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It's Not All About Trade: Preferential Trading Agreements Induce Economic Reforms in Developing Countries

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1. Introduction

In recent years, preferential trading agreements (PTAs) have proliferated. Between 1950 and 2012, 511 notifications of PTAs have been received by the GATT/WTO and 370 PTAs were notified by the GATT/WTO under Article XXIV. [1] Moreover, in the last decade alone half of the all PTAs signed involve at least one Asian economy (ESCAP, 2011). However, 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.

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 brief, we argue that these non-trade effects are central to understanding the causes and consequences of the recent wave of PTAs.

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?

2. The Argument

The conventional wisdom on these agreements advances two plausible, but in the end unconvincing, explanations. First, perhaps the EU and the US provide concessions for market access in key industries in exchange for economic reforms that create investment opportunities for their own companies in reluctant developing countries. If this view were 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 countriebe 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 pursuing economic reform further.[2]

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

[2] In our empirical analysis we show that PTAs with the EU or the US both cause reforms that would had never been carried out otherwise and lock-in reforms that were initiated and implemented before the negotiation of such PTAs.

This policy brief argues that governments of developing countries use PTAs with major powers to support and advance economic reforms that (i) produce political benefits and (ii) are difficult to implement due to domestic opposition. 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 PTAs sweeten the pot.

3. Empirical Analysis

Our empirical analysis explores two stages of cooperation between the EU and the US and developing countries. 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 EU and the US increases dramatically. Following Milner and Kubota (2005), it is argued that democratization increases a leader's demand for economic reform. Here we define democratization as an increase in a country's democracy score within the last ten years. We rely on three widely indicators of democracy: Polity IV, Freedom House, and Cheibub et al. (2010). To capture the difficulty of reform, the study distinguishes between new leaders whose power is insecure and established leaders who can more easily implement reforms (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.

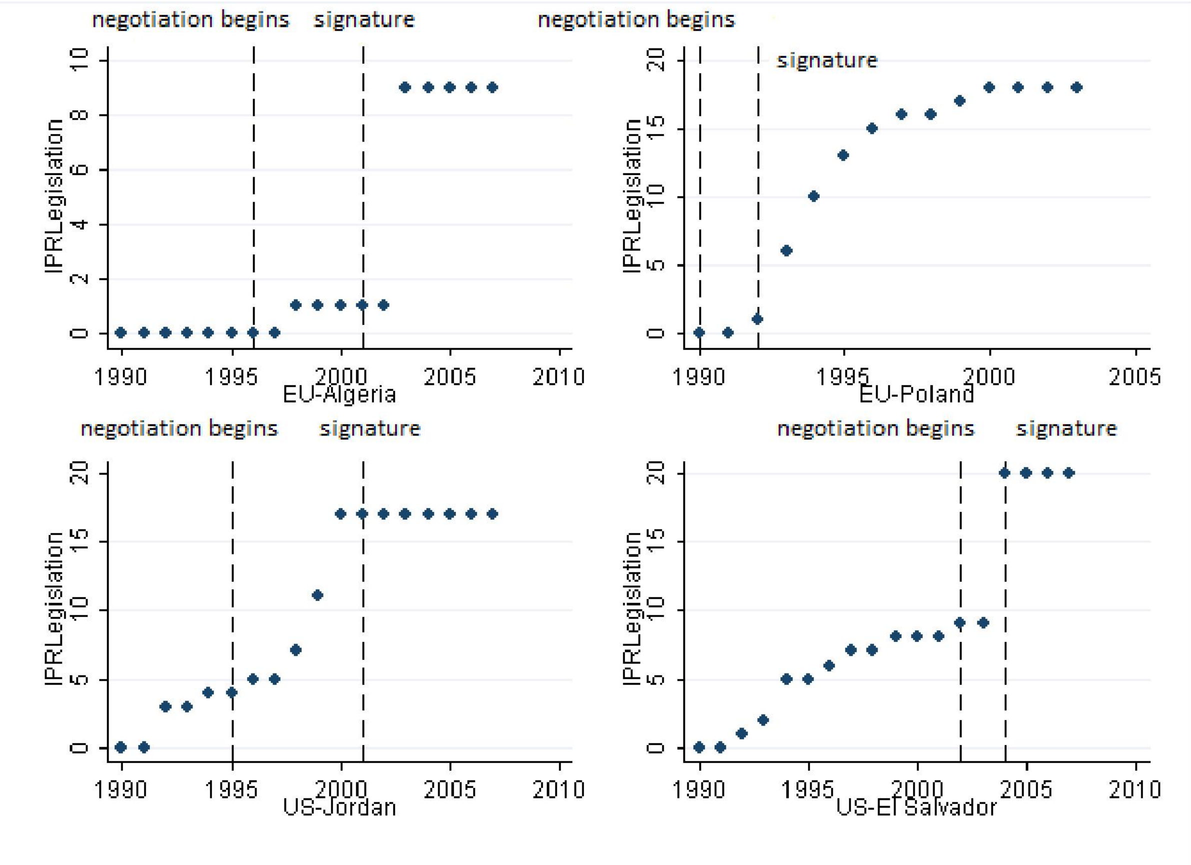
The left column of Table 1 provides a list of countries in which leader change and democratization occur at the same time. This column shows that our statistical model can predict a large number of PTA negotiations, especially for the EU. However, also for the US it captures two important negotiations, 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 relatively isolated African or Asian economies and are not 'natural' partners in contemporary PTA negotiations. Moreover, as one of the

