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Preferential Trading Agreements and Economic Reforms in Developing Countries

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Abstract

How do domestic politics influence the formation of international institutions, and what are the effects of international institutions on domestic politics? In this policy paper, we examine how leaders use preferential trading agreements (PTAs) with the European Union and the United States to promote liberal economic policies. We argue that under democratization, new leaders would benefit the most from credible commitment and side payments to compensate vulnerable domestic constituencies for their losses. Our empirical analysis shows that under democratization, leader change greatly increases the probability that the government of a developing country begins treaty negotiations. We also demonstrate that PTAs induce liberalization in different sectors of the economy.

Introduction

Preferential trading agreements (PTAs) have proliferated rapidly in recent years. Between 1950 and 2012, the GATT/WTO received 511 notifications of PTAs, with an additional 370 PTAs being notified by the GATT/WTO under Article XXIV.[3] Europe is at the forefront of this proliferation. Indeed, no other region in the world experienced the formation of as many PTAs as Europe and only Chile and Mexico formed a number of PTAs that is comparable to the number of PTAs formed by European countries.[4] Croatia is not an exception, since it joined the Central European Free Trade Agreement (2006) and PTAs with the EU, EFTA, and Turkey.

The depth and scope of these agreements varies widely. Some agreements are not much more than vague, symbolic statements about the importance of economic cooperation. Others prescribe deep economic reforms. Many of these reforms, such as the protection of intellectual property rights and financial liberalization, are only indirectly related to trade. For instance, the aforementioned Croatia-Turkey PTA is a 65-page long document, whereas the Croatia-EU Stabilization and Association Agreement (SAA) is a 218-page long treaty.

Why do countries form treaties that commit them to politically controversial reforms? Do these treaties cause economic reform across the world? Although a large body of literature has analyzed the causes and consequences of preferential trading agreements, previous studies mostly ignore the non-trade effects of PTAs. In this policy paper, we argue that these non-trade effects are central to understanding the causes and consequences of the recent wave of PTAs.

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[3] „Regional Trade Agreement Information System" (RTA-IS) database of the *World Trade Organization* (WTO), available at http://rtais.wto.org.

[4] Data comes from Regional Trade Agreement Information System" (RTA-IS) database, available at http://www.wto.org/english/tratop_e/region_e/rta_participation_map_e.htm.

The Argument

Most trade agreements are relatively uncontroversial. They amount to modest trade liberalization in a limited number of industries. However, the PTAs that major economic powers – especially the European Union (EU) and the United States (US) – form with developing countries are different. These agreements effect fundamental changes in developing countries' economic policies. Their provisions for intellectual property rights (IPRs) go well beyond the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) of the World Trade Organization (WTO). Their antitrust and government procurement provisions are equally stringent.

In the realm of international economic law, these trading agreements are exceptionally demanding. Why, then, do sovereign governments accept legally binding commitments that constrain their ability to formulate national economic policies?

The conventional wisdom on these agreements advances two plausible, but in the end unconvincing explanations. First, perhaps the EU and the US exchange market access in key industries for economic reforms that create investment opportunities for their own companies in reluctant developing countries. If this view was correct, then developing countries should be particularly willing to accept economic reforms when there is "missing trade" between them and the EU or the US. The data tell a different story.

Second, a more diabolical explanation argues that the EU and the US use their structural power to force developing countries to accept economic reforms. If this explanation held, then developing countries would be reluctant to accept economic reforms. On the contrary, the initiative on economic reforms is usually on the developing countries' side. Their governments have regularly sought external assistance for economic reform.

This policy brief argues that governments of developing countries use preferential trading agreements with major powers to advance economic reforms that (i) produce political benefits and (ii) are difficult to implement due to domestic opposition.[5] PTAs can help the government of a developing country implement contentious reforms in two ways. First, they allow the government to credibly commit to economic reform because deviations would result in the suspension of preferential trade. Second, they produce opportunities for domestic constituencies, so they might be more willing to accept economic reforms when the preferential trading agreements sweeten the pot.

Empirical Analysis

Our empirical analysis explores two stages of developing countries' cooperation with the EU and the US. First, a survival analysis is used to show that if the leader of a developing country prefers reforms but faces major political difficulties in their implementation, the probability that this country engages in PTA negotiations with the European Union and the United States increases dramatically. Following Milner and Kubota (2005), it is argued that democratization increases a leader's demand for economic reform. To capture the difficulty of reform, the

[5] For a similar argument, see also Dee and McNaughton (2011)

study distinguishes between new leaders whose power is insecure and established leaders who can more easily implement policies (Haggard and Kaufman, 1997). Strikingly, the magnitude of the interactive effect of democratization and recent leader change on the probability of PTA negotiations is larger than that of conventional gravity model variables, such as distance and gross domestic product. The results are robust to a wide range of model specifications. These include matching techniques that allow us to improve the identification of the model by accounting for selection effects.

