LEONARDO BACCINI • JOHANNES URPELAINEN

Cutting the Gordian Knot of Economic Reform

When and How International Institutions Help

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CHAPTER 1
Introduction

During the last two decades, governments across the developing world have implemented many liberal, "second generation" economic reforms.[1] Going beyond macroeconomic reform, such as anti-inflation measures and fiscal stabilization, governments have implemented liberal microeconomic policies that reduce direct state intervention in different industries. These microeconomic reforms have changed the face of global business. Developing countries have adopted policies to protect foreign direct investment, have imposed stringent rules for the protection of intellectual property rights, and have dismantled systems of pervasive trade protection. These reforms have produced handsome benefits to those willing and able to exploit the new economic opportunities that liberalization creates. Their importance is central for understanding the economic trajectories of those developing countries that have successfully stabilized their economies and are now seeking to exploit the opportunities created by economic openness (Naìm, 1994). Moreover, the study of the politics of such reforms seems less developed than the large body of literature on macroeconomic stabilization.[2]

And yet, these reforms have also provoked intense political controversy and organized opposition. Their detractors argue that the primary effects of liberal economic reforms are the redistribution of income from the poor to the wealthy, an increase in unemployment, and an increase in the political influence of large multinational corporations (Gill, 1995; McKenzie and Lee, 1991; Stiglitz, 2002). Whether these arguments are valid or not, it is clear that liberal economic reforms produce winners and losers (Nelson, 1989; Pastor and Wise, 1994; Przeworski, 1991; Schamis, 1999).

Given the immense difficulty of reform, the ability of national leaders to implement liberalizing policies remains one of the great puzzles in the field of political economy. It is fair to say that while the causes and consequences of economic reform have been among the most prominent issues in the fields of comparative and international political economy (Haggard and Kaufman, 1995; Pop-Eleches, 2009; Przeworski, 1991; Rodrik, 1996; Weyland, 2002), most key questions remain open. Why have some leaders adopted policies that, for better or worse, overhaul their national economies? Why have others continued past practices of direct state intervention?

These choices have immense consequences for the livelihoods of billions of people around the world, yet the drivers of economic reform remain poorly understood. Despite repeated exhortations by international organizations, including the International Monetary Fund (IMF), the World Bank (WB), and the World Trade Organization (WTO), and the leading liberal economies—the European Union and the United States—patterns of economic reform continue to exhibit remarkable variation both across developing countries and over time.

The central argument of this book is that many of the most important microeconomic reforms implemented in developing countries were possible because of international institutions.[3] Leaders often pursue economic reforms to generate economic growth or to redistribute wealth, but their ability to successfully implement these reforms is curtailed by domestic political opposition and a general lack of credibility of commitment to policy. Given these problems, a leader with an interest in economic reform faces a dilemma. Failure to implement economic reforms could have disastrous political and economic consequences, but efforts to implement economic reforms could also backfire. Simply put, forming a robust coalition in support of economic reform is sometimes impossible.

In such circumstances, certain international institutions—formal arrangements that "prescribe, proscribe, and/or authorize behavior" (Koremenos, Lipson, and Snidal, 2001, 762)—can help. From the IMF to bilateral investment treaties and preferential trading agreements, many international institutions contain provisions on economic policy. We argue that such international institutions provide leaders with new means to enhance the credibility of, and to create political support for, economic reform. When a leader forms an international institution with a foreign partner, the leader has the opportunity to announce a legally binding commitment to economic reform. In particular, we shall argue, North-South preferential trading agreements between a major power interested in promoting liberal economic policies and a developing country can significantly increase the likelihood and pace of liberalization in the latter country.

The legally binding commitment in these international institutions contain facilitates economic reform in two ways. First, it enhances the credibility of economic reform, thus increasing the value of liberalization. For example, foreign investors would not respond to investment liberalization unless they believed that the leader's commitment to liberalization was credible. Second, legally binding commitments on economic reform in international institutions mean that important benefits from the international institution, such as enhanced market access, are forgone without economic reform. Domestic constituencies who expect to benefit from the international institution support economic reform if liberalization is a precondition for the operation of the international institution. For example, exporters support economic reforms if these economic reforms are a precondition for trade liberalization by an important foreign partner. Thus, the international institution creates a domestic policy package that garners more support than economic reforms without the international institution.

Not all international institutions are equally useful for the promotion of economic reform. A useful international institution should contain provisions that prescribe economic reform and offer benefits, such as trade liberalization, to accompany these prescriptions. Moreover, the international institution should be formed with a foreign partner that is both willing and able to enforce commitments. International institutions cannot directly enforce commitments, but they enable reciprocal enforcement between sovereign states (Keohane, 1986). If the leader of a developing country forms an international institution with a major power interested in promoting liberalization, such as the European Union or the United States, the credibility of reform is enhanced and the leader can allocate resources, such as valuable market access, to domestic constituencies in exchange for their support for liberalization.

Bilateral and plurilateral international institutions, such as preferential trading agreements (PTAs), are particularly useful because they are easier to negotiate than genuinely multilateral institutions with an almost universal membership.[4] Not in a long time has this been as true as it has been during the first two decades of the twenty-first century. The Doha Round of the WTO, which focuses on the "new trade agenda" that promises large benefits for both least developed and emerging economies (Anderson and Martin, 2005), has been in a negotiation gridlock from its very beginning (Kessie, 2013).

When should one expect a developing country's leader to rely on international institutions? If international institutions promote economic reform by expanding the leader's strategy space, two primary conditions must be met. First, the leader must expect political-economic benefits from liberalization. Second, the leader must face domestic opposition to liberalization. When these two conditions are met, international institutions can help leaders cut the Gordian knot of economic reform.

As a concrete empirical application of this theory, we examine the preferential trading agreements that developing countries have formed with the European Union and the United States. Although PTAs are nominally trade agreements, both EU and US PTAs contain a range of provisions that prescribe deep economic reforms across the board. They constrain public subsidies to domestic companies, they expand the coverage of patent protection, they mandate dispute resolution between foreign investors and the state upon a dispute between the two, and they pry open the financial sector for European and American banks. They can often be negotiated bilaterally, and both the European Union and the United States have expressed interest in PTA negotiations with many developing countries. Consequently, the opportunity to form an international institution is usually available for a developing country's leader. In contrast, negotiating a PTA with a less liberal major power, such as China, might not help due to the power partner's unwillingness to promote and enforce liberalizing reforms.

The benefits of PTA formation for leaders who have chosen to pursue economic reform are twofold. First, PTAs are legally binding documents that enhance the credibility of economic reform. If the leader of a developing country were to renege on an economic reform written in the PTA, the leader would be in breach of the PTA. The PTA is enforced by the European Union or the United States. These are major powers with the ability to withhold trade concessions of substantial value to exporters in the developing country, so a leader who reneges on a PTA, and thus induces retaliation by the European Union or the United States, pays a high domestic political cost. Given the anticipation of a high cost, the leader's incentive to renege in the first place is diminished.

Second, a PTA can help the leader to create domestic political support for economic reform. In the absence of a PTA, reform is difficult if the constituencies and interest groups with a lot to lose from economic reform are more vocal than those who expect gains. But a PTA can tilt the balance in favor of the reformers. The PTA cannot be implemented without economic reform; and, if not implemented, the PTA does not produce the benefit of market access to the developing country's exporters and those capital owners who would benefit from foreign direct investment. Therefore, the leader of a developing country can strategically use the PTA to create benefits for influential constituencies and interest groups, who in turn will support economic reform to ensure the implementation of the PTA.

The availability of these benefits depends on the leader's initial willingness to implement economic reforms, so it would be wrong to say that the PTA itself is causing economic reform. Instead, the PTA is enabling economic reform by leaders who want it but cannot implement it by purely domestic means. Some leaders have no interest in economic reforms, others can implement economic reforms without PTAs, and yet others prefer economic reform but face domestic political opposition and difficulties in convincing domestic and international markets of the credibility of these economic reforms. Leaders in the third category can enhance their ability to implement economic reforms through the PTA strategy.[5]

According to this strategic logic, we would expect PTA formation to enhance economic reforms in a developing country if three main conditions are met. First, the developing country's leader must expect political or economic benefits from economic reforms. Second, these economic reforms must be politically controversial, and thus difficult to implement. Finally, the European Union or the United States must also expect benefits from PTA formation with the developing country in focus.

This argument has three main empirical implications that can be used to test its validity. First, we should see leaders of developing countries pursue PTA negotiations with the European Union and/or the United States when these leaders believe that their political-economic fortunes would be improved by economic reforms but they face political difficulties in their implementation. Second, we would expect the formation of a PTA to be associated with major changes in the economic policies of developing countries that form these PTAs. Finally, the PTAs should contain provisions that specifically prescribe a wide variety of deep economic reforms. The empirical part of this book provides evidence in support of all three hypotheses. An important feature of this argument is that it not only explains a country's general propensity to use international institutions to promote economic reform, but also explains the *timing* of a leader's decision to rely on this strategy. Leaders' political-economic incentives depend both on structural factors, such as regime type (Mansfield and Milner, 2012), and the current context, such as the loyalty of the leader's ruling coalition (Bueno de Mesquita et al., 2003). Our argument can be used to analyze the role of both factors, and we emphasize the dynamic nature of the argument throughout this book.

Note also that this argument does not depend on the idea that major powers coerce developing countries to implement economic reforms. While the European Union and the United States must benefit from these economic reforms to be willing to form a PTA with the developing country, we do not expect them to force the economic reforms on recalcitrant developing countries. Forcing recalcitrant leaders to implement economic reforms that face stiff political opposition is very costly, so the European Union and the United States have a natural incentive to focus on developing countries that have leaders who also expect tangible benefits from economic reforms.

The use of PTAs is a flexible strategy to internationalize the problem of economic reform. Much of the extant literature on international institutions and economic reform has emphasized multilateral organizations, such as the International Monetary Fund (IMF) (Pop-Eleches, 2009; Stone, 2011; Vreeland, 2003) and the World Trade Organization (WTO) (Steinberg, 2002). For a developing country's leader, the difficulty with a multilateral institution is that economic reforms would have to satisfy the demands of multiple members. In contrast, a bilateral or regional treaty with the European Union or the United States allows greater flexibility.

IMPLICATIONS

The argument that we detail in the chapters to follow has implications for the study of international institutions, the profusion of North-South PTAs, and the study of economic reform in comparative politics. We discuss these implications in greater depth in the concluding section. To motivate the remainder of the book, we offer a concise overview here.

Given the tremendous difficulties of implementing economic reform that we emphasized in framing our argument, one central implication of our argument is the important role that PTAs with major powers can play in promoting economic reform. Contemporary scholarship on economic reform has mostly emphasized domestic factors (Baker, 2003; Haggard and Kaufman, 1995; Milner and Kubota, 2005; Schamis, 1999; Weyland, 2002). While these accounts provide useful insights into the motives underlying economic reforms and the difficulties that the leaders implementing them face, they mostly neglect the possibility that leaders exploit international institutions to promote economic reform in the domestic economy. Consequently, purely domestic accounts of economic reform offer an overly pessimistic account of the strategies that leaders can use to liberalize economic policies. Our book shows that international institutions have played an important role in promoting economic reform in developing countries.

Scholars focusing on the international dimension of economic reform, such as Pop-Eleches (2009) and Vreeland (2003), have almost without exception emphasized the role of two multilateral organizations: the IMF and the World Bank. These studies generally find that these two Bretton

Woods institutions have often promoted economic reforms in developing countries with considerable success. However, the empirical scope of this finding is arguably limited. Bretton Woods institutions promote liberalization through arrangements that condition concessional loans on economic reform, so their usefulness for overcoming obstacles to economic reform in the absence of economic crises is limited. Moreover, organizations such as the IMF often emphasize macroeconomic stabilization instead of "second generation" microeconomic reforms. As we show in later chapters, many of the most important microeconomic economic reforms were implemented by developing countries that did not suffer from poor economic performance. Moreover, these countries did not cooperate with the Bretton Woods institutions to implement these reforms. We argue that this was because ad hoc PTA negotiations with interested major powers offered a more flexible, and perhaps even more credible, solution.

This is not to say that other scholars have not recognized the potential role of preferential trading agreements. Several economists have argued that PTA formation could promote economic reform (Ethier, 1998; Fernandez and Portes, 1998), but they have not provided any systematic empirical evidence for their claim or attempted to characterize the conditions under which countries are willing and able to use PTAs to promote economic reform.

Shadlen (2008) argues that the United States has used PTAs to induce economic reform in small Latin American economies. However, he has framed the issue as one of coercion or inducement by a major power:

> Fear of a neighboring country entering into an agreement with the US effectively changes the status quo, making it in each country's interest to do the same. Once one country negotiates, other countries may feel pressure to do so out from a fear of exclusion. (Shadlen, 2008, 12)

While such coercion is undoubtedly a part of the picture, we find surprisingly little evidence for the claim that developing countries form PTAs with the European Union and the United States because they have no choice. Instead, our evidence suggests that leaders of developing countries use these PTAs to implement economic reforms that they prefer.

For scholars of international trade, our findings reveal an important truth about PTAs: they are not all about trade, and often their most important effects are only indirectly related to trade (Gray, 2013). While much of the controversy surrounding the recent wave of PTAs has focused on whether they cause harmful "trade diversion" or allow globally optimal "trade creation" (Bhagwati, 2008; Bhagwati and Panagariya, 1996), the evidence for the effects of PTA formation on bilateral trade flows is mixed.[6] This is perhaps not surprising for vague agreements with few specific provisions, but given the breadth and depth of the PTAs that the European Union and the United States have formed, it is initially puzzling that they would have few effects on trade flows.

This book solves the puzzle. If PTAs are ultimately about a wide variety of economic reforms outside the realm of tariff politics, then the absence of a strong trade effect begins to make sense. Instead of trade liberalization across the board, our theory leads us to expect large effects on economic reform and only selective effects on trade in key sectors. Our empirical evidence suggests that previous scholarship emphasizing the non-trade rationales for preferential trading agreements, such as Ethier (1998) and Fernandez and Portes (1998), had it right. However, even these studies failed to grasp the full significance of PTAs as instruments of economic reform. Our theory and empirical evidence show that some, but not all, PTAs are uniquely suited for promoting reforms in developing countries.

In a recent book, Mansfield and Milner (2012) have developed a comprehensive model of PTA formation. They show that democratic political institutions endow governments with incentives to form PTAs, because these governments can thus credibly commit to trade policies and signal this commitment to the voters. Moreover, the incentive to commit and signal is particularly strong for left-wing parties because their incentive to liberalize is in doubt ex ante. The empirical evidence that Mansfield and Milner (2012) provide shows that these factors can help explain the recent wave of new PTAs. However, their analysis does not analyze the role of different PTAs. We show that EU and US PTAs are particularly important due to their asymmetry. Our results corroborate the argument that PTA formation has political foundations, but we also find that, by not distinguishing between different types of PTAs, Mansfield and Milner (2012) underestimate the overall importance of PTAs for economic policy in developing countries.

For the PTA literature, our argument also offers an important lesson regarding the origins of PTA proliferation. There is no shortage of literature on why PTAs "diffuse" across borders,[7] but this literature does not explain the ultimate origins of this diffusion. If PTAs are reactions to other PTAs, where do the initial PTAs come from? We show that some of the most important PTAs in existence were driven by a leader's concerns about the difficulty of economic reform.

Equally important are the implications of the argument for more general theories of international institutions. Although initial doubts about the relevance of international institutions as epiphenomenal "window dressing" (Mearsheimer, 1994–1995) have largely receded in recent years, much of the scholarship on international institutions emphasizes that their ability to facilitate commitment is severely limited by the anarchic nature of the international system (Abbott and Snidal, 2010; Downs, Rocke, and Barsoom, 1996; Fearon, 1998; Guzman, 2008). Beyond the European Union, perhaps the only unambiguous exceptions to this rule are the IMF (Stone, 2002, 2011; Vreeland, 2003) and the WTO (Reinhardt, 2001; Steinberg, 2002).

Our findings suggest that at least some PTAs fall under this category. Specifically, EU and US PTAs have allowed leaders in developing countries to implement ambitious economic reforms that would not have been possible otherwise. This finding shows that not only large multilateral institutions with a universal membership, but also more flexible bilateral and plurilateral institutions, can produce large political and economic effects in developing countries. As such, the finding provides what we consider the strongest evidence for the importance of international institutions in political economy.

The evidence that we provide for this claim is also noteworthy. A complete account of the role of international institutions on economic reform must provide an answer to three questions. First, was the international institution formed to promote economic reform? Second, were the international institutions designed in view of promoting economic reforms? Finally, did the international institution facilitate economic reforms?

To our understanding, this book is the first study that provides a comprehensive analysis of all three aspects of the problem. Using original data, we show that when the European Union and the United States form PTAs with developing countries, these PTAs are designed to maximize their effect on economic reform. We then show that these PTAs are formed by leaders of developing countries who expect benefits from economic reform but also face impediments to implementation through purely domestic means. Finally, we uncover a strong positive association between these PTAs and major economic reform. No other study provides evidence on all three facets of the problem.

For students of political economy, our findings concerning leaders' strategic use of international institutions to promote economic reform are also notable. In recent years, the focus of the study of political economy has shifted from macroeconomic and macro-political factors to the strategic behavior of individual actors, notably national leaders (Bueno de Mesquita et al., 2003; Malesky, 2008; Weyland, 2002). We contribute to this literature by examining how leaders use international institutions to suppress domestic political opposition to economic reforms and to enhance the credibility of their commitments. Our analysis is firmly grounded in the idea that the primary goal of leaders is their own political survival and that they form policies, including economic reform, to maximize the probability of political survival. Preferential trading agreements, we find, are an effective instrument for promoting economic reform.

Finally, our argument has several important policy implications. For leaders in developing countries, a PTA with the European Union or the United States offers a way to cut the Gordian knot of economic reform: in spite of intense political opposition to economic reform, a leader can implement her preferred economic reforms by internationalizing the issue through a PTA with a major power. For many developing countries, "second generation" economic reforms currently present an opportunity to climb up the value ladder in the global economy. Our findings suggest that PTAs with major powers can play a surprisingly large role in promoting such reforms.

For policymakers in the European Union and the United States, as well as other large industrialized countries, such as Japan, the unexpected effectiveness of PTA formation as an instrument of economic reform also has notable implications. In recent years, countries such as Tunisia have undergone difficult processes of democratization. As Haggard and Kaufman (1995) have shown, the process of democratization is difficult, if not impossible, to disentangle from efforts to implement economic reforms that generate economic growth and provide public goods to mass constituencies. What can major economies do to promote democratization? Our argument suggests that deeper trade cooperation can help democratizing countries lock in economic reforms and mitigate political opposition to liberalization.

THE ROAD AHEAD

The following seven chapters contain the details of our argument. Chapters 2 and 3 present the theoretical framework, and the empirical evidence is summarized in Chapters 4 through 8. Chapter 9 summarizes the argument, reflects on it, and discusses the theoretical and policy implications of the findings.

