levels above 19 percentage points, while less than 3 per cent have tariff water levels above 67 percentage points. This suggests that cooperative tariffs are observed in WTO beyond tariff bounds and well within its tariff waters.

Interestingly, the results displayed in the fourth and sixth columns strongly suggest that the degree of water needed for countries to use their market power is lower for goods in countries that have high market power than for goods in countries which have medium or low market power. Thus, non-cooperative tariffs within WTO tariff waters are more likely to be observed when countries have extensive market power.

Table 4. Is market power used within tariff waters? IV estimates

	(1)	(2)	(3)	(4)	(5)	(6)
Import market power	-0.0159** (0.0033)					
Log of import market power		-0.0168** (0.0016)				
Dummy for high and medium power (within)			-0.0026 (0.0042)			
Dummy for high power (within)				-0.0083* (0.0046)		
Dummy for medium power (within)				-0.0871** (0.0226)		
Dummy for high and medium power (across)					-0.0821** (0.0049)	
Dummy for high power (across)						-0.059** (0.0191)
Dummy for medium power (medium)						-0.0285 (0.0492)
Water	-0.0614** (0.0064)	-0.6197* (0.3611)	-0.1005** (0.0142)	-0.129** (0.0165)	-0.153** (0.0138)	-0.1299** (0.0267)
Power*water (high in (4) and (6))	-0.0099** (0.0294)	-0.1616** (0.1062)	0.063** (0.0232)	0.0902** (0.0268)	0.1336** (0.0207)	0.1034** (0.0258)
Medium market power* water				0.1031** (0.0309)		0.1071** (0.0535)
Uses power when water is large (high)	-160.61p.p. (484.25)	-10.39p.p. (7.66)	0 p.p (5.95)	9.09p.p.** (4.02)	61.45p.p** (8.21)	57.06p.p.** (12.07)
Uses power when water is large (medium)				84.48p.p.** (23.4)		26.61p.p. (31.14)
Hansen's Orthogonality Test	6.26	0.842	0.499	1.49	0.05	4.12
(p-value)	(0.01)	(0.36)	(0.48)	(0.47)	(0.823)	(0.13)
Kleibergen-Paap's Weak IV Test	1.79	0.29	471.37	10.38	686.1	4.62
(pass 5 per cent critical value?)	N	N	Y	Y	Y	Y

Note: all columns include year, HS six-digit and country x year x HS two-digit fixed effects. Standard errors are in parenthesis; ** stands for 5 per cent statistical significance and * stands for 10 per cent statistical significance. Instruments for water and power include water vapour, the average import demand elasticity in the rest of the world for a given HS six-digit good and country, the interaction between water vapour and the average import demand elasticity in the rest of the world, and between water vapour and the average across countries of the export supply elasticity from the point of view of exporters. Columns 3 to 6 use dummies derived from these variables as in Broda et al. (2008). High corresponds to the top third of the distribution and medium to the those in the middle of the distribution. Columns 3 and 4 calculate these dummies within each country elasticity distribution, whereas columns 5 and 6 calculate these dummies across all countries. F-statistics are not displayed, but they suggest that all estimated models are statistically significant at the 1 per cent level. Number of observations in each specification is 1,562,047.

The estimates in table 3 could suffer from endogeneity bias as discussed in section 2. Thus, table 4 presents results instrumenting for tariff water and market power. Water is instrumented using measures of water vapour, and market power is instrumented using the exogenous right-hand-side variables in equation (24): the average import demand elasticity in the rest of the world, and the world's export supply elasticity (although the latter is perfectly collinear with the HS six-digit fixed effects and therefore is excluded from the list of instruments).[21] The interaction of water with the importer's market power is instrumented using the interaction of water vapour with the average import demand elasticity in the rest of the world and the interaction of water vapour with the world's export supply elasticity ($e^{x\mathring{a}}$). Note that the number of instruments is larger than the number of endogenous variables, which will allows us to test for the validity of the instruments using an over-identification test.

The results in table 4 largely confirm that tariffs are set cooperatively in the absence of tariff water. The coefficient on the importers' market power is negative and statistically significant across specifications, except in the third column. Results also tend to confirm that importing countries start using their market power in in the presence of large amounts of tariff water, as the interaction between market power and tariff water is positive and significant except in the first two columns. Note that in columns 1 and 2 we cannot reject the null hypothesis that we are in the presence of weak instruments, which may bias our results and explain the statistically insignificant coefficients.