The left column of Table 1 provides a list of countries in which leader change and democratization occur at the same time.[6] This column shows that our statistical model can predict a large number of PTA negotiations, especially for the EU. However, also for the US it captures two important negotiations, namely with Mexico (1990) and Peru (2003). The right column, which shows countries that experienced simultaneous democratization and leader change but did not engage in PTA negotiations, provides further insight. In particular, it shows the importance of major power interest. Most of these countries are small and isolated African or Asian economies. Given their poverty, it is unsurprising that the EU and the US have little interest in engaging PTA negotiations. Moreover, as one of the ASEAN members, Indonesia started negotiating a PTA with the EU in 2008 and had already concluded its Partnership Cooperation Agreement with the EU in October 2008

Table 1. Countries in the sample that experience leader change during democratization

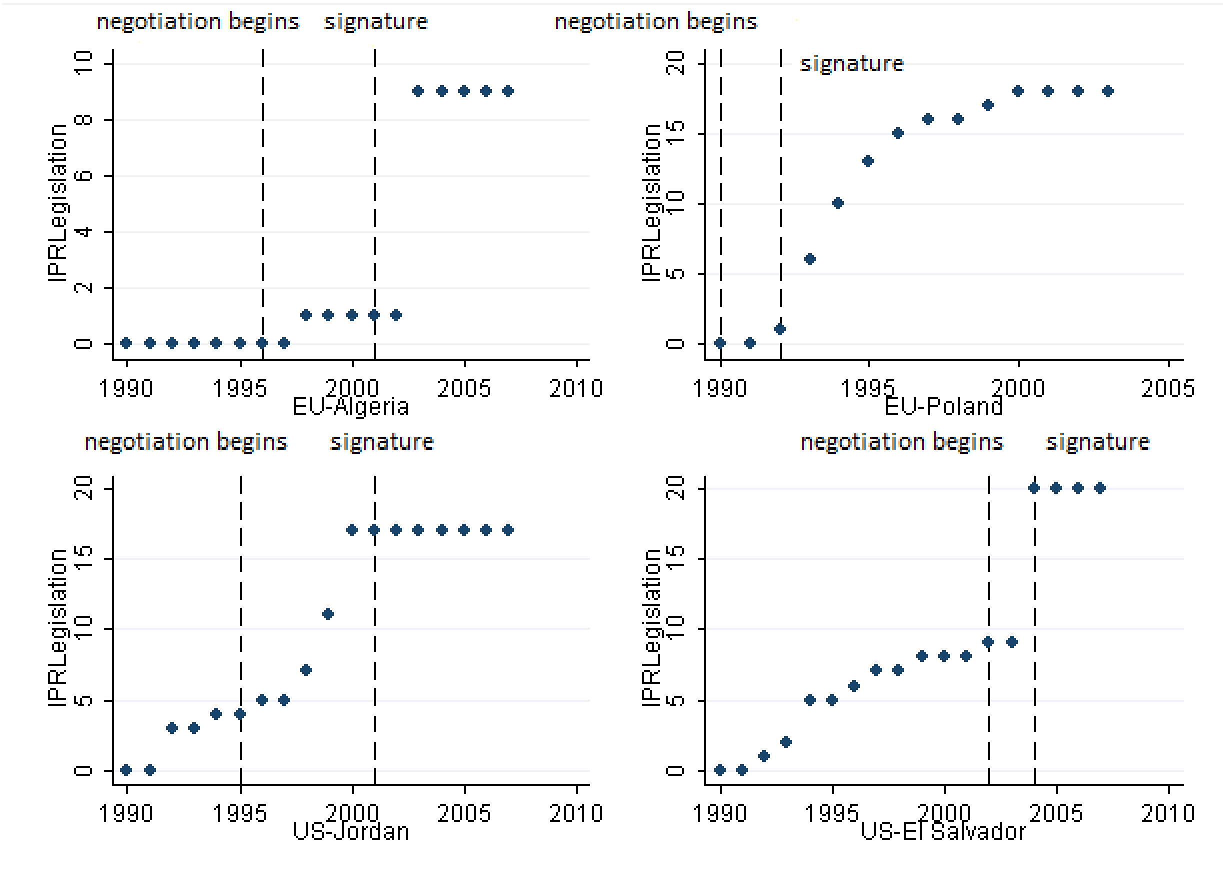
Democratization and leader change with PTA?	Democratization and leader change without PTA?
EU-Albania (2002, 2006)	Bangladesh
EU-Bulgaria (1992, 1993)	Benin
EU-Croatia (2000, 2001)	Burundi
EU-Estonia (1994, 1995)	Cape Verde
EU-Hungary (1990, 1992)	Congo, Republic of
EU-Latvia (1994, 1995)	Guinea-Bissau
EU-Lithuania (1994, 1995)	Indonesia
EU-Mexico (1995, 2000)	Kenya
EU-Poland (1990, 1992)	Madagascar
EU-Romania (1992, 1993)	Moldova
EU-Slovakia (1990, 1992)	Nepal

[6] Democratization is defined a positive change in the score of regime type over the previous ten years in at least one of these three widely used datasets: Cheibub, Gandhi, and Vreeland 2010, Polity IV, and Freedom House. Leader change capture leader turnout occurred within three years of PTA negotiations. Data comes from Archigos (2009).