Chapter 2 presents the general form of our argument concerning international institutions and microeconomic reform. It presents the general theory of how international institutions can assist leaders in developing countries in the implementation of economic reform. First, we examine the problems of economic reform in developing countries. We argue that even if economic reforms produce net benefits or redistribute wealth in ways that improve the leader's political fortunes, they often face stiff political opposition. If the leader cannot compile a domestic policy package that creates a sufficiently large coalition in support of economic reforms, the leader has an incentive to consider internationalizing the problem by engaging in negotiations on a bilateral or plurilateral international institution with a foreign partner. Such negotiations are valuable because they enable credible commitment and create opportunities to mobilize winners and compensate losers at home. However, these functions require that the foreign partner be a powerful country capable of enforcing commitments and creating surplus that can be used to shape political coalitions in the leader's own country.

The theory developed in Chapter 2 is general, so it can be applied to a wide variety of international institutions. How, then, can the empirical relevance and validity of such an abstract theory be tested? Chapter 3 applies the general model to the case of PTA formation. We begin by discussing the dilemma of a leader who wants to pursue economic reform but faces great political difficulties in implementation. Specifically, we argue that recent democratization increases a leader's incentive to reform. However, if the leader has recently gained power, her support coalition is in flux, and so her ability to implement and credibly commit to reform is in danger. While the incentive to reform can stem from many sources, and while reform can be difficult for many leaders, we argue, and later show, that the combination of democratization and leader change is a uniquely powerful predictor of the dilemma that results in PTA negotiations with the European Union or the United States.

Chapter 4 presents the first collection of evidence for our argument. If PTAs with the European Union and the United States are to promote economic reform, they should contain provisions that prescribe liberal policies. We have compiled a novel data set of the design features of virtually all PTAs in existence. A systematic analysis of this data set allows us to establish two basic facts. First, the European Union and the United States negotiate much deeper and broader PTAs than other countries. Second, the depth of these PTAs is a function of the pervasive and intrusive commitments to economic reform that the treaty texts contain.

Chapter 5 examines developing countries' varying propensities to form PTAs with the European Union and the United States. Overall, there are 71 "pairs" (EU or US and a developing country) that have at some point engaged in PTA negotiations. We collected our own data on the onset of these negotiations and tested the hypothesis that the combination of democratization (demand for reform) and leader change (difficulty of reform) has a positive effect on the probability of negotiations with the European Union and the United States, and we find that the claim holds.

Moreover, we show that democratization and leader change *do not* predict negotiations with other industrialized countries or China. We also discuss the implications of this finding and test competing hypotheses based on plausible alternative theories.

Chapter 6 is another core component of our empirical analysis. It shows that a strong positive association exists between important economic reforms—intellectual property rights, protection of foreign direct investment, and privatization—and PTA formation by developing countries. The evidence for this claim is threefold. First, we show that PTA negotiation and signature can explain the timing of major economic reforms in developing countries. Second, we demonstrate that such major economic reforms are rare in countries that do not negotiate a PTA with the European Union and the United States. Third, we show that accession into the WTO also explains important economic reforms in developing countries. The chapter also presents an innovative and flexible statistical methodology to identify major economic reforms, accounting for heterogeneity and diversity among developing countries.

Chapter 7 complements our quantitative findings with a set of statistically selected case studies of economic reform and PTA formation in developing countries. In particular, we examine the following success stories: Croatia and South Africa, each of which initiated PTA negotiations following a leader change during democratization. By focusing on cases of successful PTA negotiations and reform, we can shed light on the *causal mechanisms* of our theory, something that is difficult to do in a statistical analysis. For the cases, we leverage a variety of sources of evidence. These include primary sources, media reviews, elite interviews of key policymakers, and secondary literature. In both cases, we find direct evidence for the claim that leaders engaged in PTA negotiations in order to implement difficult economic reforms and that the PTA enhanced the political feasibility and credibility of these economic reforms. Our qualitative analysis allows us to account for a rich set of contextual factors, trace causal processes, and identify the weaknesses of our analytical framework.

In Chapter 8, we subject the theory to another qualitative test: In cases *without* democratization, is there evidence of the kind of reform demand that should drive PTA negotiations? We examine the PTAs that Chile (with EU, US) and Colombia (with US) formed relatively soon after a leader change. We show that in both cases, there were other factors that created domestic demand for economic reform, and that the change in leadership itself made liberalization difficult. These cases testify to the explanatory power of our more general theory: while democratization is an important cause of domestic demand for liberalization, our theory can also explain cases in which there was, in the absence of democratization, domestic demand for liberalization.

Chapter 9 concludes. We summarize our argument and discuss its implications. We show that the argument has implications for the research programs on economic reform, PTAs, and general theory of international institutions. We also use the argument to develop strategies for leaders in developing countries who have sought economic reforms, only to be frustrated by intense political opposition. Conversely, we propose a strategy for policymakers in the European Union and the United States that would allow them to maximize their ability to promote economic reforms in politically, economically, and geographically pivotal developing countries.

CHAPTER 2

When and How International Institutions Promote Economic Reform

Leaders join international institutions to pursue political-economic goals, and economic reform is one such goal. This chapter presents a general theory of when and how leaders can use international institutions to promote economic reform. As we explain *why* leaders want to form international institutions, we pay particular emphasis to the *timing* of international institutionalization. Thus, our theory has a strong temporal component: leaders use international institutions to promote economic reforms in specific contexts, and at specific times.[1]

Throughout, we focus on *microeconomic reforms*: liberal policies that increase economic freedom in specific sectors and industries by reducing state intervention. While much of the comparative politics literature on economic reform emphasizes macroeconomic policy, such as reducing inflation and balancing the budget, we maintain a sharp focus on microeconomic reforms. Given that most economic international institutions, with the notable exception of commodity cartels and some organizations with highly specific mandates, such as the International Labour Organization, promote liberalization, our focus is on liberal microeconomic reforms. This category of reforms is aimed at improving the performance of specific sectors by changing the incentives of economic actors. In the empirical part of the book, we examine privatization, intellectual property rights, and rules for foreign direct investment. For purposes of comparison, we also examine one macroeconomic reform, namely capital account openness, and find much weaker evidence for EU and US PTA effects on reform. Other suitable reforms include deregulation, patent legislation, tariff reductions, tax reform, and so forth. More generally, the service sector has abundant potential for microeconomic liberalization.[2] The politics of all these reforms differ significantly from the use of macroeconomic policy instruments, and this chapter explicates our model of the politics of reform in great detail.

Substantively, the analysis of microeconomic reforms is interesting for several reasons. First, the literature on international institutions and macroeconomic reforms, such as anti-inflationary policies and fiscal stabilization, is vast (Haggard and Kaufman, 1995; Steinwand and Stone, 2008; Vreeland, 2003). Our focus on "second generation" microeconomic reforms offers a fresh perspective on the role of international institutions in economic restructuring beyond the politics of crisis stabilization. Second, while macroeconomic reforms are closely tied to economic crises (Haggard and Kaufman, 1995; Pop-Eleches, 2009), microeconomic reforms are an important component of a developing country's growth strategy when it has already achieved macroeconomic stability.

Accordingly, understanding the role of international institutions in promoting microeconomic reforms is important for evaluating their role in helping developing countries change their economic trajectories in the long run. Many developing countries have by now reached relatively high living standards, and for them the major challenge is to complete the transition to an innovation economy. Finally, the primary responsibility for promoting macroeconomic reforms in the international system lies with one international institution, the IMF (Pop-Eleches, 2009; Steinwand and Stone, 2008; Stone, 2002, 2011; Vreeland, 2003, 2007). Empirically, then, analyzing macroeconomic reforms might force us to limit our attention to one multilateral organization that was formed in the aftermath of World War II and that has been extensively studied in previous research. By focusing on microeconomic reforms, we can instead leverage dozens of PTAs that have not been systematically connected to economic reform in past research.

To foreshadow, we shall argue that international institutions help leaders solve two major problems impeding liberalization. First, international institutions enable a credible commitment to policies that would otherwise suffer from time inconsistency. Credible commitment means that domestic and foreign investors expect the reforms to be durable, and this increases the economic benefits of liberalization. Second, international institutions create benefits and profits that can be distributed to domestic constituencies in exchange for their support to economic reform: by conditioning international institutionalization on economic reform, the leader creates domestic political support for economic reform. Thus, the combination of *credible commitment* and *domestic side payments* explains why leaders often rely on international institutions to implement economic reform.

By examining the benefits of international institutionalization, we can explain when and how international institutions enable economic reform in difficult political circumstances. Our argument is strong in the sense that we go beyond the possibility that international institutions, such as the IMF or PTAs, help leaders sustain past liberalization: we argue that by enhancing the credibility of commitment and by creating domestic side payments, international institutions *enable* reforms that would have been otherwise impossible.

Not all international institutions can sustain credible commitments and enable domestic side payments. These benefits are only available if the international institution contains legally binding provisions that commit a developing country's leader to liberalization, the enforcement of these provisions is credible, and the international institution offers benefits to influential domestic constituencies. Moreover, international institutions are the most useful if leaders in developing countries have some flexibility in forming them. In practice, this means that *bilateral institutions that include a major power* are the most convenient instruments of liberalization. To the extent that other regional partners have similar goals, plurilateral institutions with a handful of members are also useful.

The first section of this chapter describes our analytical approach to economic reform. In this section, we explain why leaders sometimes want to implement economic reforms but are unable to do so by purely domestic means. In doing so, we propose a theory of microeconomic reform based on three central assumptions:

1. In certain circumstances, leaders can pursue liberalization to enhance economic growth and/or furnish benefits to their supporters.
2. Due to domestic political opposition, liberalization is difficult to implement for politically weak and insecure leaders.
3. By enabling credible commitment and domestic side payments, international institutions can help leaders liberalize.

The second section explains when and how international institutions can help these leaders. Here, we explain why some, but not all, international institutions enable credible commitments and domestic side payments. The third and final section outlines the conditions under which foreign countries, particularly major powers, are willing and able to form international institutions that promote economic reform in partner countries.

The scope of our analytical model is broad. Although our empirical analysis focuses on PTAs, the theory is intended to be more general than that. The key requirements for empirical applications are twofold. First, the leader of a country must expect political-economic benefits from economic reform. Second, domestic political factors must impede such reform. In these circumstances, the leader wants economic reform but cannot rely on domestic strategies to implement the reform. The formation of certain kinds of international institutions expands the leader's strategy space and therefore increases the probability of successful economic reform through credible commitment and side payments.

Our focus is on international institutions that impose legally binding obligations on state parties. The existence of "hard law" (Abbott and Snidal, 2000) is essential for our purposes because we are interested in how international institutions allow leaders to overcome domestic hurdles to economic reform. While informal and legally non-binding "soft law" institutions can help states coordinate behavior and minimize transaction costs, as Abbott and Snidal (2000) and Lipson (1991) have argued, these weak forms of international law are not particularly helpful for leaders who face political impediments to economic reform. It is essential that the international institutions in focus can expand domestic exporters' access to foreign markets while also tying the domestic leader's hands with regard to domestic policy formation. Thus, hard law is required, and this hard law should explicitly dictate economic reform.

The approach we adopt is positive, not normative. This means that we do not require that the economic reform be beneficial for the society in the long run. Leaders may expect benefits from "partial reforms" (Gehlbach and Malesky, 2010; Hellman, 1998) that create benefits for narrow special interests. For example, while privatization can enhance the productivity of the national economy, it can also create monopolies that increase consumer prices to maximize their own profits. Our theory covers such instances, though most of the empirical analysis focuses on reforms that can be expected to generate economic growth.

The domestic political economy that we analyze comprises three types of agents. In addition to the leader who governs, the country is composed of *supporters* and *opponents* of reform. Supporters are constituencies who expect to benefit from reform, while opponents are constituencies who expect to lose. The leader cannot promote reform unless she manages to mobilize sufficiently many supporters and neutralize sufficiently many opponents. We do not theorize about the exact ratio of supporters to opponents required to implement liberalization, but one may surmise that political institutions, such as the size of the selectorate (Bueno de Mesquita et al., 2003), institutional access points (Ehrlich, 2007), and veto players (Tsebelis, 2002), influence the lowest supporter-opponent ratio that allows reform.

As noted earlier, the final section of this chapter focuses on the incentives of foreign major powers. To enforce hard law is certainly not easy in an environment that classical cooperation theorists have characterized as "anarchic" (Axelrod and Keohane, 1985). Enforcement is particularly difficult in the context of controversial economic reforms that could not have been implemented outside international institutions. In addition to the difficulties surrounding international sanctions (Baldwin, 1986; Mansfield, 1995; Pelc, 2010), domestic opposition to compliance with treaty obligations creates the leader's incentive to violate the treaty (Dai, 2006). For these reasons, we emphasize that the leader must find a major power that is willing to enforce the international institution enabling economic reform. This, we maintain, requires that the major power also benefit from the international institution and can credibly threaten the leader's country with punitive consequences upon failure to implement economic reform.

WHY LEADERS IMPLEMENT MICROECONOMIC REFORMS

Economic reform is one of the most important political decisions that leaders face. Economic reforms can unleash the potential of a national economy, as numerous success stories from East Asia (e.g., Japan, Singapore, South Korea, Taiwan, and China) to Latin America (e.g., Chile) and the Balkans (e.g., Croatia) show. But economic reforms are also fraught with political and economic dangers. Liberalization imposes large costs on previously privileged constituencies who must adjust, and these costs provoke political resistance (Milner and Kubota, 2005). Reforms may also fail, resulting in increased rent seeking and decreased economic performance (Hellman, 1998).

Economic reforms can be roughly classified as macroeconomic or microeconomic. Macroeconomic reforms are composed of changes in the policies that directly affect macroeconomic quantities; in practice, this means focusing on monetary and fiscal policy. As discussed above, microeconomic reforms change the incentives of economic changes more indirectly. For example, privatization is a microeconomic reform that changes the incentives of companies by reducing political interference with management and by replacing the government's "soft budget constraint" with a hard budget constraint (Shleifer and Vishny, 1994).

We assume that leaders enact economic policies in view of maximizing the probability of political survival (Bueno de Mesquita et al., 2003). This is not to say that we discount the possibility of intrinsic preferences stemming from worldview or ideology. Such factors are undoubtedly important. However, our theoretical analysis concentrates on the implications of domestic preference constellations for a leader's decision to reform. Domestic preferences influence a leader's decisions because these domestic preferences influence the leader's ability to stay in office. Thus, we expect political survival to be key to understanding how domestic preferences influence public policy.

In our basic model, the leader is faced with a situation characterized by certain political and economic fundamentals. These include economic performance, the distribution of power among different interest groups, institutional constraints on executive authority, and the current array of economic policies. The leader values being in office, be it due to the ability to formulate policies or due to the available private rents. Thus, the leader's primary goal is to enact policies that allow her to increase her popularity among the public and politically influential, organized special interests (Grossman and Helpman, 1994).

The leader's ultimate interest is in *outcomes*. For example, the leader could pursue economic growth, which is an economic outcome, to achieve the ultimate goal of political survival. Liberalization is simply an instrument that allows leaders to pursue their ultimate goal. Some leaders believe liberalization can benefit them, while others choose more heterodox approaches (Weyland, 2002).

As the leader considers different policies, including economic reform, she does so in view of the relative costs and benefits (Keohane, Revesz, and Stavins, 1998). Economic reform produces a variety of different benefits. Many economists have emphasized the possibility of improving economic performance through liberalization (Dornbusch, 1992; Rodrik, 1996). Economic reforms can lower consumer prices and guide factors of production into more profitable activities than previously. Even more important, economic reforms can remove dynamic distortions that prevent the national economy from achieving sustained economic growth.

These reductions in static and dynamic inefficiency are valuable to the leader for two reasons. First, they generate economic growth, which benefits the citizens, and thus increases the leader's popularity (Baker, 2003; Ferejohn, 1986; Fiorina, 1981). Second, improved efficiency creates surplus that the leader can distribute to organized interest groups in exchange for political support (Olson, 1993; Schamis, 1999). Thus, even leaders whose political survival depends on the support of a small national elite have incentives to expand the size of the economy.

Economic reforms may also have distributive effects that the leader values. Liberalization weakens sectors that were previously protected and creates new constituencies who benefit from reduced state intervention in the economy (Hathaway, 1998; Milner and Kubota, 2005; Schamis, 1999). A leader may, therefore, implement economic reforms, not because they increase economic growth, but because they weaken interest groups who oppose the leader while creating new interest groups that support the leader. For example, exporters who are dependent on intermediate goods may grow stronger if tariffs on these goods are reduced (Manger, 2009). Similarly, import competitors who are not competitive without tariffs and subsidies may go out of business upon trade liberalization (Hathaway, 1998; Maggi and Rodríguez-Clare, 1998; Staiger and Tabellini, 1987). This means that the political clout of exporters grows, while the political clout of import competitors shrinks. If these changes in the domestic constellation of preferences benefit the leader, the anticipation of these changes creates incentives to implement economic reforms.

Croatia's initial experience with privatization serves as a useful example of such distributive effects. As the Federal People's Republic of Yugoslavia collapsed and Croatia gained independence in October 1991, President Franjo Tuđman began to privatize state enterprises. By 1998, "there were almost 2500 privatized firms of which most had a minority state share" (Bicanic and Franicevic, 2003, 14). The privatization effort did not produce net benefits for the Croatian economy, however, as "privatization failed both to bring about a restructuring to firms… and provide legitimacy to new owners who continually faced challenges to their ownership and could not consolidate their financial gains." In other words, the privatized state enterprises remained at the mercy of Tuđman's authoritarian government. His rule was based on strong political support by the political-economic elite, even if "only cemented by the common acceptance of nationalist fundamentalism" (Bicanic and Franicevic, 2003, 18). Tuđman's privatization strategy was a politically rational response to the failure of the socialist economy, but it was implemented in such a fashion that it did not allow Croatia to unleash the nation's considerable economic potential. As Hellman (1998) has argued, such "partial reforms" that let "winners take all" were common across the post-communist world in the aftermath of the demise of the Soviet Union.

These benefits provide a rationale for liberalization, but one must also consider the conditions under which leaders expect benefits from implementing the reforms. We emphasize three conditions that induce leaders to consider liberalization. First, the leader has incentives to consider liberalization if the economy is currently stagnating, and the country's economic woes are related to the lack of microeconomic incentives for performance. For example, the inefficiency of state enterprises creates economic pressure to privatize, while lack of capital formation raises the salience of foreign direct investment. Similarly, lack of domestic innovation raises the possibility of new rules for intellectual property rights.

Second, the leader is more likely to consider liberalization if other countries have reaped benefits from similar reforms. For example, privatization may "diffuse" from one country to another, as one country's successful experience draws attention in other countries in the same region (Murillo, 2002; Brooks, 2005). Similarly, foreign direct investment (FDI) liberalization is more lucrative if surrounding countries have boosted their economies with open investment regimes, so that there is regional competition for foreign capital among neighbors (Simmons and Elkins, 2004).

