A Firm Delocation Theory of WTO Subsidy Rules

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Abstract

I construct a theory of trade agreements in which nations negotiate over both domestic policies and trade policies in a monopolistically competitve setting. My theory contributes to two trade policy questions: first, what problems do trade agreements solve? Second, what explains the evolution of domestic subsidy rules between the GATT and the WTO? I show that trade agreements must solve a firm-delocation problem – a prisoners' dilemma arising when nations use domestic subsidies to attract firm entry within their borders. This problem persists even when nations have both import and export policies at their disposal. GATT nonviolation complaints, designed to prevent domestic policies that undermine market access commitments, do not support efficient agreements when countries have sufficiently strong political economic motivations. This inefficiency leaves a role for additional remedies against subsidies, such as countervailing duties and WTO disputes forcing removal of "trade-distorting" subsidies.

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