Economic Integration and Rules of Origin under International Oligopoly*

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Free trade areas (FTAs) have rules of origin (ROOs) to prevent tariff circumvention by firms of non-member countries. In this paper, we have explored of ROOs in the framework of international oligopoly. In particular, we have pointed out an effect of ROOs which has been ignored in the existing literature. That is, ROOs lead to incomplete market integration (including market segmentation) for the firm located outside the FTA. Thus, ROOs generate two effects: the anti-tariff-circumvention and price-discrimination effects. The anti-tariff-circumvention effect is beneficial to the producer located in the FTA but is harmful to the producer located outside the FTA. On the other hand, the price-discrimination effect benefits the producer located outside the FTA. There is a case where the price-discrimination effect is harmful to the producer located in the FTA. Therefore, the net effect of ROOs on profits is ambiguous and depends on the magnitude of these two effects.

For the producer located in the FTA, the net effect of ROOs depends on the difference in the substitutability of products as well as that in the external tariffs. If the difference in the substitutability of products is not so large relative to that in the external tariffs, ROOs could be harmful to the producer located in the FTA.

In particular, the following two cases are noteworthy. In one case, ROOs benefit the firm

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located outside the FTA and hurts the firm located inside the FTA. Thus, although ROOs let the firm located outside the FTA face the higher tariff, they do not necessarily protect the firm in the FTA. In another case, both producers gain from ROOs at the expense of consumers. In this case, thus, ROOs become a device to generate a collusive effect.

Our analysis also sheds light on the FTA versus customs union (CU) comparison. An FTA without ROOs is regarded as a CU which sets the common tariff equal to the lowest external tariff among the members. Hence, our analysis can be reinterpreted as the comparison between an FTA and a CU. Our analysis suggests that it is not possible to determine one arrangement is always superior to the other from the viewpoint of welfare. However, we have pointed out an important role of ROOs under oligopoly, which is potentially an essential factor in the FTA versus CU comparison.