Finally, and perhaps most important, the leader's incentive to shape microeconomic incentives through liberalization is magnified if the leader believes that liberalization produces targeted benefits for constituencies that support, or could support, the leader (Hellman, 1998; Schamis, 1999). While leaders usually value economic growth, this growth is even more valuable if it can be channeled in such a fashion that loyal supporters and pivotal voters benefit the most (Bueno de Mesquita et al., 2003). Such targeting allows the leader to maximize the benefits from economic growth. In practice, liberalization allows targeted benefits when the leader's support coalition consists of companies and investors who have the resources and knowledge to exploit the opportunities that liberalization creates. For example, privatization creates opportunities for wealthy investors, as the leader can auction valuable assets to them. Investment liberalization creates opportunities for local suppliers and owners of capital coveted by large foreign corporations.

In the next chapter, we propose that democratization can be a particularly important reason that a leader might begin to implement microeconomic reforms. Following Bueno de Mesquita et al. (2003) and Milner and Kubota (2005), we argue that democratization empowers previously powerless mass constituencies. By generating economic growth and reducing consumer prices, microeconomic reforms can benefit the mass constituencies that were empowered by the democratic transition. This change occurs at the expense of the previously privileged interest groups, which benefited from the autocratic leader's policies, a problem that we discuss in detail in the next section.[3]

Throughout history, many leaders have chosen to implement heterodox policies instead of liberalization (Haggard and Kaufman, 1995). In the case of microeconomic reforms, heterodox policies comprise nationalizations, selective capital controls, high tariffs to promote import substitution, and large subsidies to promote public enterprises. We do not reject the possibility that some leaders react to poor economic performance in this fashion. However, our theory predicts that if the conditions outlined above—poor economic performance, encouraging experiences from other countries, and the existence of important constituencies that would benefit greatly from liberalization—are met, liberalization is an attractive strategy for the leader.

Yet, it is important to remember that reforms carry costs. If reforms only produced benefits, all leaders would respond to economic woes by liberalizing. The next section discusses the flip side of the problem of economic reform: some constituencies expect losses from reforms, and this may discourage a leader from pursuing liberalization.

THE DIFFICULTY OF REFORM

While furnishing benefits to leaders and their supporters, reforms also carry political costs. For one thing, reforms reduce profits to the previous beneficiaries of state intervention (Krueger, 1974). Import competitors lose markets as less expensive foreign products become available in domestic shops due to trade liberalization (Milner and Kubota, 2005). Executives and employees of state enterprises must face the vicissitudes of a free labor market upon privatization (Murillo, 2002). Domestic capital owners must compete for scarce labor by offering higher wages if foreign direct investment is liberalized. In general, these costs can be thought of as *adjustment costs* that the reforms necessitate (Dewatripont and Roland, 1995; Furusawa and Lai, 1999; Nsouli, Rached, and Funke, 2005).

Although the exact identities of the losers from reform vary from case to case, it is generally safe to assume that, in the case of microeconomic reforms, much of the opposition comes from previously protected *sectoral interests*. In the previous section, we argued that reforms can benefit constituencies that did not benefit from previous patterns of state intervention. In the case of democratization, mass constituencies would benefit if the democratic government dismantled the toppled autocrat's discriminatory economic policies. However, these benefits come at the expense of the group that used to be privileged. Thus, we assume that the leader's microeconomic reforms meet opposition from interest groups that benefit from state intervention. For example, managers of state enterprises that benefit from large subsidies have incentives to oppose privatization. Those labor unions whose salaries are inflated due to political patronage may also oppose privatization.

The expected losers from economic reform have incentives to oppose said reform. Under autocratic regimes, the losers may attempt to displace the leader through a coup. Under democratic regimes, the losers may mobilize against the leader in elections. Even if the losers cannot directly threaten the leader's political survival at a given juncture, they can try to raise institutional impediments to economic reform. They can collaborate with other parties in the political opposition to delay legislation in the parliament. They can try to influence the bureaucracies responsible for implementing economic reform. They can join forces with labor unions to mount a campaign against economic reform.

Economic reforms are also complicated by the problem of unrealistic expectations. Although the debate on the relevance of immediate adjustment costs to economic reform among political economists remains unsettled (Nsouli, Rached, and Funke, 2005), with some arguing that such costs are modest (Rodrik, 1996) and others emphasizing their large magnitude (Mukherjee and Singer, 2010; Przeworski, 1991), the fact remains that microeconomic liberalization rarely produces huge immediate improvements in citizens' well-being.[4] If large segments of the population are disappointed with the results of economic reform in the short and medium run, then there is a risk of reform reversal (Dewatripont and Roland, 1995; Haggard and Kaufman, 1997; Przeworski, 1991). This risk of reversal may, in and of itself, reduce the probability of successful reform because it deters investors from capitalizing on the opportunities that reform provides. If economic reforms fail to create confidence among investors, liberalization may fail to generate economic growth.

The problem is further amplified by uncertainty concerning the distribution of benefits. Fernandez and Rodrik (1991) show that even if the aggregate benefits from liberalization are known to be positive, the majority of individuals may have a rational incentive to oppose the reform because the distribution of benefits is uncertain. Again, this puts the leader in a difficult position: without reform, economic problems ensue sooner or later; and yet, the majority of citizens oppose the reforms.

The "paradox of plenty" that characterizes the surprising negative effects of oil price surges on oil exporters offers an excellent illustration. In a detailed case study, Karl (1997) documents how several Venezuelan governments reacted to phenomenal increases in oil export revenues during the 1973 and 1979 oil crises. These governments first increased public spending to appease growing constituency demands for oil rents, and then failed to reduce public spending as oil export revenues dried out: "even when oil prices and government income plunged, government behavior did not change" (Karl, 1997, 162). The Venezuelan governments' repeated failure to avoid severe economic recession through prudent fiscal policy resulted from a combination of public expectations of low taxes and welfare spending, underdeveloped bureaucratic institutions, and relentless rent seeking by influential special interests. Thus, even though the Venezuelan leadership was in a difficult economic position, it was never able to implement economic reforms until economic recession was unavoidable. Leader change inevitably followed, as the incumbent failed to distribute rents to her previous supporters.

Algeria's experience with trade liberalization offers another interesting illustration. In 2004 Algeria formed a trade treaty with the European Union. While this agreement created economic opportunities for Algerian exporters and promoted economic reform, liberalization also threatened a large number of small businesses that were not competitive vis-à-vis their European counterparts in the absence of state intervention. Reflecting these concerns, in 2008 an Algerian newspaper wrote that "300,000 small Algerian firms currently at risk from the competition of European commodities are lobbying protectionist trade policy to their own government."[5] Even though Algeria is not a democratic country, such popular opposition to the government's economic policy presented a difficult dilemma to President Abdelaziz Bouteflika.

In post-apartheid South Africa, President Nelson Mandela's government also faced opposition to economic reform. In 1998, as South Africa's economy took a turn for the worse after three good years, the Congress of South African Trade Unions threatened to withdraw its support of the African National Congress due to Mandela's fiscal policy, "which included included cutting back on government employment, holding government wage increases to low real levels, and privatizing or restructuring a range of state-owned companies" (Hirsch, 2005, 163).

In summary, our theory of reform captures the leader's predicament. On the one hand, economic reforms often promise efficiency and distributional benefits, especially if major shocks, such as democratization, have shuffled the constellation of domestic interests. On the other hand, interest groups expecting to lose mobilize to oppose these reforms, and the public may lack the patience to wait for the gains from the reforms. If the leader fails to implement the reform, the economy may stagnate and groups benefiting from reform complain; if the leader implements the reform, the opposition mobilizes and even those who expect to win may be disappointed due to a lack of instant gratification.

Given that there is usually, if not always, some opposition to reform, in the next chapter we argue that the security of the leader's rule is key to understanding how difficult the leader's predicament is. If the leader is a secure one, perhaps due to popularity and/or a stable ruling coalition, she can implement the reforms and weather the resulting political storm. In such circumstances, the leader's immediate political cost is so low that the sacrifice is worth the increased political support and rents that are available in the future. But if the leader is an insecure one, any effort to liberalize may result in the leader's toppling. Thus, the difficulty of reform is maximized: Why pay the immediate political cost of reform when it is quite plausible that one will not survive in power to reap the benefits of liberalization?

For our purposes, the key observation is that a leader's expectation of gross benefits from economic reform does *not* immediately cause this reform. Even if economic reform produces gross benefits, the leader has no incentive to implement it whenever the probability of success is too low relative to the cost of reform. Indeed, a leader who expects benefits from reform must surmount formidable political obstacles. The extent to which a leader can exploit economic reform for political gain depends on the availability of instruments and strategies that can reduce the gross costs of reform below the gross benefits. From this, it follows that many opportunities for economic reforms valued by leaders are forgone. Leaders either choose not to even try because the probability of success is low while the cost is high, or the leaders attempt to implement economic reforms that soon die an untimely death under relentless political pressure.

If economic reform is often difficult due to domestic opposition and other obstacles to liberalization, what are the strategies that leaders can use to implement economic reforms? It is natural to begin with domestic strategies. Leaders can try to suppress opposition by denying the opponents access to political decision-making. A right-wing government could, for instance, try to exclude labor unions from political deliberations. Leaders can also try to bribe opponents by offering side payments to them. A left-wing government could, for example, negotiate increased wages for labor unions in exchange for privatization. Such strategies are an integral component of the political processes that ultimately result in economic reform, except in the most totalitarian of dictatorships.

Alternatively, leaders can try to mobilize the potential supporters of reform. Schamis (1999) offers an excellent comparative analysis of such strategies in different Latin American countries. He finds that from Argentina to Mexico, much of the economic reform that leaders implemented was carefully crafted to increase rents for potential winners of liberalization. Such strategies coalesced the winners' coalition, and thus allowed the leader to consolidate her political power through economic reform. In the case of Chile, for example, Schamis (1999, 249) offers the following account of General Augusto Pinochet's liberal economic reforms:

> The liberalization experiment in Chile thus shows a collective action pattern: key policymakers of the Pinochet government served on the boards and in the executive offices of large economic conglomerates before and after holding cabinet and central bank positions, leading to collusion between economic and political power. Beneficial policy contexts allowed these firms to extract rents and consolidate positions of leadership, even monopoly ones, in their respective sectors.

Stated differently, Pinochet was able to sustain liberalization by ensuring that influential business interests reaped most of the gains while other societal groups with less political clout bore most of the burden.

But, sometimes, these strategies fail. Geddes (1994) reviews cases of economic reform in 20 developing countries and identifies a common pattern in three cases—Senegal, Zambia, and Venezuela—of reform failure:

> The parties that traditionally benefited from state intervention in the economy were still politically dominant at the time reforms were initiated; and the costs of reform, though not unusually high in comparative perspective, fell on a large part of the urban population (including party activists) rather than primarily on the urban working class.

In each case, the leader initiated economic reforms to improve the performance of the economy. However, these economic reforms also imposed costs on the leader's traditional support base. Consequently, the leader was forced to abandon them, even though the expected economic cost of failing to reform was also high.

These examples again illustrate the importance of how secure the leader's rule is. Secure and powerful leaders can withstand temporary political opposition to reform. Over time, as the reforms are consolidated, such reform withers away because the opposition incurs the resulting adjustment cost, and thus no longer has an incentive to continue opposition (Hathaway, 1998; Nsouli, Rached, and Funke, 2005). In contrast, weak leaders may hesitate to liberalize because their rule is continuously under threat.

The very reason we are writing this book is that workable domestic strategies for implementing economic reforms are often not available. Economic reforms often produce highly concentrated losses for constituencies that were previously strengthened by state intervention. In such circumstances, the leader's ability to implement economic reform is severely constrained. Either the leader must create such a lucrative compensation package that the beneficiaries of state intervention are willing to abandon their previous rents for it, or the leader must create such a powerful winners' coalition that these influential opponents of economic reform can be overcome. The difficulties associated with these strategies are compounded by the uncertain nature of economic reform. In each case, the cost subtracted from the benefits of economic reform is thus large.

This is where international institutions enter the game. By engaging international institutions in the domestic reform process, a leader can expand her menu of strategies of creating political support for reform. From the International Monetary Fund (IMF) to the World Trade Organization (WTO) and trade treaties, many international institutions have played this role. In the next section, we examine the microanalytics of this proposition.

WHEN AND HOW CAN INTERNATIONAL INSTITUTIONS HELP?

If a leader wants to liberalize but faces stiff domestic political opposition, her first recourse is a domestic policy package. However, if such policy package is either not feasible or too costly, the leader must consider alternative courses of action. In this section, we argue that under certain, empirically identifiable conditions, international institutions can help the leader cut the Gordian knot of reform. *If the leader forms an international institution with a major power, and the international institution mandates liberal economic policies, she can enhance the credibility of liberalization while creating tangible benefits for domestic constituencies, which increases domestic political support for reform.*

For our purposes, international institutions are defined as "explicit arrangements, negotiated among international actors, that prescribe, proscribe, and/or authorize behavior" (Koremenos, Lipson, and Snidal, 2001, 762). This definition emphasizes the fact that international institutions embody explicit commitments by state parties. While other scholars have given much broader definitions of institutions and regimes (Krasner, 1982; Young, 1999), we are interested in international institutions as specific instruments of domestic political survival. Consequently, the role of more implicit institutions, such as widely accepted norms and beliefs, is less important. If a leader is to promote economic reform in a given political situation, she cannot expect a new norm or culture to rapidly emerge and thwart immediate threats to political survival. Leaders cannot design a worldwide norm, for such norms emerge slowly, and often accidentally, over time (March and Olsen, 1998). But leaders can negotiate formal treaties.

Our general theory can be applied to bilateral, plurilateral, and multilateral institutions. For example, both IMF arrangements and bilateral agreements on sovereign debt would qualify in the field of international finance. However, there are good reasons to believe that bilateral and plurilateral institutions, such as regional trade agreements, are strategically more suited for promoting microeconomic reforms than genuinely multilateral institutions. The former are easier and faster to form than multilateral institutions, as bilateral and plurilateral negotiations provide leaders with more flexibility than multilateral negotiations. To us, negotiating a multilateral agreement among dozens or hundreds of countries to promote specific microeconomic reforms appears unnecessarily difficult.

Classical cooperation theory emphasizes the benefits of institutionalization at the international level (Abbott and Snidal, 1998; Keohane, 1984). Most important, this literature notes that international institutions can help states achieve cooperation in the form of mutually profitable policy adjustments. Specifically, international institutions allow states to minimize the transaction costs of coordinating state behavior at the international level. For example, institutions can reduce the cost of enforcing collective action to mitigate negative externalities (Barrett, 2008). Similarly, institutions can help states pool resources and disseminate information about behavior and preferences (Dai, 2002).

More recently, the role of international institutions as instruments in domestic politics has also been recognized. For example, some scholars have emphasized that IMF programs allow governments to force their preferred policies on reluctant domestic constituencies (Drazen, 2002; Vreeland, 2003). Others have argued that international agreements enhance the credibility of trade reform, and thus encourage domestic producers to adjust (Maggi and Rodríguez-Clare, 1998; Staiger and Tabellini, 1987). Yet others have argued that international organizations can help governments in democratizing states credibly commit to economic and political reform (Mansfield and Pevehouse, 2006). And yet others have argued that international institutions allow a leader to tie her successor's hands (Gruber, 2000).[6]

Our debt to this latter approach, which emphasizes domestic-international linkages, is immense. Indeed, our model is inspired by ideas presented in these works. However, our focus is different. A large part of the previous research on the domestic effects of international institutions focuses on what international institutions *can* do for leaders. We build on this foundation, but our primary interest is not only in *why*, but also in exactly *when* leaders choose to use such international institutions. In other words, we examine the situational characteristics that induce leaders to build international institutions for domestic political purposes. We go beyond broad macro-level factors, such as regime type and state power, and instead offer a self-contained account of the domestic political economies that motivate leaders to consider international institutionalization. As we discuss the benefits of international institutionalization, it is essential to recall that such benefits are conceived in a specific situation that calls for economic reform.

Recall that we have, so far, characterized the conditions under which leaders expect benefits from economic reform but find implementation difficult and costly due to domestic opposition. Moreover, we have considered the possibility of domestic strategies. Based on these factors, we have proposed that in the case of interest, the expected benefits of reform fall below the costs.

Given that this condition holds, the leader has an incentive to consider the use of international institutions. Assuming domestic strategies are unavailable or ineffective, how can international institutions help the leader? If international institutions can increase the probability of success or the benefits of reform, the leader's incentive to implement reform increases. This is also true if the political cost of reform decreases when international institutions enter the game.

We now explore the causal mechanisms through which international institutions can increase the expected benefits or reduce the expected costs of economic reform. Recall that we need to explain why international institutions increase the leader's expected payoff. In principle, there are three ways in which international institutions can achieve this. First, international institutions can increase the probability that economic reform, if implemented, succeeds. Second, international institutions can enhance the value of economic reform, conditional on successful implementation. Third, international institutions can reduce the domestic political cost of implementing liberalization.

We will claim that international institutions can achieve all three goals. To substantiate this claim, we first note an important difference between domestic policy formation and international institutionalization. Compared to domestic policy formation, the leader's role as the central actor is pronounced in international negotiations (Milner, 1997; Putnam, 1988). Legislatures, special interest groups, the judiciary, and bureaucratic agencies cannot engage directly in international negotiations on economic reform commitments (Vreeland, 2003). The leader, however, can engage in such negotiations. In our argument for why international institutions can help leaders implement economic reform, this institutional difference is the first building block. In general, international negotiations allow the leader more initiative than domestic policy formation.

We recognize that domestic actors can constrain the executive's authority through legislation, especially in democratic countries. For example, the president of the United States can engage in "fast track" negotiations with foreign countries about trade cooperation only if so authorized by the Congress. Among other things, this authorization played an important role in the NAFTA negotiations (Cameron and Tomlin, 2000). Similarly, legislatures can enact legislation to constrain the leader's ability to negotiate IMF or World Bank loans. For example, in December 2009, the Nigerian House of Representatives prevented the government from signing a World Bank loan worth US$300 million. Along with other prominent Nigerian politicians, Honorable Femi Gbajabiamila, the minority whip and the leader of an opposition party, Action Congress, questioned the motivations of the government and argued that the negotiations are illegal, saying that "[t]here is no point for investigation or hearing the other side. It was reported on the floor the other day that the people involved had apologised. It is an illegality."[7]

All else constant, though, the leader's centrality in foreign policy is greater than in domestic politics. The primary means by which domestic political actors influence foreign policy is through ratification—be it formal or informal—of international agreements (Milner, 1997; Putnam, 1988). Importantly, the existence of this ratification constraint is not a problem for our theoretical approach. We claim that the leader negotiates international institutions in such a fashion that enables the simultaneous passing of domestic economic reform and domestic ratification of treaty commitments. The leader negotiates a treaty that contains a policy package. If economic reform is an integral component of this policy package, but the policy package also confers benefits to key domestic constituencies, the policy package can be implemented even though reform would be impossible without the policy package. The inclusion of benefits from international institutionalization moves the policy package within the "win set" (Putnam, 1988) of pivotal domestic constituencies, and ratification is made possible.