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

Note: Countries with leadership changes perceived as democratization in the sample. The left column shows instances where there is a simultaneous negotiation of major PTA (years inside brackets refer to the start of negotiations and the time the PTA was signed). The right column shows instances where democratization and reform process proceeded without PTA negotiation and signature.

Figure 1. Preferential trading agreements and intellectual property rights.



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

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.

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 and some 'behind-the-border' areas (cf. Dee and McNaughton, 2011). 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 1 shows when the reforms in IPR legislation were implemented in relation to signature of the PTA for EU-Algeria (after signature), EU-Poland (after signature), US-Jordan (during negotiations), and US-El Salvador (after signature). 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.[3]

Moreover, comparable countries with democratization processes that did *not* negotiate a treaty with the EU or the US implement rarely this type of reforms. Matching the negotiating countries (treatment group) and similar countries that never negotiated a treaty (control group) reveals 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 account openness is much smaller than on other forms of economic reform that we considered.

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

Table 2. Summary of structural breaks in economic reform data for developing countries that sign a PTA with the EU and/or the US

Type of Reform	EU		US	
	# Reforms	# PTA[4]	# 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

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 implementation. For example, Chile's former president Ricardo Lagos made liberal economic policies the cornerstone of his presidential campaign in 1999. However, President Lagos had a very weak and very heterogeneous ruling coalition that included both pro-market and Marxist deputies. A top Chilean official, to whom we promised anonymity at the time of the interview, revealed that PTAs with the US and the EU were used as an instrument to persuade reluctant domestic constituencies to accept further liberalization.[5] To support his claim, this official argued that the liberalization in the banking and insurance sectors, which are important part the financial market, would have been impossible to achieve without the agreements with the EU and the US.

4. Conclusion

This evidence prompts a remarkable conclusion: the deepest and broadest preferential North-South trading agreements in most developing countries are ultimately about economic reform. Governments of developing countries form them mostly to promote a wide variety of economic reforms. Many of these economic reforms are only loosely related to tariffs, trade barriers 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 North-South preferential trading agreements are not only about trade. If our argument survives the test of history, preferential trade agreements may prove tangential and neutral to multilateral trade liberalization.

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[4] Number of PTAs with available data.
[5] Interview by the authors on 9th of July, 2010.

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