EU-Slovenia (1993, 1997)	Niger
EU-South Africa (1995, 1999)	Pakistan
US-Mexico (1990, 1992)	Suriname
US-Peru (2003, 2006)	Sri Lanka

Notes: Countries with leader change under democratization in the sample. The left column shows instances of PTA (years inside brackets refer to the start of negotiations and the time the PTA was signed). The right column shows instances without PTA negotiation and signature

Figure 1. Preferential trading agreements and intellectual property rights



Notes: PTA negotiation and cumulative number of legislation acts protecting IPRs approved by the national legislature in four developing countries.

Second, we use non-parametric estimation techniques (i.e. rolling regressions) to show that a strong positive association exists between preferential trading agreements and major economic reforms in intellectual property rights, privatization, and legal protection of foreign direct investment. To a lesser extent, they also promote financial liberalization. Countries that negotiate a treaty with the EU and the US implement major economic reforms during and immediately upon the conclusion of these negotiations. Figure 2 shows the reform patterns in IPR legislation for EU-Algeria (signed), EU-Poland (signed), US-Jordan (negotiations), and US-El Salvador (signed). We measure the number of legislative acts protecting IPRs approved by the national legislature in a developing country from 1990 to 2007. High values of this variable imply strict IPRs regulations.[7]

What is more, comparable countries that did *not* negotiate a treaty with the EU or the US implement rarely this type of reforms. If we match the negotiating countries (treatment group) and similar countries that never negotiated a treaty (control group), we find that the negotiating countries implement reforms with respectively 86 percent frequency for the EU PTAs and 61 percent frequency for the US PTAs, whereas the non-negotiating countries implement reform with 48 percent frequency.

Table 2 compares EU and US PTAs. It shows that there is little difference between EU PTAs and US PTAs, though the former generally outperform the latter in promoting economic reform. The table also shows that the PTA effect on capital openness is much smaller than on other forms of economic reform that we considered.

Table 2. Economic reforms

Type of Reform	EU		US	
	# Reforms	# PTA[8]	# Reforms	# PTA
IPR	9	18	6	18
Privatization	11	14	9	16
Capital openness	3	11	2	18
Investment profile	10	15	5	15
Any of the above?	19	22	11	18

Notes: Summary of structural breaks in economic reform data for developing countries that sign a PTA with the EU and/or the US.

Finally, we complement the quantitative analysis with case studies of Chile, Colombia, Croatia, and South Africa. In all these countries, we find a combination of a leader's willingness to pursue economic reforms and major political obstacles to their

[7] The data are compiled by the authors from the World Intellectual Property Organization dataset: http://www.wipo.int/portal/index.html.en.

[8] Number of PTAs with available data.

implementation. For example, Croatian Prime Minister Ivica Račan made liberal economic policies the cornerstone of his campaign for the 2000 elections. However, Račan had a very fractionalized and heterogeneous ruling coalition that included six parties among which the Croatian Peasants Party advocated economic interventionism by the state and was generally skeptical about free-market economic policies. Two Croatian economists revealed that SAA with the EU were used as an instrument to persuade reluctant domestic constituencies to accept pro-market economic reform, especially in foreign direct investment and capital liberalization.[9]

Both economists confirmed also the validity of the timing argument, which is a crucial element of our theory. Croatia used the PTA with the EU to implement at that specific point of time reform that it would have implemented anyhow in the future. Moreover, François Riegert, representative of the European Union in Croatia, acknowledged that "the SAA provided the framework for political dialogue, promotion of trade and economic relations, and a mechanism for the implementation, management and monitoring of socio-economic policies. It was an essential contractual framework to strengthen relations with the EU, and to ultimately prepare Croatia for EU membership. When the CRTA had examined the goods aspects of the Agreement, Croatia was not yet an official candidate for EU Accession. Today, Croatia is not only a candidate, but its accession to the EU is relatively close."[10]

Conclusion

This evidence prompts a remarkable conclusion: the deepest and broadest preferential trading agreements are ultimately about economic reform. Governments of developing countries form them to promote a wide variety of economic reforms. Many of these economic reforms are only loosely related to tariffs and other trade concerns. For the policy makers and practitioners, this conclusion is noteworthy. A heated debate on the global trade effects of preferential trade agreements has been ongoing for decades. Some have argued that preferential trading agreements cause harmful trade diversion (Bhagwati and Panagariya, 1996), while others have proposed that they could be building blocks for multilateral trade liberalization (Soloaga and Winters, 2001). Instead, we propose that some of the most important recent preferential trading agreements are not only about trade. If our argument survives the test of history, preferential trade agreements may prove tangential to multilateral trade liberalization.

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