To understand this logic, consider a country in which treaties must be formally ratified. Suppose further that the leader has already exhausted domestic strategies for economic reform. Even in the presence of the ratification constraint, it is possible that the leader can create an international institution that produces benefits for domestic veto players. For example, the leader could present a treaty to the legislature that (i) requires economic reform *and* (ii) enhances market access to foreign partner countries. Such a treaty garners the support of exporters, and this increase in support may be enough to tilt the balance so that economic reform is possible. Without the treaty, exporters would not support economic reform, and thus economic reform would be too costly for the leader.

The *ex post* ratification constraint notwithstanding, the primary constraint on the leader's ability to negotiate international institutions has foreign origins: a leader cannot negotiate a treaty that is unacceptable for foreign partners. In pursuit of analytical clarity, we ignore such constraints for the time being. In this section, we examine how the leader would negotiate international institutions if foreign countries were generously willing to help her with the implementation of economic reform. In the next section, we then characterize the conditions under which the relevant foreign countries—major economic powers, such as the European Union and the United States—are indeed willing to do so.

Suppose now that the leader engages in negotiations on establishing an international institution, so as to promote economic reform at home. For the international institution to help, it must, at the very least, meet two primary criteria. First, it must be directly relevant to economic reform. In particular, the international institution must contain provisions that enable, perhaps even dictate, policies that promote economic reform in the leader's country. This is a rather obvious point, and so we do not belabor it here.

Second, and more important, the international institution must somehow increase the leader's ability to promote economic reform. This occurs through two causal mechanisms. For one, international institutions allow the leader to *credibly commit* to reform. This is important for attracting FDI, encouraging domestic businesses to invest, and inducing both producers and consumers to implement the costly adjustments that help lock in liberal policies. Moreover, credible commitment encourages the supporters of economic reform to mobilize because the value of successful mobilization goes up. In this setting, the government's liberalization efforts will provoke a market response, perhaps in the form of increased FDI, and this increases the value of economic reform. The increased credibility of the reform enhances its value to the leader, and thus the leader is more likely to implement the reform in the first place. While credible commitment allows the leader to consolidate already planned reforms, enhanced credibility also increases the probability that the leader can initiate the reforms.

Additionally, international institutions create new opportunities to offer *domestic* side payments to influential constituencies. These domestic side payments expand the set of constituencies who may expect to win from the implementation of a policy package that contains both the international institution and economic reform, while shrinking the set of constituencies who expect to lose from such a domestic issue linkage.[8]

Consider first the strategy of credible commitment. By adopting legally binding obligations to implement economic reforms, the leader increases the cost of reversing those reforms (Büthe and Milner, 2008; Mansfield and Pevehouse, 2006; Pevehouse, 2005; Vreeland, 2003). The country's failure to honor these obligations would result in negative reputational consequences, from reduced investor confidence to suspension of cooperation by foreign countries (Guzman, 2008; Tomz, 2007). Moreover, the foreign partner can legitimately retaliate any defections, and this further increases the leader's cost of defection. Such credibility encourages economic actors, both domestic and foreign, to invest and undergo costly but ultimately profitable adjustments. Without the credible commitment, liberalization may have little effect on producer and consumer behavior, which means that the leader does not reap the benefits of liberalization. International enforcement mechanisms are complementary to domestic enforcement mechanisms.

As the leader forms an international institution that prescribes economic reform, the domestic cost of defection increases. The existence of an international treaty legitimizes the demands of pro-liberalization groups (Dai, 2005), and thus further tilts the domestic balance of power in favor of the supporters of reform. Moreover, many international institutions contain monitoring mechanisms that can reveal information about non-compliance to interest groups and interested citizens, and thus increase the government's incentive to comply (Mansfield and Milner, 2012; Mansfield, Milner, and Rosendorff, 2002).

In the case of liberalization, these credibility mechanisms are further strengthened by the adjustment process itself. If the international institution enables liberalization, the resulting adjustments by affected companies help consolidate the reform (Hathaway, 1998). As companies adjust their policies to the new economic environment under liberalization, they have less to gain from protection and state intervention. This means that if the aforementioned credibility mechanisms help the leader trigger the adjustment process, a virtuous cycle of further adjustment may ensue.

Stone (2002) offers an example of how the IMF has successfully given credibility to economic reform in small post-communist countries, such as Bulgaria. The IMF has promised economic assistance to these countries in exchange for economic reforms. By threatening to suspend loan programs in the absence of economic reform, the IMF has given these countries' governments a powerful incentive not to deviate from their promises of economic reform, even in the presence of domestic political mobilization.[9]

How does this increased cost of reversal expedite economic reform? The primary benefits are twofold. First, credibility increases the leader's own payoff from economic reform. Economic reforms are useful because they change the behavior of producers, consumers, and investors. If these targeted groups do not believe that the reform is credible, they have no incentive to incur the costly adjustments that would be profitable given successful economic reform (Büthe and Milner, 2008; Kydland and Prescott, 1977; Mansfield and Pevehouse, 2006; Przeworski, 1991). Foreign direct investment does not increase, exporters do not invest in production facilities that would allow them to capitalize on changed relative prices, and so on. Thus, improved credibility means that the leader has stronger incentives to initiate reforms.

Second, credibility mobilizes winners. As we argued earlier, the leader's ability to pass economic reform is fundamentally dependent on the formation of a supporting coalition. Unless economic reform is credible, such supporting coalition is difficult to form. Why would potential winners from economic reform mobilize to support the leader unless the leader's promise to change policies is credible?

To be sure, credible reform may also mobilize losers. This undermines the beneficial mobilization effect of credibility. But the importance of this point should not be overstated. Economic reform is very difficult, if not impossible, without a supporting coalition. While losers' mobilization may partially offset the effects of the formation of a supporting coalition, the probability of success is bound to be very low without such a supporting coalition. Additionally, some of the losers react to enhanced credibility by adjusting, and this reduces the size of the opposing coalition. For these reasons, on balance, we expect the mobilization of winners to be strategically more important than the mobilization of losers.

To illustrate the benefits of credibility, one only has to consider the relationship between PTA formation and foreign direct investment. Büthe and Milner (2008) find that PTA formation results in a substantial increase in foreign direct investment in developing countries, and other authors report similar findings (Baltagi, Egger, and Pfaffermayr, 2008; Levy Yeyati, Stein, and Daude, 2003).[10] Büthe and Milner (2008) ascribe the effect to legally binding provisions that require a leader of a developing country to respect property rights, reduce discrimination against foreign companies, and so on: "Unilateral, domestic policy choices can often be easily changed, especially if the change is at the expense of foreign private actors... a government can make a more credible commitment regarding present and future economic policies by entering into international agreements that commit its country to the liberal economic policies that are seen as desirable by foreign investors" (Büthe and Milner, 2008, 742). If such legally binding provisions are expected to be "window dressing," then they are hardly of interest for domestic groups in the developing country. But if the provisions are expected to be genuinely binding, so that they do increase foreign investors' willingness to purchase assets in the developing country, they also change domestic constituencies' incentives. Most important, groups that expect to benefit from foreign direct investment—by selling assets, finding new jobs, acquiring advanced foreign technology, forming joint ventures, and so on—have incentive to support the leader in PTA negotiations, ratification, and implementation.

In the case of intellectual property rights, the relationship between PTA implementation and Special 301 legislation of the United States offers a useful illustration. Every year, the US Trade Representative surveys intellectual property rights (IPR) in the trading partners of the United States. If a country is deemed not to enforce intellectual property rights, it is placed on a "priority list," which is essentially a blacklist of countries whose policies for intellectual property rights are lax, as deemed by the US Trade Representative. One issue that Special 301 reports emphasize is the consistency of a country's IPR policy with the provisions of a PTA with the United States. When NAFTA entered into force, for example, the 1995 Special 301 report noted that "Mexico revised its patent law to come into compliance with its NAFTA obligations." NAFTA increased the Mexican government's incentive to implement IPR reform because failure to do so would have jeopardized trade cooperation with the United States.

But credible commitment is not the only benefit of international institutions: the evidence we provide in this book tells a more complex story. In addition to credibility, our argument emphasizes the importance of international institutions for a leader who wants to change the domestic power balance between opponents and supporters of economic reform at home. We argue that international institutions allow leaders to manipulate the composition of the supporter and opposition coalitions. In addition to "lending credibility" (Stone, 2002), we argue, international institutions can help leaders secure the initial acceptance of economic reform.

In general, this part of our argument builds on the idea of "two-level games" first proposed by Putnam (1988). As he notes, leaders engaged in international negotiations must simultaneously play two games: one international, the other domestic. While most of his analysis focuses on the effects of domestic constraints on international outcomes, he also proposes that leaders can use international negotiations to shape the domestic political context: “if international pressures reverberate within domestic politics, or if issues can be linked synergistically, then domestic outcomes are not exogenous, and the two levels cannot be modeled independently” (Putnam, 1988, 456). While Putnam’s two-level analysis is too abstract to generate detailed predictions, in the case of economic reform, we can build on this logic to advance empirically falsifiable claims.

The argument is based on the idea that international institutions allow leaders to combine economic reform with other issues that change domestic constituencies’ calculus. If economic reform is prescribed by an international institution, then rejecting that international institution due to the economic reform also results in rejecting *all other* elements of the international institution, for cooperation fails to materialize. To the extent that these other elements promise additional benefits for the initial domestic supporters of economic reform, the international institution can help them mobilize. To the extent that these other elements promise countervailing benefits for initial opponents of economic reform, the international institution can reduce their incentive to mobilize in opposition to economic reform.

This arguments has two prongs. For one, the international institution contains provisions that benefit the supporters of economic reform. For example, consider a politically controversial proposal to liberalize investment. Since such liberalization creates profit opportunities for capital owners, they support the proposal. If the proposal is embedded in a PTA that also creates export markets in the European Union or the United States, the capital owners have even stronger incentives to support the PTA than the initial proposal, provided they expect profits from increased exports. Given these incentives, the supporters of the initial proposal mobilize even more aggressively than they would have without the PTA. In this case, the PTA contains an “issue linkage” (Davis, 2004; Sebenius, 1983; Urpelainen, 2011) that increases the probability that the initial reform passes.

Second, opponents of the political controversial reform may be compensated for their losses. Suppose, for example, that an existing exporter is opposed to reduced production subsidies for intermediate goods because said goods are important for the production of the final goods exported. This exporter would clearly oppose the leader’s proposal to enhance competition policy by slashing state subsidies. Now, consider instead the possibility that the enhanced competition policy is built into a PTA with a major foreign market. If the PTA creates new export opportunities, the enhanced competition policy becomes more palatable because the new export opportunities offset the cost of reduced state subsidies to intermediate goods, either in full or in part. This mechanism also allows the international institution to change the domestic balance of forces in favor of the reform, thus allowing the leader to implement a new policy that would have been politically too controversial without the PTA. To approach the argument from a somewhat different angle, consider a domestic "veto player" in the leader's country who has the ability to stop economic reform. Suppose, for simplicity, that the veto player can reject any reform proposal (Tsebelis, 2002). If the benefits of reform, B^{veto}, fall below the costs, C^{veto}, then the veto player rejects it because $B^{veto} - C^{veto} < 0$. But suppose that the international institution also increases market access to foreign countries. If this market access is worth $M^{veto} > 0$, then the domestic veto player does support the international institution so long as $M^{veto} + B^{veto} - C > 0$. Even though economic reform remains costly, the additional market access gives the veto player a material incentive to support the international institution. In other words, the issue linkage between economic reform and market access turns the veto player from an opponent of economic reform to a supporter of the policy package that comprises both economic reform and market access.

These effects are directly beneficial for the leader. If economic reform through purely domestic legislation fails, the international institution may nonetheless succeed in promoting liberalization. The leader engages in international negotiations and presents to domestic actors a package that combines economic reform and other policies. Political cleavages concerning this combined package differ from a purely domestic legislative act concerning economic reform. If the international institution is designed in view of garnering political support, it results in more active mobilization by supporters and less active mobilization by opponents.[11]

IMF conditionality offers an illustration of this logic. When the IMF offers a loan to a country, it does so conditional on the implementation of policy reforms, such as balancing the budget and privatization (Vreeland, 2007). If a leader expects benefits from fiscal austerity and privatization, but domestic resistance to these actions is intense, an IMF loan can help. The IMF loan provides the leader with resources that can be strategically allocated to the supporters of economic reform. Thus, domestic constituencies have stronger incentives to announce their support for the economic reform. Even if they expect modest losses from economic reform, they will support it when they expect a large enough share of the IMF loan.

Vreeland (2003) offers a related, though not identical, argument. He claims that the IMF can be a "scapegoat" for economic reform. More specifically, the IMF is an instrument of coercion that a leader uses to impose reform on an unwilling population. If a leader negotiates an IMF loan, and domestic constituencies reject it, international investors become fearful that this country may not be willing to implement economic policies according to IMF preferences in the future. To the extent that international investors believe IMF policies are warranted, a country's explicit rejection of the IMF reduces investment and increases the cost of borrowing money from international financial markets. This argument would explain, in particular, why leaders sometimes negotiate IMF loans in spite of relatively good economic performance (Vreeland, 2003).

Our argument for why international institutions can promote economic reform imposes far less demanding requirements for their institutional capabilities than Vreeland's (2003) account of the IMF as an instrument of coercion. The coercion argument requires that a rejection of the international institution automatically result in punitive consequences, be it through direct sanctions or through market reactions. Our argument is different. We expect that the international institution expands the leader's ability to pass domestic policies, and thus allows the leader to create domestic coalitions in support of economic reform. As such, our argument applies to a much wider range of international institutions than the unusually influential IMF.

Indeed, there are good reasons to believe that bilateral institutions are often strategically *superior* to multilateral institutions. Consider, for example, a new leader whose power is insecure. If this leader must manage a democratic transition, so that economic liberalization is of paramount importance, the leader can hardly afford to engage in lengthy negotiations with a multilateral institution. If the leader can instead adopt the more flexible strategy of negotiating a bilateral strategy, such as a PTA with provisions on economic reform, the leader has a higher chance of concluding the negotiations in a relatively short period of time. This enables the leader to implement the badly needed liberal reforms without costly delay or, in the extreme case, loss of power.

To foreshadow our case studies that follow, consider Croatia. As the authoritarian government of Franco Tuđman ceased to exist with Tuđman's death in 1999, Croatia was in an extremely difficult situation. Previous economic reforms had failed to improve the country's economic performance, though they did allow the nationalist elite to retain power and become wealthy (Bicanic and Franicevic, 2003). The new government formed by Ivica Račan comprised six parties with very different ideological preferences. Such a fractionalized government, under constant and intense pressure from the nationalist supporters of Tuđman's Croatian Democratic Union, was not in a position to easily implement the economic reforms that would allow Croatia to achieve sustained economic growth.

Negotiations with the European Union on a Stabilization and Association Agreement (SAA), a PTA model designed for the Balkans, allowed a way out. Croatia finished negotiations already in May 2001, and thus agreed to implement deep economic reforms while obtaining access to the lucrative European markets. The political and economic value of European integration reduced opposition to economic reform and mobilized the supporters of liberalization, while also allowing a credible commitment to economic reform—failure to comply with the PTA would have delayed or even prevented Croatia from applying for membership in the European Union.

Ivica Račan's government was, by engaging in international negotiations, able to set Croatia on a path to a market economy. According to an early World Bank (2003, 3) report, "if the experience of the [South Eastern European countries] is any guide, European integration under the SAA will be key for Croatia's long term development projects… only those countries which have undertaken the necessary economic, political and institutional reforms can accrue some of the key benefits of European integration such as increased trade flows and FDI."[12] His successor, Ivo Sanader, built on this foundation and implemented most of the reforms required for EU membership (Gray, 2009, 931). The resulting increase in economic growth and well-being has been an unqualified success story among post-communist countries. Indeed, Croatia gained membership in the European Union on July 1, 2013.

International institutions can also help developing countries reform in several other ways. One possible side payment that could accompany economic reform is foreign aid that is explicitly designed to reduce the cost of liberalization. In an article related to this book, we show that developing countries forming a PTA with the European Union or the United States experience a large inflow of aid within five years of signature (Baccini and Urpelainen, 2012).[13] Interestingly, we find that the European Union and the United States increase their aid only in sectors that are subject to economic reforms commonly prescribed in a PTA, such as industrial development and privatization programs. Conversely, sectors excluded from PTA treaties and not subject to reform, such as fisheries and tourism, experience no increase in EU or US foreign aid upon PTA signature. To illustrate the importance of foreign aid as a side payment, in the Appendix[14] we show the effect of PTA formation on EU aid to Chile and Croatia, as well as US aid to Costa Rica and Jordan. As these developing countries formed PTAs with the major powers, they secured additional foreign aid. In conjunction with our finding that the foreign aid was targeted in sectors relevant to economic reform, these cases provide suggestive evidence for the role of side payments in promoting an international approach to economic reform.

Had these developing countries instead relied on purely domestic reform strategies without international negotiations, they would not have been able to secure this additional foreign aid.

In sum, we have argued that certain international institutions can help leaders break domestic gridlocks that prevent economic reform. These international institutions must enhance the credibility of the liberalization commitment, must create benefits to domestic constituencies, and must be flexible enough so that the leader can actually negotiate them without unacceptable delay. A graphical illustration of this argument is provided in Figure 2.1. It shows how otherwise impossible economic reforms become possible after international negotiations. International institutions, then, make economic reform an art of the possible.

However, there is also the need to find a *partner* for international institutionalization. Countries cannot unilaterally form international institutions, so the leader's ability to liberalize requires finding a suitable partner. In the final section of this chapter, we argue that major economic powers with global interests, notably the European Union and the United States, are both willing and able to form international institutions that promote liberalization in developing countries. We now detail the general argument, and discuss the specific case of PTAs in the next chapter.

MAJOR POWERS AS PARTNERS: CREATING SURPLUS, ENFORCING AGREEMENTS

International institutions are formed in negotiations between sovereign states. A leader cannot simply choose to unilaterally create an international institution to advance domestic economic reform. Instead, the leader must

Figure 2.1 International Institutions and Economic Reform. If negotiations on an international institution are possible, and the international institution can enhance the credibility of commitments while providing side payments to domestic constituencies, the leader's ability to promote reform improves.

negotiate to form an international institution with a foreign partner. The foreign partner is useful if it is interested in forming an international institution and is capable of enforcing commitments to liberalization.

In this section, we examine the conditions under which a leader can find foreign partners who are interested in and capable of forming an international institution that advances economic reforms. We argue that *major economic powers* are best positioned to play this role. Their interests are global, so they are potentially interested in promoting economic reform in developing countries. Moreover, we argue that major economic powers are both willing and able to enforce treaty commitments.