However, as in the OLS results in table 3, the amount of tariff water needed for the derivative of tariffs with respect to market power to become positive is still very large, suggesting that we only observe a positive correlation on a small number of tariff lines. Significant levels of tariff water are required to observe non-cooperative tariffs in the WTO.[22]

4.1 FEAR OF RETALIATION

The results described above suggest that WTO members tend to behave more cooperatively than is legally required. Why is it that they do not use their market power when there are no legal constraints? A potential explanation is fear of retaliation from trading partners. Consider a country with a significant amount of tariff water in its tariff schedule. When evaluating whether or not to raise its tariffs to non-cooperative levels, the cost of retaliatory trade measures by trading partners with significant amounts of market power and tariff water would have to be weighted against the terms-of-trade gains associated with the non-cooperative tariff.

Blonigen and Bown (2003) and Bown (2004) have shown that retaliation threats make importing countries less likely to impose antidumping measures and more likely to behave cooperatively within the WTO legal commitments. In order to explore whether fear of retaliation can make WTO members behave more cooperatively outside the WTO legal commitments, i.e within WTO tariff waters, we first need to construct a measure of fear of retaliation and then check whether importing countries are more prone to using their market power within their tariff waters when they have little fear of retaliation from their trading partners.

Let's denote the fear of retaliation in country c by F_c which, by construction, does not vary across tariff lines, as trading partners do not necessarily retaliate within the same tariff line, but can retaliate across their entire import bundle.[23] We define fear of retaliation as the average maximum

[21] We do not use the import share of the importer in world trade, which appears on the right-hand side of equation (24) because this is likely to be endogenous to applied tariffs.

[22] These results are broadly confirmed when using an instrumental variable (IV) between estimator instead of the within estimator used for the results reported in table 4. Indeed our main source of variation is across HS six-digit lines and within HS two-digit lines for each country and year, and therefore the between estimator provides very similar results to the ones reported in tables 3 and 4. Results of tables 3 and 4 are also confirmed when using data for individual European countries. The results are similar to those described in tables 3 and 4 and are available upon request.

[23] There are some well-known anecdotal examples of this. In 1999, the United States imposed 100 per cent tariffs on nine different goods imported from Europe ranging from pecorino cheese to cashmere clothing, in retaliation against the European Union's banana regime.

increase in tariffs in partner countries that would lead to the same decline in country c's value of exports than if all partners were to increase their current applied tariffs to their bound levels. This definition is similar in spirit to the one used to define trade restrictiveness in Anderson and Neary (1996, 2003). To apply their concept we use the partial equilibrium approach developed by Feenstra (1995) and used by Kee et al. (2009) to measure trade restrictiveness. We denote country c's partner countries with subscript j while we continue to use subscript p to identify products. Fear of retaliation in country c is then defined as:

$$F_c : \Delta\left(\sum_p \sum_j p^*_{p,j} m_{p,j,c}\right)_{\Delta t_{p,j}=W_{p,j}} = \Delta\left(\sum_p \sum_j p^*_{p,j} m_{p,j,c}\right)_{\Delta t_{p,j}=F_c} \tag{25}$$

where $m_{p,j,c}$ represents country j's imports of product p from country c. Note that on the right-hand side of (25) we index the world price by product p, given that we allow for products of type p imported by different countries to be heterogenous and assume that all countries change their applied MFN tariffs to the same uniform tariff that replicates the change in imports from country c, which is described on the left-hand side of this expression.

Totally differentiating both sides of the equality in equation (25), noting that by definition the change in partner tariffs on the left-hand side is equal to the extent of water available in their tariff schedule, allows us to solve for the fear of retaliation in country c, F_c. Note that the marginal change in world prices faced by importer j following a change in its MFN tariff on each good p (assuming goods from different sources are homogenous) is given by:[24]

$$\frac{\partial p^*_{p,j}}{\partial t_{p,j}} = \frac{\varepsilon^m_{p,j}}{\left(1+t_{p,j}\right)\left(\varepsilon^*_{p,j}+\varepsilon^m_{p,j}\right)} \tag{26}$$

where $\varepsilon^m_{p,j} > 0$ is the absolute value of the import demand elasticity of good p in partner j.

