

Domestic Product Standards and Free Trade Areas*

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Abstract

This study considers endogenous determination of domestic standards on products that cause negative consumption externalities in the presence of a possible free trade area (FTA) in a three-country world, and examines how an FTA affects the optimal levels of (external) tariffs and standards chosen by each country and national welfare. We demonstrate that under an FTA, member countries' standards become more stringent than under a tariff-war equilibrium based on the most-favored-nation (MFN) clause. Member countries' welfare may or may not be higher under the FTA than under the MFN equilibrium, whereas the nonmember country unambiguously become better off after the FTA formation. We also compare two regimes, national standards and harmonization, regarding the choice of standards by the FTA members and show that in comparison with the national standards, harmonization of standards within an FTA will lead the member countries to choose less stringent standards and make the formation of the FTA more favorable.

Keywords: Regionalism; Optimal tariffs; Standards; Free trade areas; International oligopoly

JEL classifications: F12; F13; F15; F18

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