To see why major powers play a key role, consider the dual function that we have proposed for international institutions: credible commitment and domestic side payments. An international institution is ideal for promoting economic reform if it helps the leader achieve both goals. We begin by showing that major powers, as members of international institutions, can do this. We consider each function in turn, and then examine the major power's incentive to collaborate with the developing country's leader on economic reform.

First, major powers can help the leader form a package deal that results in a more favorable domestic balance of power between domestic opponents and supporters of reform. Major powers can, by virtue of their size and power, promise lucrative economic benefits to their partners (Baldwin, 1986; Bueno de Mesquita and Smith, 2009). If the United States negotiates an economic agreement, such as preferential market access or a framework for promoting investment, with a poor African country, the opportunity cost of failing to seal the deal is high for this African country. Given that exporter interests often have considerable political clout in developing countries, a government's failure to negotiate a trade treaty with a major economic power would result in domestic backlash from exporter interests. In the case of the United States, for instance, Shadlen (2008, 14) observes that"[t]hose actors within a given developing country who stand to benefit from increased access to the US market have more weight in policy making than those who stand to lose from regulatory harmonisation." This tendency is further strengthened by competition with other developing countries for preferential market access (Shadlen, 2008). The opportunity cost of such failure is probably much less if the United States is replaced by Iceland or Mongolia.

Second, major powers can enforce commitments. International institutions do not, in and of themselves, enforce anything. As Axelrod and Keohane (1985, 250) put it, "[i]nternational regimes do not substitute for reciprocity; rather, they reinforce and institutionalize it." More specifically, international institutions reduce the cost of enforcement by providing clear standards for behavior (Morrow, 2002), by creating information concerning compliance (Keohane, 1984), and by giving the enforcers a normative rationale for imposing sanctions on defectors (Pelc, 2010). Such functions are hardly useful, though, unless they are combined with structural power (Baldwin, 1986; Krasner, 1991). Clear standards for behavior are not helpful unless violating them results in punitive consequences; information concerning compliance is not relevant for incentives unless it helps a leader avoid punishment; and normative rationales for imposing sanctions are not useful unless such sanctions have potential.

Major powers can enforce compliance with international institutions in multiple ways. They can withdraw the concessions they made upon forming the international institution (Keohane, 1986). They can use economic sanctions (Baldwin, 1986). They can suspend cooperation in other issue areas (Guzman, 2008; Lohmann, 1997). The combination of these possible approaches constitutes a major power's response to non-compliance.

In addition to being capable of enforcement, major powers also have a clear *interest* in doing so. The microeconomic reforms that we analyze, such as privatization and investment liberalization, are of interest to the major power because they create profitable businesses opportunities, such as investment, to large corporations with headquarters in the major power's jurisdictions, such as banks and automobile manufacturers (Cameron, 1997; Chase, 2005; Manger, 2009). Liberalization opens new markets and creates investment opportunities for large corporations, and these large corporations have incentives to demand that their governments form international institutions to promote liberalization.

If the leader of a developing country threatens to reverse the reforms, and thus impose a cost on a corporation, the major power's government suffers a political and economic cost if it fails to protect the corporation's interest. For example, if the government of the United States fails to respond to a developing country's decision to close an American company's manufacturing plant, the company and business interest groups, such as the US Chamber of Commerce, may reduce campaign contributions to the government.[15]

Moreover, the major power's failure to enforce treaty commitments may carry a reputational cost. A major power with global economic interests pays a reputational cost if it fails to enforce one agreement. This failure to enforce causes third parties to discount the major power's credibility, and this in turn means that non-compliance with other similar agreements increases.

Consider, again, the case of intellectual property rights. For decades, the United States has pushed other countries to adopt more stringent rules for IPR legislation (Sell, 1995). This is so because American companies are leaders in technology innovation in many industries, and thus they incur huge losses from piracy. One way the United States has tried to coerce other countries, since 1989, to adopt new IPR rules is through Special 301 legislation.[16] As a blacklist, Special 301 allows the United States to influence the contours of trade cooperation with other countries. Indeed, one key issue that the Special 301 legislation emphasizes is the policies of different PTA partners. Countries that violate their IPR commitments are called out for this. The fact that a foreign country has accepted a legally binding obligation to change its domestic IPR legislation provides the US Trade Representative a strong normative and economic rationale for threatening this country with sanctions.

Another example of enforcement can be found in one of our case studies that follow, namely South Africa's PTA with the European Union in the post-apartheid era. Not only does the PTA contain a wide range of provisions for economic liberalization, from trade liberalization to enhancing competition policy and promoting the privatization of South Africa's public enterprises, the treaty text also provides for a legally binding dispute-resolution mechanism that allows the European Commission to sue South Africa for failing to comply. Furthermore, the PTA's ability to promote the implementation of economic reform has been remarkably impressive. According to Dr. Wilhelm Smalberger, a South African trade official who played a central role in implementing South Africa's PTA with the European Union, the European Commission has been so satisfied with South Africa's progress that it has not filed a single complaint by the time of the interview, almost 13 years since the PTA entered into force in 1999.[17]

This reasoning suggests that major powers *can* enforce international commitments. But do they have the incentives to form international institutions in the first place? Recall that a leader interested in economic reform must form an international institution that specifically prescribes economic reform. Why would a foreign major power care about domestic economic reform in the leader's country?

There are several reasons for this. The first, and in our view the most important one, is the availability of economic benefits. Major economic powers have global interests. They are home to large multinational corporations that roam the globe in search of ways to optimize their supply chains and find new markets. Enter foreign countries interested in economic reform. To the extent that these economic reforms increase profits available to multinational corporations from a major power, these economic reforms are valuable to the government of the major power. They help this government garner the support of influential business interests. For example, they can do so by enabling foreign direct investment (Büthe and Milner, 2008) and by prying open markets (Cameron, 1997).

Such interests played an important role in NAFTA negotiations. As Manger (2009) has shown, a major issue in the NAFTA negotiations was the creation of a system whereby American companies, such as automobile manufacturers, would be able to invest in Mexico. This would allow Mexico to increase foreign direct investment, a key goal for the Salinas administration (Cameron, 1997). It would also benefit the United States, because investment in Mexico would reduce the cost of automobile manufacturing. This would enhance profits for American automobile producers while also decreasing consumer prices. A similar logic can be applied to other sectors, such as machinery and textiles.

Second, major powers sometimes also have political incentives to promote economic reform in foreign countries. To the extent that such economic reforms promote political stability—and we recognize that not all do—they can serve the strategic interests of major powers. For example, economic growth in the Balkans and Eastern Europe improves European security and reduces negative externalities, such as drug trade and human trafficking. Similarly, economic growth and industrial diversification in the Middle East can help the United States stabilize this volatile but politically central area. Thus, even if the developing country's leader is primarily interested in the political-economic benefits of liberalization, this does not mean that a major power, such as the European Union or the United States, cannot use the international institution to achieve its geopolitical goals.

Such stabilization functions are explicitly recognized in many PTAs. Consider EU Stabilization and Association Agreements (SAAs) in the Balkans.[18] These agreements impose reform conditions on partner countries, such as trade liberalization and competition policy, and thus increase the value of these markets for European companies. But the agreements also contain provisions for foreign aid aimed at economic modernization and democratic reform. In the Western Balkans, the EU Community Assistance for Reconstruction, Development, and Stabilisation is based on the SAAs that the European Union has formed. The program provides aid to reinforce "democracy and the rule of law" and "promote social development and structural reform" in view of "implement[ing] the obligations in the Stabilisation and Association Agreements."[19]

In sum, major powers play a key role in international institutionalization because they are willing *and* able to enforce treaty commitments. If the leader of a country is to use international institutions for promoting economic reform, she must create international institutions that impose legally binding obligations related to reform. These obligations must be enforceable, and they must be accompanied by benefits that allow the leader to shape domestic political coalitions in such a fashion that enables economic reform. A graphical illustration of this argument is provided in Figure 2.2. In the absence of domestic reform strategies, a developing country's leader considers negotiations with a major power. If the major power is willing to form an international institution, so as to promote economic reform in the partner country, the leader can achieve higher levels of liberalization than would be otherwise possible.

To complete the argument, we should address two remaining issues. First, why cannot major powers enforce reform without international institutionalization? In some cases, major powers could attempt to "purchase" reform through foreign aid (Bueno de Mesquita and Smith, 2009), or even coerce liberalization through the threat of sanctions (Baldwin, 1986). However, such strategies are costly to major powers for several reasons. On the one hand, in the absence of institutionalized standards for behavior, third parties may not perceive unilateral sanctions as legitimate (Pelc, 2010). A major power that is unable to maintain a reputation for benign use of power must pay the high cost of coercion (Ikenberry, 2000; Stone, 2011). Thus, major powers have material incentives to avoid relying on unilateral coercion unless faced with an exception situation. On the other hand, the absence of a formal treaty may also reduce domestic political support for enforcement. If international institutionalization increases foreign direct investment or intra-industry trade, domestic investors and exporters have stronger incentives to lobby for treaty enforcement *ex post* than *ex ante*.

Second, both bilateral and multilateral institutions can help leaders achieve economic reform. Multilateral institutions, such as the IMF and the WTO, have the advantage of creating treaty commitments with respect to multiple foreign countries. Thus, the cost of treaty non-compliance is

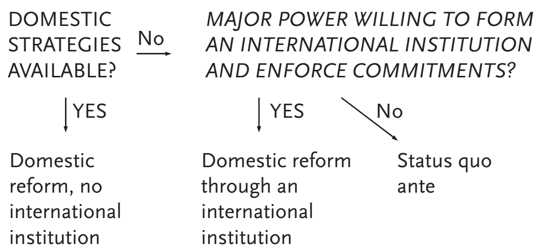

Figure 2.2 International Institutions, Major Powers, and Economic Reform. This figure is identical to the previous one, except that it emphasizes the role of major powers in international institutionalization.

high. Bilateral institutions have the advantage of flexibility, as they do not require a large international coalition. As long as one major power is willing to form an international institution with the leader's country, the leader has an opportunity to attempt economic reform through international institutionalization. Conversely, no leader of a developing country can initiate multilateral negotiations with a reasonable expectation of overcoming domestic impediments to economic reform anytime soon. In the quantitative analysis, we thus focus mostly on bilateral institutions to attain sufficient empirical variation for hypothesis testing. However, we also account for multilateral institutions. In the case studies, we then examine the roles of multilateral and international institutions in greater detail.

CHAPTER 3

Preferential Trading Agreements as Helpful International Institutions

The previous chapter summarized our theory in *general terms*. We deliberately formulated the theory in general, perhaps even abstract, terms, because we do not believe that the theory's applicability is limited to PTAs. In this chapter, we show how the theory can be used to understand leaders' political-economic decisions in a real context of substantive import. Specifically, we apply the theory to a leader's decision to form a PTA with the European Union or the United States. Recall that our general theory predicts international institutionalization when the following conditions are met:

1. A developing country's leader expects political-economic benefits from liberalization.
2. Due to domestic political opposition, implementing the reform is difficult for the leader.
3. There is an opportunity to form an international institution with a major power that is capable of enforcing commitments and generating domestic side payments.

This chapter first proposes empirically powerful proxies for the leader's interest in liberalization and the difficulty of reform implementation. Next, we explain why PTAs between a developing country and the European Union or the United States are uniquely suitable for cutting the Gordian knot of economic reform.

The remainder of this chapter is organized as follows. First, we develop empirical measures for our key independent variables, namely a leader's demand for economic reform and the difficulty of reform. If a PTA can help leaders promote economic reform, when would we expect leaders to rely on PTA negotiations to promote economic reform? Our general argument emphasizes the coincidence of demand and supply factors: leaders should engage in PTA negotiations if these leaders both expect benefits from economic reform (demand) and face considerable difficulties in the implementation of economic reform (supply).

On the demand side, we emphasize *democratization*. Previous scholarship offers a series of compelling arguments for why democratization increases public demand for economic reform (Biglaiser and Danis, 2002; Haggard and Kaufman, 1997; Mansfield and Pevehouse, 2006; Milner and Mukherjee, 2009). As countries democratize, their leaders' political fortunes become contingent on economic performance. Against a backdrop of autocratic rule, improved economic performance requires liberalization, including that of the microeconomic type. In this section, we summarize these arguments and review the evidence for them. We maintain that leaders of developing countries have incentives to pursue microeconomic reforms during democratic transitions.

While our primary focus on the demand side is on the democratization process, we do not intend to discount economic conditions that induce leaders to promote economic reform. In this chapter, we therefore also discuss the role that *economic crises* play in inducing leaders to search for an EU or US PTA. Similar to democratization, we argue that economic crises create demand for reform. By accounting for economic crises along with democratization, we can offer a more complete view of a leader's demand for economic reform.

On the supply side, we emphasize the difficulties that *new leaders* face in the implementation of economic reform. Building on previous research on the vulnerability of leaders (Bueno de Mesquita et al., 2003; Haggard and Kaufman, 1997), we argue that new leaders should have particular difficulties in creating the domestic strategies that would enable economic reform. New leaders' rule is not yet consolidated, their support coalition is unstable, they lack experience, and they do not have a proven track record. Thus, they should have the most to gain from an international approach through PTA negotiations. For new leaders, implementing economic reforms during democratic transitions is difficult without international institutions, so these leaders have strong incentives to seek international institutionalization to enable liberalization.

Next, we explain why EU and US PTAs are appropriate international institutions for promoting economic reform. To apply the theory, we need to verify that the international institution in focus can both enable credible commitments *and* help the leader increase domestic support for reform. In this regard, PTAs with major powers hold considerable potential. As to credible commitment, PTAs contain specific legal obligations concerning economic policy (Ahluwalia, 2002; Büthe and Milner, 2008). Major powers can also punish leaders and countries who fail to comply with PTAs by withdrawing trade concessions and reducing foreign direct investment (Shadlen, 2008).

A PTA with a major power also provides an excellent opportunity for side payments that mobilize winners and suppress opposition. The import markets of the European Union and the United States are the largest in the world. Even limited opening or consolidation of previous trade commitments through a PTA produces very large benefits for exporters in developing countries (Cameron, 1997; Shadlen, 2008). Thus, a leader in a developing country can use the promise of a PTA with the European Union or the United States to fundamentally change the domestic political conditions, so as to enable meaningful progress toward liberal economic reform.

The emphasis on microeconomic reforms also suggests that EU and US PTAs are an empirically appropriately focus. For this book, we collected original data on the institutional design of every PTA formed so far. The analysis, detailed in the next chapter, showed that not only the European Union and the United States, but also other countries, focus almost exclusively on *microeconomic reforms* in their non-trade provisions. PTAs are instruments of trade and investment, and microeconomic reforms from privatization to investment liberalization have important ramifications for trade and investment. It would not make sense to analyze EU and US PTAs if they did not contain provisions for the microeconomic reforms of interest. Similarly, it would not make sense to analyze any international institutions that do not contain such provisions. Conversely, analyzing effects of EU and US PTAs on macroeconomic reforms would be empirically inappropriate, given that these agreements were never designed to promote macroeconomic reform.

In sum, this chapter shows that PTA negotiations between developing countries and the European Union or the United States are ideal for assessing the explanatory power of our theory. This logic is summarized in Table 3.1. When democratization creates demand for liberalization due to the political empowerment of mass constituencies, but a new leader lacks the political capital to push through economic reforms, we expect PTA negotiations with the European Union or the United States to be initiated. These PTA negotiations enable credible commitments and side payments, and thus allow the leader to cut the Gordian knot of economic reform.[1]

Table 3.1. APPLYING THE GENERAL THEORY TO PTA NEGOTIATIONS

Theoretical Concept	Empirical Measure	Notes
Reform demand	Democratization, economic underperformance	Mass constituencies demand public goods
Reform difficulty	New leader	Lack of experience, unstable ruling coalition
International institution	PTA with EU or US	Credible commitment, domestic side payments

Compared to PTAs, few other international institutions hold similar potential for promoting the reforms of interest. The Bretton Woods institutions have a nearly universal membership, and so developing countries cannot join the IMF or the World Bank to promote reform under democratization. While we do analyze the role of IMF and World Bank programs in the reform process in subsequent chapters, the irrelevance of accession means that the conditions for applying our theory are only partially met. The WTO does offer opportunities for accession, but most developing countries joined the organization in 1995, which is unsurprising in light of the economic cost of remaining outside the global trade regime (Steinberg, 2002). Many of the reforms we analyze here have started to blossom in developing countries only later, rendering the WTO largely irrelevant. Most other economic organizations, such as bilateral investment treaties (Simmons and Elkins, 2004), simply do not have the economic scope that the PTAs in focus have. Finally, analyzing the universe of economic organizations would be exceptionally difficult, because we would have to somehow standardize their reform provisions to avoid comparing apples and oranges.

Our focus on EU and US PTAs is motivated by the need to avoid analyzing agreements that hold little reform potential. As the next chapter shows, EU and US PTAs are dramatically different from other PTAs. A developing country does not have incentives to engage in negotiations with a country that is either unwilling or unable to enforce the microeconomic reforms that we emphasize in this study. In the case of the European Union and the United States, the data allow us to show that they are interested and capable of promoting liberalizing reforms by their developing country partners. For most PTAs formed by other countries, this is not the case. They contain few reform provisions beyond tariff cuts, suggesting that the two partners do not have a common interest in promoting liberalizing reforms. This pattern is in line with our theory. The European Union and the United States have particularly strong incentives to promote liberalization in developing countries, which implies that these two major powers are ideal partners for developing countries interested in implementing liberal reforms.

While we do not emphasize Japanese and Chinese PTAs, both warrant a brief comment and will be examined in the empirical analysis. Japan's PTAs are all very recent, usually follow an EU or US PTA, and are mainly concentrated in Asia. It would be difficult to isolate their effects on reform, given that so little time has passed and other PTAs have already been negotiated. Compared to the European Union and the United States, Japan is not nearly as important as an import market, and so it is less able to enforce commitments than the other two major powers. Moreover, Japan's own economic performance in the past two decades has been weak (Warner, 2011). Simply put, Japan is not in a position to enforce liberalizing reforms across the globe, and this means that most developing countries cannot use a Japanese agreement to promote their reforms. For these reasons, the European Union and the United States seem a more natural focus for this book.

As to Chinese PTAs, our design data show China's unwillingness to promote liberal microeconomic reforms. Given the central role of state intervention in the Chinese economy, with state-owned enterprises remaining central to the system, this does not come as a surprise (Lin and Milhaupt, 2013). For our study, the key implication is that the conditions for applying our theory are not met because of China's lack of interest in reform. Without a major power interested in liberalization, the leader of the developing country cannot use the agreement to shape domestic political coalitions or credibly commit to policy change. Our theory predicts that PTAs can promote economic reforms if, and only if, they are formed in negotiations with a major power that is interested in liberalization.

The remainder of the chapter explains in greater detail how the theory can be applied to examine the formation and effects of EU and US PTAs. On the domestic side, the first section explains why democratization creates demand for economic reform in a developing country. Similarly, the second section explains why new leaders face difficulties in the implementation of economic reform. The third section discusses PTAs as international institutions capable of promoting economic reform. The final section discusses the role of economic crises and summarizes plausible alternative explanations that we will address in greater detail in the empirical chapters to follow.