Differentiating equation (25) with respect to changes in partner tariffs $t_{p,j}$, using equation (26), and solving for F_c yields (while taking the absolute value of the changes in exports):

$$F_c = \frac{\sum_p \sum_j m_{p,j,c} \dfrac{\varepsilon^m_{p,j}}{\left(1+t_{p,j}\right)\left(\varepsilon^*_{p,j}+\varepsilon^m_{p,j}\right)}\left(1+\varepsilon^{x*}_{p,c}\right)W_{p,j}}{\sum_p \sum_j m_{p,j,c} \dfrac{\varepsilon^m_{p,j}}{\left(1+t_{p,j}\right)\left(\varepsilon^*_{p,j}+\varepsilon^m_{p,j}\right)}\left(1+\varepsilon^{x*}_{p,c}\right)}. \tag{27}$$

where $\varepsilon^{x*}_{p,c}$ is the export supply elasticity of country c as an exporter of product p. The comparative statistics are clear. If the importing partner country has great market power (i.e. a small $\varepsilon^*_{p,j}$), then the tariff water ($W_{p,j}$) on exports of that good from that partner has a greater weight in our measure of fear of retaliation. Similarly, the stronger the import demand from the partner, the

[24] This is obtained by starting from the identity between the total imports of good p by country j being equal to the total exports of the rest of the world of good p to country j, and then differentiating.

larger the weight given to water in that partner's product. The same is true for exports to that partner as well as the export supply elasticity of country c of product p.

Equation (27) enables us to quantify the fear of retaliation in each country in the sample. We then split the countries into countries with high, medium and low levels of fear of retaliation. We use data for the year 2006 to estimate (27), since this is the year before the financial crisis. We then estimate equation (14) separately for countries with low and high fear of retaliation. We expect to find more evidence of cooperation within tariff waters for countries with a high level of fear of retaliation, and more evidence of non-cooperative tariff-setting for countries with a low level.

Table 5 shows the IV results of the estimation of equation (14) for the two sample of countries with low and high fear of retaliation. We use two measures of market power: the log of the inverse export supply elasticity in columns 1 and 2, and a dummy that takes a value of 1 for observations that are in the top and middle third of the distribution of market power across all countries and goods in columns 3 and 4.

In the absence of tariff water, market power is negatively correlated with applied tariffs in the samples concerning both low and high levels of fear of retaliation, except perhaps in column 3 where the negative coefficient is not statistically significant. More interestingly, the use of market power in the presence of large amounts of tariff water is only observed for countries with a low level of fear of retaliation. Indeed, the coefficient on the interaction of market power and tariff water is positive and significant only in the sample of countries which have low fear of retaliation. In the case of countries which have more to lose from retaliation from their trading partners, there is no evidence of non-cooperative tariff-setting as the coefficient on the interaction between market power and tariff water is either negative or not statistically significant.

Table 5. Market power and fear of retaliation – IV estimates

	(1) Low level of fear	(2) High level of fear	(3) Low level of fear	(4) High level of fear
Log of import market power	-0.0087**	-0.0064**		
	(0.0015)	(0.0025)		
Dummy for high and medium power (across)			-0.0153	-0.0742**
			-0.0102	(0.0078)
Water	0.2303	-0.3166**	-0.0814**	-0.139**
	-0.1667	(0.1329)	(0.0140)	(0.0362)
Power* water	0.0779*	-0.0744*	0.0273*	0.0763
	(0.042)	(0.042)	(0.0151)	(0.0525)
Hansen's Orthogonality Test	2.585	7.231	0.255	25.23
(p-value)	(0.11)	(0.01)	(0.61)	(0.00)
Kleibergen-Paap's Weak IV Test	1.118	1.069	98.94	465.95
(pass 5 per cent critical value?)	N	N	Y	Y

Note: all columns include year, HS six-digit and country x year x HS two-digit fixed effects. Standard errors are in parenthesis; ** stands for 5 per cent statistical significance and * stands for 10 per cent statistical significance. Instruments for water and power include water vapour, the average import demand elasticity in the rest of the world for a given HS six-digit good and country, the interaction between water vapour and the average import demand elasticity in the rest of the world, and between water vapour and the average across countries of the export supply elasticity from the point of view of exporters. F-statistics are not displayed but they suggest that all estimated models are statistically significant at the 1 per cent level. Number of observations in columns 1 and 2 is 429469 and 557664, respectively. In the case of columns 3 and 4, the number of observations is 358,669 and 675,740, respectively.

5. CONCLUDING REMARKS

The paper explores the extent of cooperative and non-cooperative tariff-setting in the WTO in the presence of a terms-of-trade rationale for cooperation. We exploit the extent of tariff water of WTO members to distinguish between the potential for cooperative and non-cooperative tariff-setting. In principle, the absence of tariff water reflects cooperation in tariff-setting, as tariffs cannot be legally increased to exploit the importer's market power. On the other hand, tariff water opens the door to non-cooperative tariff-setting, as tariffs could be increased to further exploit market power without violating the importer's WTO commitments.

To guide us in our empirical study, we build a simple model where politically motivated governments put an extra weight in their objective function to the profits of producers in the import-competing sector, as well as exporters. Depending on the costs and gains from cooperation, tariffs are set either cooperatively or non-cooperatively. When the gains from cooperation are too small, an exogenous tariff bound is set, leading to tariff water in the importing countries' tariff schedules. We then show that when countries cooperate, tariffs are negatively correlated with the market power of the importer. Indeed, the more market power the importer has, the stronger the incentives for exporters in the rest of the world to negotiate harder for lower tariffs. On the other hand, when tariffs are set non-cooperatively, we have the textbook positive relationship between importers' market power and tariffs.

To test these predictions, we first estimate the degree of market power (the inverse of the rest-of-the-world export supply elasticity faced by each importer) at the tariff line level for more than 100 WTO member countries. Our econometric approach is based on Kholi's (1991) revenue function approach, and is sufficiently flexible to allow us to also estimate export supply elasticity for each exporter.

We use then our elasticity estimates to study the effects of market power on tariffs with and without tariff water. Because market power and tariff water may be endogenous we use an instrumental variable approach where the extent of tariff water above the prohibitive tariff (water vapour), the average import demand elasticity in the rest of the world and the export supply elasticity of the world are used as instruments.

Results are in line with the theoretical predictions. We find that in the absence of tariff water, importing countries' market power tends to be negatively correlated with applied tariffs, which is consistent with cooperative tariff-setting. On the other hand, in the presence of tariff water, the relationship between importers' market power and tariffs tends to become positive, suggesting a tendency towards non-cooperative tariffs.

However, the positive correlation between importers' market power and tariffs is only observed when levels of tariff water are above 20 percentage points. In the presence of moderate levels of tariff water, WTO members tend to set their tariffs cooperatively. Thus, cooperation is not only observed in the negotiation of bound tariffs, but is also present within WTO's tariff waters.

One explanation for cooperative behaviour in the absence of legal constraints is the fear of retaliation from trading partners with significant amounts of market power and tariff water. We show that WTO members that have little to lose from retaliation tend to set tariffs non-cooperatively within their tariff waters, while WTO members that may have more to lose in case of retaliation are more likely to set tariffs cooperatively within their tariff waters.

In sum, the paper shows that WTO members' negotiated tariffs are consistent with the internalization of terms-of-trade motives not only when these tariffs are close to bound levels, but also in the presence of moderate amounts of tariff water.

REFERENCES

Amador M and Bagwell K (2012). Tariff revenue and tariff caps. *American Economic Review.* 102(3): 459–65.

Anderson J and Neary P (1996). A new approach to evaluating trade policy. *Review of Economics and Statistics.* 63:107–125.

Anderson J and Neary P (2003). The mercantilist index of trade policy. *International Economic Review.* 44:627–649.

Arellano M and Bond S (1991). Some tests of specification for panel data: Monte Carlo evidence and an application to employment equations. *Review of Economic Studies.* 58:277–297.

Arellano M and Bover O (1995). Another look at the instrumental variable estimation of error-components models. *Journal of Econometrics.* 68:29–51.

Bagwell K and Staiger RW (1999). An economic theory of GATT. *American Economic Review.* 89(1): 215–248.

Bagwell K and Staiger RW (2011). What do trade negotiators negotiate about? Empirical evidence from the World Trade Organization. *American Economic Review.* 101(4):1238–73.

Beshkar M, Bond E and Rho Y (2012). Tariff binding and overhang: Theory and evidence. Working paper.

Blonigen B and Bown C (2003). Antidumping and retaliation threats. *Journal of International Economics.* 60:249–273.

Bown C (2004). On the economic success of GATT/WTO dispute settlement. *Review of Economics and Statistics.* 86:811–823.

Broda C, Limão N and Weinstein DE (2008). Optimal tariffs and market power: The evidence. *American Economic Review.* 98(5):2032–65.

Caves DW, Christensen LR and Diewert E (1982). Multilateral comparisons of output, input, and productivity using superlative index numbers. *Economic Journa.l* 92:73–86.