DEMOCRATIZATION: DEMAND FOR ECONOMIC REFORM

According to the theory presented in the previous chapter, a leader's likelihood of pursuing liberalization increases if there is political demand for economic reform. We argue that democratic transitions increase such political demands. Accordingly, our theory generates the prediction that democratic transition increases a leader's willingness to pursue liberalization. In the following sections, we complete the argument examining when and how international institutions help leaders achieve liberalization under democratization.

By *democratization*, we refer to the establishment of political institutions that allow the population to choose their leaders in competitive elections (Cheibub, Gandhi, and Vreeland, 2010; Przeworski, 1991).[2] This definition emphasizes the centrality of political competition for democracy (Bueno de Mesquita et al., 2003). If a country democratizes, the number of people who have a say on the choice of their government increases. In authoritarian regimes, political survival is based on retaining the support of central elite constituencies, such as the military or the Communist Party (Wintrobe, 1998). In democratic regimes, mass constituencies play a more important role.

Based on this characterization, democratization shifts a leader's incentives from accumulating wealth for the autocratic elite to providing public goods to the people. But, the process is not an easy one. As Keefer (2007) has shown, leaders in democratizing countries also feel the temptation to cultivate clientilist relations with specific ethnic, religious, and economic groups. These countervailing incentives mean that democratization does not automatically result in improved public good provision. It is as though democratization opens a window of opportunity for leaders to shift their political strategy toward catering to mass constituencies, but sometimes this window of opportunity is not used.

For our analysis, the main issue of interest is if democratization endows leaders with incentives to liberalize their economic policies. Fortunately, the literature on the relationship between democratization and economic reform is extensive. We emphasize here the demand effect of democratization: if a country democratizes, the government has incentives to reform economic policies to reflect the new political realities. Under authoritarian rule, rational leaders design economic policies to provide themselves and their elite supporters with rents from state intervention. Democratization, in contrast, increases the benefits of economic policies that generate benefits for mass constituencies (Bueno de Mesquita et al., 2003; Haggard and Kaufman, 1997; Mansfield and Pevehouse, 2006; Milner and Kubota, 2005).

Empirically established examples include tariff reductions (Baker, 2003), lower barriers to entry for small businesses (Djankov et al., 2002), reallocation of public spending from elite subsidies to healthcare and education (Bueno de Mesquita et al., 2003), privatization (Biglaiser and Danis, 2002), and trade liberalization (Milner and Kubota, 2005). Democratization is positively associated with these reforms, as democratic governments try to improve their economic performance to improve their chances of political survival. Notably, many of the aforementioned reforms have an important microeconomic component. From consumers to small businesses, democratization empowers mass constituencies. Microeconomic liberalization allows these previously powerless mass constituencies to engage in profitable activities. This generates economic growth, further increasing the leader's benefits from liberalization. Thus, we maintain that democratization will, in addition to promoting macroeconomic policy change, encourage leaders to implement sectoral liberalization.

The positive effect of democratization on reform also applies to broader reforms. According to Haggard and Kaufman (1995) and Geddes (1994), democracy has facilitated the implementation of broader macroeconomic reforms during the "third wave of democratization" (Huntington, 1991) toward the end of the Cold War. Fidrmuc (2003) also shows that in the post-communist world, democratization has a robust positive effect on economic liberalization in internal and external markets, as well as privatization.

At the same time, several studies suggest that the relationship between democratization and economic reform is contingent. The argument against a positive democratization effect on reform is based on electoral pressures. If voters are averse to adjustment costs, democratic governments may succumb to the populist pressure to delay reforms. Bunce (2001) analyzes the relationship between democratization and reform in various regions, finding that a robust positive relationship is found in the post-communist world, while the evidence in Latin America and Southern Europe is more mixed. She maintains that the differences can be attributed to the different mandates of governments in transitional democracies, the timing of democratization, and the agenda of political transformation.

Block (2002) provides evidence of fiscal and monetary policy manipulation in nine transitional democracies in Africa, suggesting that the government's electoral opportunism may raise impediments to systematic and predictable policy formulation. This again highlights the notion that even if democratization promotes liberalization in most cases, it may also have countervailing effects that undermine liberalization strategies.

To test the assumption that democratization encourages reform, we also examined the empirical association between democratization and various economic reforms. We summarize the key findings here; the details of the test are provided in the online Appendix. Since our theory emphasizes the interactive effect of leader change, we focused the test on countries that democratized without leader change. If we are correct to claim that democratization creates demand for reform, we should see at least some liberalization, even without a PTA, when there is no leader change. The reforms we considered are those used in the rest of this book: intellectual property rights, privatization, capital account openness, and investment liberalization. We found that democratization is strongly associated with liberalization, as shown in Table 3.2. Recently democratized countries frequently tilt their policies toward a more liberal position.

Democratization, then, accords with our notion of an increase in demand for economic reform. Under conditions of democratization, leaders have inherited economic policies that used to be optimal—in the sense of the political second best—for a leader whose political survival depended on elite support. According to the literature on economic policy in autocracies, such policies often featured high levels of state intervention that allowed the leader's loyal supporters to extract rents from the society (Milner and Kubota, 2005; Weyland, 2002). These economic policies, however, are no longer optimal under democratization. Owing to changes in the nature of political competition, leaders of democratizing countries have incentives to implement economic reforms to consolidate their rule and survive electoral competition.[3]

Recalling the complex nature of democratization processes, this is not to say that democratization would *automatically* result in economic reform. For one illustration, economic reforms may produce immediate losses for some mass constituencies or pivotal groups (Dewatripont and Roland, 1992, 1995). For example, even if privatization of inefficient state enterprises is expected to produce static and dynamic efficiency gains, the employees of state enterprises may oppose privatization out of fear that they cannot

Table 3.2. DEMOCRATIZATION AND ECONOMIC REFORM

Type of Reform	Observations	Positive Changes	Frequency
IPR	44	24	0.55
Capital account openness	35	14	0.4
Privatization	44	30	0.68
Investment liberalization	22	18	0.82

find equally lucrative employment in the labor market (Biglaiser and Danis, 2002). These adjustment costs may provoke opposition to economic reform (Przeworski, 1991), and the problem is worsened if individual uncertainty about the distributional effects of reform increases opposition (Fernandez and Rodrik, 1991). Thus, even though economic reform would create benefits that the leader could distribute to mass constituencies to increase her electoral support, the cost of implementing those reforms could be high and the prospect of success uncertain.

Democratization may not often create an immediate and overwhelming popular movement for economic "shock therapy," yet it is hard to imagine that democratization would *increase* popular support for previous systems of state intervention that transferred wealth from the broad population to the leader and her cronies.[4] Only very irrational mass constituencies would continue to support policies that previously deprived them of the spoils of their labor. Thus, in comparison to previous authoritarian rule, demand for economic reform can be expected to increase during democratic transitions. Indeed, empirical research offers compelling evidence for this notion: democratization increases economic reform relative to authoritarian rule (Baker, 2003; Biglaiser and Danis, 2002; Milner and Kubota, 2005; Milner and Mukherjee, 2009; Rodrik, 1996).

If economic reform creates demand for reform, why does not the leader simply implement economic reform? We discuss our analytical notion of supply constraints in later chapters, but it is useful to overview the context of economic reform in democratizing countries already at this point. This context is essential for understanding the difficulties that leaders face when implementing reform. We highlight three issues here: vested interests, time inconsistency, and unrealistic popular expectations.

First, democratization does not imply that leaders can simply ignore previously powerful elites. Democratic institutions develop slowly, and the consolidation of democratic rule is a lengthy and precarious process (Keefer, 2007; Svolik, 2008). Elites privileged by previous structures of state intervention continue to support these structures and mobilize against democratic leaders who try to dismantle them. This implies that even though successful economic reform would allow democratic leaders to improve their electoral prospect, success is difficult to attain. Elite opponents of economic reform may bribe legislators and bureaucrats, fund the political opposition, or in the extreme case attempt a coup.

Haggard and Kaufman (1995, 185) provide an excellent overview of such problems in a number of democratizing countries. Consider, for example, Bolivia's experience with economic reform after free multiparty elections in 1980. In 1983, the debt crisis hit Bolivia. The left-wing Siles government tried to adjust the economy to the crushing debt burden through a variety of "off the shelf" policy measures, such as currency devaluation, wage restraint, and tax reform. But the government's proposals were blocked in the legislature by powerful interest groups. In addition to high levels of labor militancy, the military and business elite allied with opposition parties in the legislature to undermine the Siles reform program. As Haggard and Kaufman (1995, 186) note:

> By 1985, the Bolivian economy was collapsing. Siles yielded to Congressional pressures to advance the calendar for new presidential elections and resigned from office eighteen months ahead of the scheduled end of his term.

Bolivia's inability to avoid a fiscal disaster was not due to popular opposition to reform. It was due to the fact that influential interest groups, such as the powerful military and the business elites that had previously supported the autocratic ruler, were not willing to give up their prerogatives.

Second, the uncertain and precarious nature of democratization processes creates a problem of time inconsistency (Kydland and Prescott, 1977). Leaders have strong incentives to promote consistent and systematic reforms, yet they also have incentives to abandon those reforms if political opposition proves more powerful than expected (Mansfield and Pevehouse, 2006; Whitehead, 1996). Moreover, electoral competition means that government change may occur, and this could result in reversal of economic policies. This lack of credibility is a problem because the success of economic reform is fundamentally dependent on the expectations of producers, consumers, investors, and political actors. If they believe the economic reform will be implemented, their rational reaction is to adjust their own behavior accordingly. Investors respond to changes in relative prices through capital acquisition, exporters build new production facilities, consumers increase their spending, and opponents of reform stop mobilizing because they see the reversal to previous policies as a lost cause. These adjustments allow the leader to consolidate reforms and maximize the gains from these reforms.

The case studies in Haggard and Kaufman (1995, 183–196) also provide ample evidence for the credibility problem. As recently democratized regimes in Argentina, Bolivia, Brazil, and Peru tried to cope with adverse international economic conditions in the 1980s, their ability to credibly commit to a coherent reform program was limited. As Haggard and Kaufman (1995, 197) recount:

> The central challenge faced by these new governments lay in the combination of fragmentation with the polarizing effects of populist and left oppositions.... In all four cases, the final descent into hyperinflation overlapped with the onset of presidential campaigns, fundamental uncertainty about the policies of the successor administration, and a virtually complete deflation of the power and credibility of the incumbent government.

A particularly vicious form of time inconsistency is the problem of "partial reform." Hellman (1998) offers an excellent summary of this problem in post-communist countries. As recently democratized countries attempt to implement economic reforms, they often succeed in a partial way. Such partial reforms do change relative prices, but they also fall well short of producing the public goods that the leader needs to create political support among mass constituencies. They may even make matters worse. Yet they are often consolidated because they create large rents for elites (Gehlbach and Malesky, 2010). For a leader attempting to build a broad base of popular support, this is a major problem.

Such partial reforms come in many forms. Hellman (1998, 219) provides the following description, worth quoting in some length:

> Examples of such rent-seeking activities have been ubiquitous in the post-communist transitions. Rapid foreign trade liberalization with incomplete price liberalization has allowed state enterprise managers to sell their highly subsidized natural resource inputs (for example, oil and gas) to foreign buyers at world market prices. Price liberalization without concomitant progress in opening market entry or breaking up monopolies has created opportunities for some producers to earn monopoly rents. Privatization without reform of the credit mechanism has allowed managers to divert subsidized state credits earmarked to uphold production into short-term money markets at high interest rates. In each case, these arbitrage opportunities have have generated rents to those in a position to take advantage of these market distortions.

A final problem has behavioral origins. Even if mass constituencies expect to benefit from economic reform, at least in the long run, they may become dissatisfied with the leader's reform performance. Haggard and Kaufman (1997) demonstrate that democratization creates enthusiasm among mass constituencies for improved living standards. Such enthusiasm may or may not be rational, but sometimes it results in disappointment. Economic reforms may fail for the above reasons, and the resulting problems are compounded by popular dissatisfaction with the leader's performance. This, again, increases the cost of reform to the leader.

Building on prospect theory, Weyland (2002, 43) notes that since "[e]conomic or political crises put many people in the domain of losses... under these circumstances, political leaders and common citizens will display risk acceptance." This argument implies that when the going gets very rough, leaders are able to implement drastic reforms because people are loath to accept the idea of certain losses relative to the *status quo ante*. But it also implies that if these drastic reforms help avoid the worst crisis, the leader's ability to continue economic reform is again compromised: "If... these drastic plans overcome the acute, severe crisis... political leaders enter the domain of gains and as a result turn to risk aversion" (Weyland, 2002, 44).

In Brazil, for instance, upon seizing power in 1990, President Collor initiated drastic economic reforms to control hyperinflation in the young democracy. The initial program proved to be success, as "[t]he temporary success of the Collor Plan, which quickly reduced inflation, allowed the president to initiate a series of market reforms" (Weyland, 2002, 151). But "after an initial push, he accomplished much less because he encountered serious political obstacles.... The government faced resistance from trade unions and some powerful business sectors... and never gained stable majority support in Congress" (Weyland, 2002, 151). The initial popular support for drastic reforms to control hyperinflation did not translate into a coherent economic policy over time. Only two years later, President Collor resigned.

In sum, democratization creates popular demand for economic reform, and thus allows us to capture the theoretical idea that leaders engage in negotiations on international institutions—in this case PTAs—due to domestic political demand for economic reform. However, the existence of popular demand does not imply that the leader can easily implement economic reform. Vested interests oppose reform and do their best to undermine a reformist leader. Time inconsistency prevents the leader from maximizing gains from reform and may even create a spiral of negative expectations that results in the dismantling of the reform. These facts imply that economic reforms are potentially risky, and this risk is further compounded by the possibility of popular dissatisfaction.

If economic reform under democratization is difficult, would we expect all democratizing states to rely on international institutions? This would be a rather implausible categorical claim: when there is domestic political demand for economic reform, some leaders can capitalize on this demand

and simply implement the liberalizing policies they prefer (Haggard and Kaufman, 1997). In the next section, therefore, we identify a factor that maximizes the difficulties that a leader faces in implementing economic reform: leader change. This factor, we argue, helps us identify which leaders in democratizing states have the most to gain from international institutionalization.

NEW LEADERS: DIFFICULTY OF REFORM

The previous section provided our argument for why democratization increases a leader's willingness to implement economic reform relative to authoritarian rule. While this increase in demand for liberalization may induce economic reforms if the democratic transition is overseen by an established and stable regime, empirical evidence shows that liberalization during democratic transition is far from easy (Haggard and Kaufman, 1995; Keefer, 2007; Pevehouse, 2005). Thus, leaders overseeing democratic transitions may face a dilemma: although there is domestic political demand for liberalization, opposition is also so powerful that liberalization may result in a loss of power before the political benefits of reform kick in. To fully develop our application to PTA formation, we thus need a measure of a leader's ability to implement economic reforms through purely domestic channels: for some leaders, liberalization requires the formation of a suitable international institution with a major economic power.

To measure the difficulty of economic reform, we rely on recent *leader change*. By leader change, we refer to a situation in which a new individual begins to occupy the highest political office in a country. In a parliamentary democracy, this position would be the prime minister's office. In a presidential democracy, the new leader would be the president. We argue that new leaders are politically weaker than established leaders. Thus, new leaders are often unable to implement liberal economic policies without external assistance.

It is important to clarify that we do *not* argue that leader change is the exclusive reason that leaders face reform difficulties. There are many others, including heterogeneous preferences in ruling coalitions and organized opposition to economic reform. We argue, and then show, that leader change is a substantively important and empirically identifiable cause of reform difficulty. Accordingly, we use leader change as a proxy for reform difficulty. The choice of this proxy is justified by its substantive importance and the possibility of precise empirical measurement.[5]

We do not distinguish between different mechanisms of leader change. Sometimes leader change follows a military coup. In other times, it follows a politburo's collective decision to depose the current leader. In parliamentary democracies, elections may result in the choice of a new prime minister. In presidential democracies, elections determine the president. For us, the cause of leader change is less important than the consequences of leader change. Our theory does not generate hypotheses concerning the potentially different effects of various types of leader change.

While distinguishing between different mechanisms is not important, the new leader's "newness" is. Sometimes leader change occurs within a consolidated ruling coalition. For example, an authoritarian ruler could step down and leave his eldest son to rule the country. In such cases, leader change is only partial. We expect genuine leader changes to produce larger effects than partial leader changes, such as hereditary succession.

We argue that a new leader's rule is more precarious than an established leader's rule. This means that a new leader finds it more difficult to create a coalition for economic reform. It also means that a new leader finds it particularly difficult to credibly commit to economic reforms. For these reasons, new leaders have particularly strong incentives to resort to international institutions as they promote economic reform.

As explained in the previous chapter, reform difficulties stem from a lack of credible commitment and the leader's inability to craft a domestic policy package that secures a sufficiently large and robust domestic majority for liberalization. For new leaders, both problems are present. On the one hand, a new leader lacks credibility simply because she has yet to form a track record. This problem is further compounded by the empirical observation, as documented in the following chapters, that new leaders are particularly vulnerable to losing office. Even a new leader who seems highly committed to liberalization cannot guarantee that her political competitors would continue liberalization in the future. On the other hand, a new leader's ability to create domestic coalitions through policy packages is compromised by the instability of her ruling coalitions. In such circumstances, it is difficult for new leaders to consolidate their rule and implement substantial economic reforms.

To counter the above argument, some scholars have noted that new leaders may benefit from a temporary "honeymoon" period that allows them to implement liberal economic policies (Haggard and Kaufman, 1997). While this argument is correct, we believe it to have limited explanatory power in the case of microeconomic reform. This is so for two reasons. First, while honeymoon periods increase a leader's popularity, they do not mitigate opposition by organized interest groups. If a leader worries about a coup or losing the support of organized interests in the long term, inevitably short-lived honeymoon periods are not helpful. Second, the temporary nature of honeymoon periods undermines the leader's credible commitment to liberalization. Even if a leader were able to implement liberalization during the honeymoon period, investors would not believe these favorable political conditions to last for long. And when the short honeymoon is over, the harsh reality of domestic political opposition to liberalization becomes apparent. Anticipating potential implementation problems, investors fail to respond to the incentives that liberalization was supposed to create, and so the leader's gains from temporary liberalization during the honeymoon period would be limited.

We should emphasize here that our empirical argument may not apply particularly well to perfectly "consolidated democracies" (Svolik, 2008), such as the United States or Sweden. In consolidated democracies, institutions such as political parties are more important than individuals (Keefer, 2007; Licht, 2010). Thus, leader change is a less important event than in autocracies or transitional democracies. Even in consolidated democracies, some leaders and governments are stronger than in others. But leader changes occur in the shadow of robust political institutions, so an individual's importance is reduced.