Croome J (1995). *Reshaping the World Trading System: A History of the Uruguay Round*. World Trade Organization.

Edgeworth F (1894). Theory of international values. *Economic Journal.* 4:606–638.

Feenstra R (1995). Estimating the effects of trade policy. In: *Handbook of International Economics.* Vol. 3.

Foletti L, Fugazza M, Nicita A and Olarreaga M (2011). Smoke in the (tariff) water. *The World Economy.* 34(2):248–264.

Gawande K, Krishna P and Olarreaga M (2012). Lobbying competition over trade policy. *International Economic Review.* 53(1):115–132.

Grossman GM and Helpman E (1995). Trade wars and trade talks. *Journal of Political Economy.* 103(4):675–708.

Hoekman B and Kostechi M (2009). *The Political Economy of the World Trading System.* Oxford University Press. Third Edition.

Horn H, Maggi G and Staiger R (2010). Trade agreements as endogenously incomplete contracts. *The American Economic Review*. 100(1):394–419.

Kee HL, Nicita A and Olarreaga M (2008). Import demand elasticities and trade distortions. *The Review of Economics and Statistics.* 90(4):666–682.

Kohli U (1991). *Technology, Duality, and Foreign Trade: The GNP Function Approach to Modeling Imports and Exports.* The University of Michigan Press. Ann Arbor, Michigan.

Olarreaga M, Soloaga I and Winters A (1999). *What's Behind MERCOSUR's Common External Tariff?* , Policy Research Working Paper Series 2231. World Bank.

Semykina A and Wooldridge J (2010). "Estimating panel data models in the presence of endogeneity and selection: Theory and application. *Journal of Econometrics.* 157(2):375–380.

UNCTAD study series on

POLICY ISSUES IN INTERNATIONAL TRADE AND COMMODITIES

No. 30 Sam Laird, David Vanzetti and Santiago Fernández de Córdoba, **Smoke and mirrors: Making sense of the WTO industrial tariff negotiations**, 2006, Sales No. E.05.II.D.16.

No. 31 David Vanzetti, Santiago Fernandez de Córdoba and Veronica Chau, **Banana split: How EU policies divide global producers**, 2005, 27 p. Sales No. E.05.II.D.17.

No. 32 Ralf Peters, **Roadblock to reform: The persistence of agricultural export subsidies**, 2006, 43 p. Sales No. E.05.II.D.18.

No. 33 Marco Fugazza and David Vanzetti, **A South–South survival strategy: The potential for trade among developing countries**, 2006, 25 p.

No. 34 Andrew Cornford, **The global implementation of Basel II: Prospects and outstanding problems**, 2006, 30 p.

No. 35 Lakshmi Puri, IBSA: **An emerging trinity in the new geography of international trade**, 2007, 50 p.

No. 36 Craig VanGrasstek, **The challenges of trade policymaking: Analysis, communication and representation**, 2008, 45 p.

No. 37 Sudip Ranjan Basu, **A new way to link development to institutions, policies and geography**, 2008, 50 p.

No. 38 Marco Fugazza and Jean-Christophe Maur, **Non-tariff barriers in computable general equilibrium modelling**, 2008, 25 p.

No. 39 Alberto Portugal-Perez, **The costs of rules of origin in apparel: African preferential exports to the United States and the European Union**, 2008, 35 p.

No. 40 Bailey Klinger, **Is South–South trade a testing ground for structural transformation?**, 2009, 30 p.

No. 41 Sudip Ranjan Basu, Victor Ognivtsev and Miho Shirotori, **Building trade-relating institutions and WTO accession**, 2009, 50 p.

No. 42 Sudip Ranjan Basu and Monica Das, **Institution and development revisited: A nonparametric approach**, 2010, 26 p.

No. 43 Marco Fugazza and Norbert Fiess, **Trade liberalization and informality: New stylized facts**, 2010, 45 p.

No. 44 Miho Shirotori, Bolormaa Tumurchudur and Olivier Cadot, **Revealed factor intensity indices at the product level,** 2010, 55 p.

No. 45 Marco Fugazza and Patrick Conway, **The impact of removal of ATC Quotas on international trade in textiles and apparel,** 2010, 50 p.

No. 46 Marco Fugazza and Ana Cristina Molina, **On the determinants of exports survival,** 2011, 40 p.

No. 47 Alessandro Nicita, **Measuring the relative strength of preferential market access,** 2011, 30 p.

No. 48 Sudip Ranjan Basu and Monica Das, **Export structure and economic performance in developing countries: Evidence from nonparametric methodology,** 2011, 58 p.

No. 49 Alessandro Nicita and Bolormaa Tumurchudur-Klok, **New and traditional trade flows and the economic crisis,** 2011, 22 p.

No. 50 Marco Fugazza and Alessandro Nicita, **On the importance of market access for trade,** 2011, 35 p.

No. 51 Marco Fugazza and Frédéric Robert-Nicoud, **The 'Emulator Effect' of the Uruguay round on United States regionalism,** 2011, 45 p.

No. 52 Sudip Ranjan Basu, Hiroaki Kuwahara and Fabien Dumesnil, **Evolution of non-tariff measures: Emerging cases from selected developing countries,** 2012, 38p.

No. 53 Alessandro Nicita and Julien Gourdon, **A preliminary analysis on newly collected data on non-tariff measures,** 2013, 31 p.

No. 54 Alessandro Nicita, Miho Shirotori and Bolormaa Tumurchudur Klok, **Survival analysis of the exports of least developed countries: The role of comparative advantage,** 2013, 25 p.

No. 55 Alessandro Nicita, Victor Ognivtsev and Miho Shirotori, **Global supply chains: Trade and Economic policies for developing countries,** 2013, 33 p.

No. 56 Alessandro Nicita, **Exchange rates, international trade and trade policies,** 2013, 29 p.

No. 57 Marco Fugazza, **The economics behind non-tariff measures: Theoretical insights and empirical evidence,** 2013, 33 p.

No. 58 Marco Fugazza and Alain McLaren, **Market access, export performance and survival: Evidence from Peruvian firms,** 2013, 39 p.

No. 59 Patrick Conway, Marco Fugazza and M. Kerem Yuksel, **Turkish enterprise-level response to foreign trade liberalization: The removal of agreements on textiles and clothing quotas,** 2013, 54 p.

No. 60 Alessandro Nicita and Valentina Rollo, **Tariff preferences as a determinant for exports from Sub-Saharan Africa,** 2013, 30 p.

No. 61 Marco Fugazza, Jan Hoffmann and Rado Razafinombana, **Building a dataset for bilateral maritime connectivity,** 2013, 31 p.

No. 62 Alessandro Nicita, Marcelo Olarreaga and Peri Silva, **Cooperation in the tariff waters of the World Trade Organization,** 2014, 39 p.

Copies of UNCTAD study series on *Policy Issues in International Trade and Commodities* may be obtained from the Publications Assistant, Trade Analysis Branch, Division on International Trade in Goods and Services, and Commodities, United Nations Conference on Trade and Development, Palais des Nations, CH-1211 Geneva 10, Switzerland (Tel: +41 22 917 4644). These studies are accessible at http://www.unctad.org/tab.

QUESTIONNAIRE

UNCTAD Study series on

POLICY ISSUES IN INTERNATIONAL TRADE AND COMMODITIES

(Study series no. 62: Cooperation in the tariff waters of the World Trade Organization)

Readership Survey

Since 1999, the Trade Analysis Branch of the Division on International Trade in Goods and Services, and Commodities of UNCTAD has been carrying out policy-oriented analytical work aimed at improving the understanding of current and emerging issues in international trade and development. In order to improve the quality of the work of the Branch, it would be useful to receive the views of readers on this and other similar publications. It would therefore be greatly appreciated if you could complete the following questionnaire and return to:

Trade Analysis Branch, DITC
Rm. E-8065
United Nations Conference on Trade and Development
Palais des Nations, CH-1211 Geneva 10, Switzerland
(Fax: +41 22 917 0044; E-mail: tab@unctad.org)

1. Name and address of respondent (optional):

____

____

____

____

2. Which of the following describes your area of work?

Government	☐	Public enterprise	☐
Private enterprise institution	☐	Academic or research	☐
International organization	☐	Media	☐
Not-for-profit organization	☐	Other (specify)	________________

3. In which country do you work? ____

4. Did you find this publication to your work? ☐ Very useful ☐ Of some use ☐ Little use

5. What is your assessment of the contents of this publication?
☐ Excellent ☐ Good ☐ Adequate ☐ Poor

6. Other comments:

____

____

____

____

Printed at United Nations, Geneva
GE.14-50017 – January 2014 – 253

UNCTAD/ITCD/TAB/62

United Nations publication
ISSN 1607-8291