We also recognize that leader change sometimes results from democratization. Some democratization processes are guided by the established elite: leaders who recognize the need to accommodate their political opponents through the formation of democratic political institutions. Others involve the replacement of the authoritarian elite with a completely new democratic regime (Haggard and Kaufman, 1995). This rich variation across cases of democratization allows us to test our argument in spite of the positive correlation between democratization and leader change.

With these caveats in mind, consider now in a leader who wants to implement economic reforms, perhaps due to recent democratization. How exactly does this leader's ability to do so through domestic channels depend on her experience and tenure? We expect new leaders to face more difficulties in creating a political coalition for economic reform. Economic reform is easier for established than for new leaders, and this is so for two reasons.

First, a new leader's winning coalition remains in flux. As Bueno de Mesquita et al. (2003, 287) explain, "[m]embers of the current coalition who suspect they will not be included in the incumbent's long-run coalition want to depose the new leader before she can learn affinities and realign her coalition." Given this, it is hard for a new leader to identify loyal members of the coalition and rely on their support throughout the difficult process of economic reform.

Ceteris paribus, an established leader has more information about her ruling coalition's willingness to support economic reform than a new leader. Moreover, established leaders have more loyal supporters who have a vested interest in keeping their leader in power. This means that they have fewer incentives to oppose the leader's economic reforms, even if the supporters' benefits from economic reform are modest.

Second, a new leader's lack of reputation amplifies the problem of credible commitment. An established leader has already survived in office for years, and so both elite and mass constituencies have relatively accurate information concerning her ability and preferences. A new leader, in contrast, is under constant suspicion. Potential supporters of reform worry that she will not be able to implement them. They also worry that she may be deposed. Potential opponents of reform intensify their mobilization against economic reform because they understand that the reform effort can be dismantled with high probability.

Our case study of post-apartheid South Africa in Chapter 7 provides a particularly lucid illustration of these problems. When Nelson Mandela became the president of South Africa in 1994, his government had virtually no experience with economic governance. This lack of experience meant that investors had little, if any, confidence in Mandela's ability to reform the stagnating South African economy. Indeed, President Mandela was in such a difficult position that he had to appoint apartheid-era technocrats to key positions in his administration because "the boys from the stock exchange and elsewhere seem to be very jittery."[6] As we interviewed Faizel Ismail, one of South Africa's lead negotiators in trade talks with the European Union, he told us that Mandela's coalitions comprised "young and inexperienced leaders who had spent the previous years hidden in the bush. . . the skepticism from the market was understandable."

The data on leader survival provide compelling evidence for new leaders' weak prospects of political survival. In the online Appendix, we provide a graph on the relationship between a leader's tenure and probability of political survival.[7] A leader's probability of losing power decreases rapidly with experience. In line with our theoretical expectations, this relationship is particularly strong for recently democratized countries.[8] Moreover, political survival is generally much more difficult in democratizing than in other countries. This observation lends further credibility to our argument. In the democratizing context, new leaders are generally not politically safe.

These problems do *not* go away even if there is demand for economic reform in the society, as is true in times of democratization. This argument is fully developed by Haggard and Kaufman (1997, 277) who note that "the transition itself raises expectations that government will respond to new political constituencies… policy reform is difficult precisely because economic problems are more acute and demands for short-term economic relief more widespread." Even in the absence of a genuine crisis, "new democratic governments faced a different, but not necessarily less serious, agenda of policy reforms" (Haggard and Kaufman, 1997, 278).[9]

In sum, economic reforms present a dilemma for new leaders: they are difficult to implement, yet they are also very important for political survival. For reasons explained above, PTAs can help. Recall that a new leader's primary problems are (i) the difficulty of forming a powerful political coalition for economic reform, and (ii) the credibility of the economic reform. We argue that PTA negotiations with the European Union or the United States allow the leader to implement liberal reforms in spite of domestic political opposition.

PREFERENTIAL TRADING AGREEMENTS: ENABLING ECONOMIC REFORM

If a leader needs economic reform but faces political opposition, what is she to do? We argue that engaging in PTA negotiations with the European Union or the United States can help the leader implement liberal policies. Forming a PTA with the European Union or the United States both (i) enables credible commitment to liberalization, and (ii) allows the leader to implement a domestic policy package that generates political support while implementing economic reform. Moreover, both the European Union and the United States have shown a lot of interest in negotiating bilateral trade agreements with many developing countries, so leaders in these countries have the opportunity to engage in PTA negotiations at the right time.[10]

To make the case, we need to show that PTAs are ideal international institutions for credible commitment and domestic side payments. Accordingly, this section is organized as follows. We first define a PTA. Next, we detail our argument: Why are PTAs ideal for implement liberal reforms? We conclude with a summary of empirical hypotheses based on the idea that leaders needing reform (democratization) but facing reform difficulty (leader change) are particularly interested in PTA negotiations with the European Union and/or the United States.

To begin with, we define a *preferential trading agreement* as any set of international arrangements under which each member of the agreement grants special market access to the other members' goods and services

(Anderson and Blackhurst, 1993; Bhagwati and Panagariya, 1996; De Melo and Panagariya, 1996; Pomfret, 1988). The defining idea of a PTA is that the members set lower trade barriers on goods produced within the preferential grouping than on those produced elsewhere (Viner, 1950). PTAs include free trade areas (e.g., the Asean Pact), common markets (e.g., NAFTA), customs unions (e.g., CARICOM), and economic monetary unions (e.g., the EU). Moreover, trade agreements can be both bilateral (i.e., between two member countries) and plurilateral (i.e., among at least three countries). Finally, a PTA can be "offensive" in that it aims to increase trade, or it can be "defensive" in that it aims to maintain current levels of trade (Shadlen, 2008).

This definition highlights the fact that PTAs are, at least nominally, instruments of trade cooperation. Indeed, all PTAs that we consider contain some provisions on trade liberalization. Most of these provisions are tariff schedules that impose upper bounds on member states' tariffs on foreign imports in specific industries. However, as we show in the following chapters, many PTAs also contain provisions for a much wider range of economic reforms. This is important for our purposes, because our interest lies in explaining a much wider range of economic reforms than trade liberalization.

Indeed, our general argument can only be applied to international institutions containing provisions for economic reform. Therefore, we need to focus on those PTAs that prescribe economic reforms. While some PTAs focus on a rather narrow set of reforms that are directly related to trade liberalization, we provide data showing that many PTAs contain a large number of economic provisions that prescribe extensive economic reform. This is the set of PTAs we are interested in. If the government of a developing country engages in negotiations on a PTA that prescribes a wide variety of economic reforms, it is essentially negotiating an agreement that increases the probability that such economic reforms succeed. For a PTA to prescribe economic reform, we require that it contains specific goals and targets for economic reform. This is a crucial difference, for the number of PTAs that mention economic reform as an aspirational goal is large. Such aspirational goals, however, do not constitute enforceable legal commitments. Thus, we say that a PTA prescribes economic reforms only if it contains specific targets for reform.

To understand this crucial difference, let us consider some examples. The PTA between Australia and Papua New Guinea was signed in 1991. It involves an industrialized country and a developing country. Australia is by far Papua New Guinea's largest source of imports and its number one export market. The Australia–Papua New Guinea treaty is a 34-page long document that includes no investment and services provisions—only a vague statement about the importance of investment in the relations between the two countries—and no provisions on IPR protection, government procurement, or competition policy. Moreover, the agreement does not have a dispute settlement mechanism (DSM) to facilitate enforcement. Although this PTA is probably important for trade, especially for Papua New Guinea, it can hardly be expected to have any effects on economic reform in Papua New Guinea. Similarly, the Albania-Turkey PTA signed in 2006 does not regulate sectors such as investment, services, IPR protection, and competition policy. It does include a dispute settlement mechanism, but with very limited sanctioning power. Again, the Albania-Turkey PTA can be important for trade between two geographically proximate partners, but it cannot be expected to produce any other economic reforms.

Consider now another agreement, namely the EU-Latvia Association Agreement. This agreement was signed in 1995. The agreement contains 239 pages and is filled with detailed requirements for competition policy, government procurement, state aid to enterprises, and so on. For example, the second paragraph of Article 3 states that "[t]he Association Council, bearing in mind that the principles of the market economy are essential to the present association, shall proceed regularly to examine the application of the Agreement and the implementation by Latvia of economic reforms on the basis of the principles referred to in the preamble." In other words, the PTA explicitly establishes a monitoring mechanism for implementation. The second paragraph of Article 67 states that "Latvia shall continue to improve the protection of intellectual, industrial and commercial property rights in order to provide… for a level of protection similar to that existing in the [European] Community, including effective means of enforcing such rights." The first paragraph of Article 68 requires that "Community companies… shall be granted access to contract award procedures in Latvia under a treatment no less favorable than that accorded to Latvian companies." These two articles illustrate concrete reform targets. This agreement, we argue, can do much more than liberalize trade between Latvia and the European Union.

Although our approach differs somewhat from previous research on PTA formation and effects, many of the building blocks of our argument can be found in studies that try to explain the profusion of PTAs. For this reason, we begin with a concise review of the relevant parts of the extant literature. In this review, we focus only on arguments that directly inform our approach. In general, the key argument from earlier research is that PTAs enable credible commitment. According to Büthe and Milner (2008), a PTA allows a country to credibly commit to liberal investment policies. This creates confidence in the credibility of the government's liberalization effort among foreign investors, and thus the inflow of FDI grows. Their quantitative analysis of the effect of PTA formation on FDI inflows to developing countries supports this view.

As to economic reform more generally, both Ethier (1998) and Fernandez and Portes (1998) note that international commitments can reduce a leader's incentive to renege on economic reforms. Ethier (1998, 1155) notes that this is particularly true of a PTA with a major power: "The fact that the agreement is with a big country (often the dominant trading partner) adds a credible enforcement mechanism. Because such arrangements allow for deeper integration, they can contain obligations to undertake specific measures central to the reform effort." Our argument builds on this argument, but we also (i) examine the domestic political conditions under which leaders have incentives to tie their hands, and (ii) allow a PTA to shape the domestic coalitions supporting and opposing reforms.

Mansfield, Milner, and Rosendorff (2002) and Mansfield and Milner (2012) offer a complementary informational argument. They note that democratic leaders have incentives to signal to uninformed voters that they are not adopting trade policies that harm consumers. By forming trade agreements, they create domestic "whistle-blowers" with incentives to publicize the government's protectionist trade policies. This allows the government to send a credible signal to voters that possible economic woes are not due to the government's trade policies. Indeed, they find evidence that democratic countries are more likely to form a PTA than autocratic countries.

Regarding the possibility of reshaping political coalitions, we are not aware of any systematic analyses. In the case of NAFTA, however, both Cameron (1997) and Pastor and Wise (1994) note that President Salinas's efforts to liberalize trade and increase investment were driven by a turn from his party's traditional support base of urban constituencies and small businesses to a new alliance with big business. We adopt this logic and develop it into a general analytical model that applies to international institutions more generally. Shadlen (2008) notes that the possibility of a PTA with a major power often mobilizes powerful exporter interests in developing countries, but he does not develop this argument into a full-fledged model of the domestic politics of PTA formation.

Based on the existing literature, we can now summarize our argument. First, a PTA facilitates political coalition formation because the leader can mobilize constituencies who would benefit from export opportunities and increased foreign direct investment. Thus, even if the new leader's rule is not consolidated and supporters hesitate to affirm their alignment with the new leader, out of fear that the leader will soon be deposed, they may mobilize in support of a PTA that achieves foreign market access. Backed by a major economic power's resources and wealth, these benefits do not depend on the leader's personal traits or experience.

Moreover, a PTA also enables credible commitment. Even if the current leader's political survival is subject to some uncertainty, the PTA is enforced by a major economic power. Unless the replacement holds very extreme preferences, she does not have incentives to endanger market access and foreign direct investment. The economic reform is already implemented, at least in part, so previously opposing constituencies have adjusted and they have fewer incentives to oppose it. But the benefits of market access and foreign direct investment remain—that is, unless the replacement reneges on treaty commitments by reversing economic reforms without much political benefit.

For these reasons, a leader who wants to liberalize but faces considerable political opposition has strong incentives to engage in PTA negotiations. The leader's domestic political weakness does not mean that the leader cannot engage in PTA negotiations, as such negotiations are in most countries a privileged domain for the executive. As we argued in the previous chapter, the leader can use the PTA negotiations to create a domestic policy package that influential domestic constituencies are willing to accept, in a fashion resembling Putnam's (1988) "synergistic linkage."

How exactly does a government trying to implement economic reforms in difficult circumstances benefit from forming a stringent PTA with a major power? The answer lies in the fact that the PTA enhances market access to the major power, and the major power can punish the government of a developing country for failing to implement economic reform by removing this market access. This is useful for two reasons.

First, market access allows the government to give side payments to domestic losers while also mobilizing winners from economic reform. If a domestic constituency expects to lose from economic reform, it may nonetheless be willing to accept a deal that creates market access and thus increases profits from exports (Cameron, 1997). Thus, domestic "issue linkage" allows the government to expand the coalition in support of economic reforms (Mayer, 1992), and this will in turn translate into electoral gain.

In the next chapter, we examine data on tariff reductions in EU and US PTAs. Contrary to common belief, we find that both the European Union and the United States have often offered immediate tariff reductions in many tariff lines to their partners. Accordingly, the developing country partners of the European Union and the United States reap handsome gains from these PTA negotiations. These gains can be used to mobilize export industries to support the PTA, and if the PTA also contains reform provisions, the increased support from export industries enables the leader to implement liberal economic reforms as well.

The example of the Central American Free Trade Agreement (CAFTA) is particularly illustrative. The Central American member countries to this treaty are, with the partial exception of Costa Rica, heavily dependent on US markets for apparel and textiles (Shadlen, 2008). Domestic agricultural constituencies were also strongly opposed to increasing market access for large American agribusinesses. Given this constellation of preferences, leaders of CAFTA countries would not have been able to implement economic reforms, such as investment liberalization or tariff reductions, without an additional bonus. This bonus was provided by reduced US tariffs for textiles and, perhaps more important, the stabilization of these tariff reductions through federal legislation.

Second, market access enhances the credibility of commitment. Suppose that the government forms a PTA with a major power, and then reneges on important provisions in the agreement. Based on the principle of reciprocity, the major power is no longer obliged under international law to comply with the increased market access. Thus, it can punish the government of the developing country by withdrawing this market access. Given that the market access was not unilaterally implemented prior to the agreement, such a threat of reversal to the status quo is credible. At the same time, for the developing country the reversal could result in a substantial loss of export revenue. The effectiveness of such retaliation is increased if the newly granted market access induces companies in the developing country to make (partially) irreversible investments, and thus creates a dependence relationship (Hirschman, 1945; McLaren, 1997).

Notably, the international dimension of a PTA is central to both credible commitment and domestic side payments. If a country joins a PTA, failure to implement the economic reforms enshrined in the treaty text is not only a negative signal to international capital markets, but also a violation of international law. This means that the reneging country pays a reputational cost that would not apply to failing to implement domestic promises of economic reform (Guzman, 2008). Moreover, failure to comply with a PTA provides a major power with a legitimate rationale for withdrawing trade concessions. Therefore, a PTA allows major powers to withdraw trade concessions upon the partner's defection at a lower reputational cost. Indeed, to maintain their own credibility, major powers may have to withdraw trade concessions; otherwise, third parties would no longer find these major powers' threats of enforcement credible.

Consider, for example, South Africa's PTA with the European Union. The rather difficult negotiations of the Trade, Development, and Co-operation Agreement between South Africa and the European Union were concluded in 1999. The PTA increased South Africa's access to European markets, and this effect was particularly pronounced given that South Africa did *not* qualify for preferential access because Brussels classified it as an industrialized market economy.[11]

The EU–South Africa PTA contained specific requirements for competition policy reform and privatization. For example, Article 35 in Section D stipulates that those restrictions on competition and abuses of market dominance that would affect trade with the European Union violate the PTA. Moreover, Article 35 states that the state parties must implement the laws and regulations needed to comply with the competition provisions within a period of thee years from the entry into force of the PTA. Had South Africa failed to reform competition policy, and thus continued to support domestic producers while discriminating against European corporations, or had South Africa failed to privatize any of the state's substantial assets in mining and other key industries, the European Union could have withdrawn the agricultural trade concessions. This would have been very costly for South African producers and politically profitable for many European politicians: not only would the withdrawal of concessions have been legal, but it would also have provided protection for European farmers in key member countries, such as Italy and France. Unsurprisingly, then, South Africa has complied with the PTA. For example, an Organisation for Economic Co-operation and Development (OECD, 2003) Peer Review praises South Africa for an excellent track record in privatization of state enterprises.

Of course, a stringently designed PTA is of no use unless it is enforced. This is why the selection of the PTA partner is important. If a small developing country forms a PTA with another small developing country, the enforcement of contractual obligations will be difficult. But if a small developing country forms a PTA with a major power, one that has a genuine global interest in economic reform and is capable of exacting punishments for non-compliance, the credibility of the provisions contained in the PTA is increased. Thus, we expect that PTAs with major powers with an interest in economic reform are the most useful for implementing economic reform.

Given this, the most important partners for PTAs that enable economic reform are the European Union and the United States. These are the largest and wealthiest import markets in the world. Their commercial interests are global, as each is home to numerous large multinational corporations that command global supply chains. Any withdrawal of trade concessions by either major power would have substantial negative consequences for their developing country partners. As shown in the next chapter, the breadth of the economic reforms prescribed by the European Union and the United States in their PTAs is broader than the breadth of economic reforms in other PTAs. For instance, reforms prescribed in EU PTAs are twice as broad as PTAs signed by China, and almost three times as broad as reforms prescribed in PTAs signed by all the countries of the world (excluding the EU, US, and China). Moreover, the US PTAs have an even broader scope.

Economic reform is also a key reason that major powers are willing to engage in such PTA negotiations in the first place. They pay a political cost for the PTA because they must implement tariff reductions that they would not otherwise implement. But they also gain because they can pry open markets in the partner country while also promoting economic reforms that are beneficial for them. Stringent protection of intellectual property rights, increased investment opportunities, access to the banking sector, service liberalization, and other similar economic reforms benefit the major powers. As Chase (2005), Cameron and Tomlin (2000), and Manger (2009) have shown, political influential industries from automobile manufacturers to investment banks have recently shown a keen interest in promoting liberalization in developing countries. Liberalization allows them to capture service markets and invest in the developing country for productivity gains.[12]

Chase (2005, 216) shows that pro-NAFTA manufacturing and service industries in the United States lobbied aggressively for a trade treaty with Mexico and Canada, while the opponents of the treaty were not particularly vocal and often accepted concessions such as rules of origin. The rationales behind their aggressive lobbying were "market pressures to capture unexploited scale economies or to reduce labor costs by expanding regional production sharing" (Chase, 2005, 185). Cameron and Tomlin (2000, 225) add the commercial interests of the financial sector to the mix, as "there was no prospect of a NAFTA without liberalization of financial services." Mexico's large economy presented a new frontier for American banks that had already exhausted many of the opportunities in the well-developed financial sectors of the United States.

Finally, Manger (2009, 25) shows that as soon as the United States formed NAFTA, major European automobile makers such as Volkswagen, worrying about investment discrimination, started to lobby aggressively for a trade agreement with Mexico. They worried that failure to form a PTA with Mexico would give American manufacturers a large competitive advantage, given the low cost of car production in Mexico. He also finds a similar logic behind Chile's PTAs with the European Union and the United States, as American and European investors lobbied for a treaty that would guarantee enhanced access. Each worried about being left out had Chile formed a PTA with the other economic superpower.

This logic holds across the range of microeconomic reforms that we consider here. Privatization, service deregulation, and other forms of microeconomic liberalization create businesses opportunities for American and European corporations, so the European Union and the United States have domestic political-economic incentives to initiate PTA negotiations with as many developing countries as possible. When these economic reforms are tied to specific provisions in a PTA or some other international treaty, the credibility and stability of liberal policy are also enhanced, and this benefits the major power by creating profitable investment opportunities for companies (Hollyer, 2010). To be sure, the incentives of the European Union and the United States have changed over time. The first three decades of European trade integration were largely focused on internal affairs, and the union formed only a handful of relatively shallow and narrow agreements with neighboring countries (Mansfield and Milner, 1999). At the time, internal integration was simply more important than the creation of external investment opportunities for major corporations. Similarly, the United States had fewer incentives to promote microeconomic liberalization in other countries than it has today. As Chase (2005) argues, the key forces behind US interest in PTAs, beginning with NAFTA, are the increased importance of economies of scale and higher labor costs that started to bedevil American companies toward the end of the 1970s. Incidentally, this offers a potent explanation for why the European Union and the United States paid little attention to PTAs before the end of the Cold War.

There is often opposition to PTAs in the European Union and the United States. Labor unions and import competitors in the European Union and the United States often oppose PTA formation, as they worry about increased exports from developing countries. In practice, however, this opposition has not proven to be a major barrier to PTA formation. As our data in the following chapters show, most EU and US PTA negotiations are concluded within a year or two. Chase (2005, 216) proposes that at least in the case of NAFTA, which was more controversial than most PTA negotiations, the reason was that the pro-NAFTA industries were more concentrated and politically organized than the opponents of the deal. Moreover, the Clinton administration was able to use rules of origins to reduce opposition to the treaty Chase (2005, 213). While the exact strategies that the European Union and the United States use to reduce opposition are beyond the scope of this book, the case of NAFTA offers some insights into why PTA formation has not been as difficult as expected.

It is also important to remember that while EU and US markets loom large for virtually all of their developing country partners, the opposite is not always true. Consequently, EU and US opposition to a PTA with any given small developing country may ultimately be limited. In many cases, the change in exports from the developing country upon PTA formation is limited to certain sectors, and these sectors can be strategically chosen by manipulating the tariff reduction schedule. As discussed above, the next chapter contains original data on patterns of tariff reduction schedules in EU and US PTAs. While liberalization often applies to a large number of sectors, an equally large number are left out. Moreover, a handful of strategically selected sectors have very long transition periods, sometimes up to a decade. These sectors are often the politically sensitive ones, such as agricultural products.

It is important to emphasize that EU and US PTAs are not a case of coerced economic reform. One could argue, going against our thesis, that the major powers are simply forcing developing countries to implement economic reforms left and center. In most instances, we do not find this argument compelling, and in this section we propose a more nuanced argument, based on realizing joint gains. For example, Gruber (2000) proposes that Mexico's entry into NAFTA was driven by Canada's forming a bilateral trade agreement with the United States in 1988. Following Cameron (1997) and Manger (2009), our argument instead emphasizes Mexico's ability to implement and lock in economic reforms, especially in regard to FDI. A better case for "ruling the world" can be made for CAFTA, given the small size of these economies and their competition for textile markets in the United States (Shadlen, 2008). We will return to the idea that stringent PTAs are exclusively driven by major powers' interest in the empirical analysis. In those chapters, we provide extensive evidence that this view is in many instances flawed.

The argument that we offer is different. We accept the premise that major powers obtain some benefits from enforcing stringent PTAs for developing countries, and this is why they are interested in PTA negotiations with developing countries. But we also argue that the developing country government's consent is necessary because otherwise the credibility of the beneficial reforms is very limited, and the major powers are not able to credibly commit to exacting ruthless punishments for the developing country's failure to sign or ratify a PTA.

We are not alone in arguing that developing countries' preferences influence the formation of North-South PTAs. In a recent paper, Manger and Shadlen (2011) also emphasize developing countries' interests in North-South PTAs. Specifically, their goal is to explain why developing countries negotiate North-South PTAs when they already have preferential market access through the Generalized System of Preferences (GSP) and other related schemes. They propose that PTAs, which require reciprocal trade liberalization, provide more reliable and stable market access compared to the GSP, which offers unilateral concessions that are easily reversed. To test this argument, Manger and Shadlen (2011, 1) develop the concept of "political trade dependence," or "the degree to which market access is subject to political idiosyncrasies in concession-granting" from the developed country. Empirically, they show that increased political trade dependence causes developing countries to lock in their existing market access to the European Union and the United States through a PTA. This argument is entirely compatible with ours, as we include another rationale for PTA formation with major powers: leaders in developing countries want reforms that are domestically difficult to implement.

Why are major powers not able to threaten much smaller developing countries with sanctions should they fail to agree on demanding reforms? The reason is that *ex ante*, major powers may not have much interest. First, the small developing countries have relatively small markets, so capturing these markets produces relatively limited benefits. Second, given that the developing country has yet to liberalize the economy to a great extent, the major powers' domestic companies have yet to invest heavily in them. Third, forcing smaller countries to adopt trade agreements would have detrimental consequences for the major powers' credibility and reputation in multilateral trade negotiations and economic cooperation in general.

Why, then, is the story different *ex post* after a mutually agreeable PTA has been formed? There are several reasons for this. First, companies in major powers will increase their investment in the developing country, and thus create fixed assets that they want to protect (McLaren, 1997). Second, the reputational cost of enforcing the agreement disappears because this agreement was based on mutual consent and respect for national sovereignty (Guzman, 2008). Finally, the fact that the developing country's government was itself interested in negotiations shows that the potential for successful reform is there, and thus the major power can expect to realize economic gains from investment and so on in the long run.

The major power may also support a PTA because it wants to encourage and reward broader political-economic change in the country. Major powers are interested in policies in developing countries not only for their own sake, but for broader strategic reasons. They have an interest in political stability and economic prosperity in neighboring countries and in regions of strategic importance.

To illustrate this proposition, consider the NAFTA and the US-Colombia PTA.[13] In the case of NAFTA, the United States had a foreign policy interest in supporting the relatively moderate and liberal administration of Carlos Salinas de Cortari. As Krugman (1993, 18) explains in his defense of NAFTA:

> Carlos Salinas de Cortari's government is not a model of democratic virtue. From the U.S. point of view, however, it is the best Mexican government in either nation's history. Salinas' market-oriented reformers have done their best to break with a long tradition of anti-American rhetoric… [n]ot that long ago U.S. intelligence analysts worried that Mexico hammered by the debt crisis and plunging oil prices might become a radicalized national security nightmare. The friendly neighbor it has instead become is like a State Department dream come true.

In the case of Colombia, concerns about narcotics also played an important role. For a long time, the United States had cooperated with the Colombian government to combat the local drug cartels. In the US ratification debate, numerous members of Congress have argued that "Colombia is a crucially ally of the United States in Latin America and that if the FTA with Colombia is not passed, it may lead to further problems in the region… the agreement had implications for the economic and security interests of the United States in Colombia" (The Proposed U.S.–Colombia Free Trade Agreement." Congressional Research Service, January 2011, 24).

Given the wide variety of interests that major powers have in PTA implementation, it is not altogether surprising that examples of PTA enforcement are readily found. This is so both for the European Union and the United States. Consider, for example, the case of the SAA between the European Union and Bosnia Herzegovina. While Bosnia had for years sought to form this agreement with the European Union, the negotiations had failed because Bosnia's political and economic reforms had stagnated. One particularly difficult issue was police reform. In September 2005, the International Crisis Group offered the following somber conclusion: "the police reform needed to begin negotiations on a SAA with the EU appears hopelessly blocked" (International Crisis Group, 2005, i). When Bosnia finally managed to negotiate an SAA in 2008, ratification was delayed because several EU member states were concerned about the durability of the reforms in Bosnia. And after all EU member states had ratified the agreement in

2010, the SAA between Bosnia and the European Union did not enter into force "because it was the only way to avoid the situation in which the agreement would be immediately suspended given that Bosnia had failed to meet its obligations."[14]

The United States has also found institutionalized strategies to enforce, and comply with, its PTA obligations. In NAFTA, for example, private investors are allowed to request legally binding arbitration if they believe that one of the state parties has violated its treaty obligations and thus has caused harm to the investor. Though NAFTA dispute resolution is a controversial issue, especially in cases involving environmental or labor standards, many cases are settled, and those that do result in an actual legal ruling are being complied with. These data will be analyzed in Chapter 6 on the reform effects of EU and US PTAs. To be sure, an international court's ability to enforce behavior should not be measured as the number of rulings issued. It suffices that the international court deters breaches, so that no rulings are required. In an ideal world, the long shadow of the international court would deter potential defectors from violating international law. While this means that identifying the enforceability of an international institution such as EU or US PTAs is difficult, we offer in the following chapters multiple forms of evidence for the claim that both the European Union and the United States are, if necessary, capable of imposing costs on developing countries that fail to comply with their PTA obligations.

In sum, a developing country's leader who faces domestic political opposition to desirable liberalization can kill two birds with one stone by engaging in PTA negotiations with the European Union or the United States: the PTA is a helpful international institution because it allows credible commitment while also generating benefits that the leader can use as domestic side payments.

EMPIRICAL IMPLICATIONS

So far, we have shown the following:

1. A PTA with the European Union or the United States creates benefits to domestic constituencies, and this increases support to economic reforms necessary for the implementation of the PTA.
2. A PTA with the European Union or the United States enables credible commitment to economic reform.
3. The European Union and the United States have incentives to form and enforce the PTA.

This means that we now have a self-contained analytical model of the relationship between democratization, leader change, and PTA formation. This argument is summarized in Figure 3.1. This figure shows the causal pathway from democratization and leader change to international institutionalization. It also indicates that the PTA is expected to result in economic reform.

Specifically, this yields the following hypotheses:

> **Hypothesis 1**. *Under democratization, leader change increases the probability of PTA negotiations with the European Union and the United States.*
> **Hypothesis 2**. *Negotiating and forming a PTA with the European Union and/or the United States increases the probability of implementing economic reform.*

While our focus is on the causes and consequences of PTA formation, it is useful to briefly consider our expectations for democratization without leader change, as well as our expectations for leader change without democratization. Outcomes under these conditions can be compared against the baseline of autocratic rule.

In preceding text, we have argued that democratization increased the demand for economic reform. Without leader change, democratization should therefore cause economic reform. If an established leader is powerful enough to maintain control of the democratization process, then she can also liberalize even without the external support that a PTA affords. However, such reforms may prove partial because the established leader continues to favor her core supporters even during democratization (Hellman, 1998; Keefer, 2007). At any rate, democratization without real leader change should increase the probability of PTA negotiations with the European Union or the United States.

As to leader change without democratization, it seems plausible that both the probability of reform and PTA negotiations could increase. Every

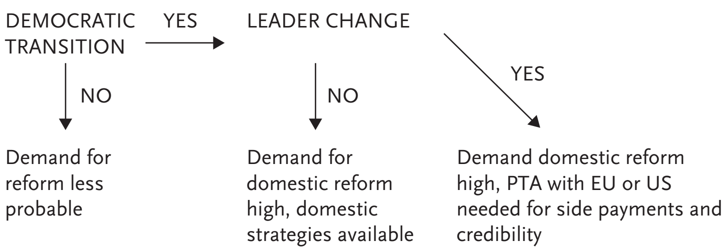

Figure 3.1 Democratization, Leader Change, and Preferential Trading Agreements. Since the PTA can be bilateral, it is also a more flexible strategy than multilateral institutionalization.

time a new leader gains power, policy change may occur, if only because the new leader has different preferences from those of the previous leader. Thus, a new leader might even choose to promote liberalization through PTA negotiations even in the absence of democratization. However, we would expect leader change without democratization to have a smaller effect on reform and PTA negotiations than leader change under democratization. During a democratic transition, a new leader's incentives to focus on liberalization are pronounced. Given the difficulties that new leaders face, the most likely outcome is economic reform in the shadow of PTA negotiations and, later, implementation.

ALTERNATIVE EXPLANATIONS

PTA formation is a complex process. For a rigorous empirical test of our theory, it is therefore important to examine additional factors and, in particular, to consider plausible alternative explanations. We examine alternative explanations through a series of rigorous quantitative tests. We trace political processes in a series of comparative case studies. Four such explanations stand out for their importance.

In this section, we focus on alternative explanations that could plausibly explain the patterns we observe in the empirical data.[15] We focus on these because they are the most serious threat to empirical inference. In the empirical chapters, we also account for other covariates of PTA formation and explore the role of factors such as government ideology.

Economic Crises

The first alternative explanation is the relationship between *economic crises* and PTA formation: Perhaps countries are willing to engage in treaty cooperation in difficult times? This explanation, we argue, is broadly consistent with our general argument, especially in conjunction with democratization and leader change. Thus, we do not attempt to refute this explanation in the empirical analysis. Instead, we show, both in the quantitative analysis and the case studies, that economic crises played a role in explaining PTA formation between major powers and developing countries, but only in contexts characterized by underlying demand, such as recent democratization, and the leader's political difficulties. In the absence of these factors, they do not result in PTA formation.

Economic crises can induce PTA formation for two reasons. First, they are in and of themselves a potential demand factor for economic reform. Some economic crises are driven by largely exogenous factors, such as worldwide recessions. But others result from poor economic policy. As the costs of failed economic policies become apparent, governments face pressure to change these policies. Neither elites nor mass constituencies benefit from economic hardship.

Second, economic crises also strengthen the demand effect of democratization. Democratization increases demands for a variety of public goods, and poor economic performance increases the salience of economic issues. Thus, economic crises increase the urgency of economic reform in democratizing countries.

A related issue worth discussing here is the possibility that economic crises cause democratization and leader change. This is certainly a plausible possibility. Poor economic performance makes leaders vulnerable to political challenges and, in authoritarian regimes, jeopardizes the leader's ability to maintain elite support (Bueno de Mesquita et al., 2003; Haggard and Kaufman, 1995). Yet there are many economic crises that result in neither democratization nor leader change. We can, therefore, reject the possibility that economic crises are the *exclusive* cause of PTA formation by showing that such crises do not predict PTA formation in the absence of democratization and leader change.

Several of our case studies in the following chapters underscore the importance of crises. In post-apartheid South Africa (see Chapter 7), President Mandela's government inherited an economy that had been stagnating for a decade under international sanctions. Upon Franjo Tuđman's death in 1999, Croatia's economy was paralyzed by the legacy of a civil war and a failed privatization program. Even in Chile, where many economic reforms had been implemented already in the 1990s, unemployment stubbornly remained at high levels upon President Lagos's inauguration. And yet, our case studies underscore the importance of leader change and democratization. Economic crises themselves did not induce PTA negotiations: neither South Africa's last apartheid ruler, F. W. de Klerk, nor Croatia's *de facto* dictator Franjo Tuđman engaged in PTA negotiations. It was only with the coincidence of democratization and leader change that PTA negotiations, and the subsequent economic reforms mandated by the treaty, began.

Coercion

Another key issue that we want to flag before beginning our empirical analysis is what we find to be the most plausible explanation for the association between PTA formation and economic reform: major economic powers *demand* economic reform in exchange for market accession, and leaders in partner countries accept these economic reforms as a *necessary evil*.

This hypothesis would explain the association between PTA formation and economic reform. It would also lead one to expect a positive association between PTA formation and economic reform. Yet it has several very different empirical implications. First, leaders engaging in PTA negotiations should bargain hard to *avoid* economic reforms. We should not see evidence of these leaders endorsing the reforms. They should, instead, demand less stringent reform requirements and then go to their domestic audiences arguing that they were forced to adopt such reforms. Qualitative case studies allow us to examine the merits of this hypothesis.

Depending on how coercion is expected to unfold, the coercion argument generates two additional hypotheses. On the one hand, one might argue that established leaders, not new leaders, should be particularly suitable targets for coerced reform. For established leaders, economic reform is easier than for new leaders due to reasons discussed earlier. Thus, they are more willing to pay the cost of economic reform in exchange for market access. This is exactly the opposite of what our theoretical argument leads one to expect.

On the other hand, one could also argue that new leaders are particularly vulnerable to external pressure by the European Union and the United States because these new leaders' rule is not secure.[16] This would explain why leader change induces PTA formation, and it could also explain the interactive effect with democratization. If democratization increases a leader's probability of losing power, then it amplifies the vulnerability effect of being a "rookie." To test this alternative hypothesis, we examine whether *authoritarian reversals* also increase the effect of leader change on PTA formation. Of all leaders, new authoritarian leaders are particularly vulnerable to deposition. What is more, for them the fate of losing office—imprisonment, death, exile—is much more dreadful than for democratic leaders. By examining the interactive effect of a new leader and authoritarian reversals, we can examine the validity of this variant of the coercion hypothesis.

Rewarding Democratization

Another possibility is that the European Union and the United States use PTAs to reward or coerce democratization in developing countries. If this is the case, the association between PTAs and economic reform could ultimately be about democratization. In this case, the PTA itself would not directly promote economic reform, but instead would be a reward for democratization, which would in turn result in economic liberalization. In this case, the PTA would only promote reforms indirectly, through democratization.

Testing this alternative hypothesis is easy. If the claim holds, then democratization should promote PTA formation even *without* leader change. If the European Union and the United States are interested in promoting democratization, they should reward it even if the previous government remains in power. Indeed, rewarding new leaders for the democratization that brought them into power would not offer any incentives to incumbent authoritarian rulers.

Rewarding Economic Reform

Earlier, we considered the competing explanation that the European Union and the United States reward democratization. Another possibility is that the European Union and/or the United States reward economic reforms, using the PTA as a "carrot" to induce otherwise reluctant leaders to join. Of course, our theory also recognizes that EU and US interest in the developing country is crucial, but we expect said interest to be unimportant unless the leader of the developing country also wants a treaty. If the European Union and the United States simply reward economic reforms that the leaders prefer not to implement, then we should see EU and US PTAs regardless of the developing country's expected benefits from the treaty. Conversely, if our theory is valid, we should see EU and US PTAs where the agreement can build domestic political support for reforms by generating gains for domestic constituencies.

To test the alternative hypothesis, in subsequent chapters we investigate the effects of leader change and democratization contingent on the sectoral composition of the developing country's economy. Agricultural producers may not expect benefits from the PTA because the European Union and the United States are extremely reluctant to liberalize agricultural imports, and the service sector is vulnerable to competition from efficient European and American service producers. In contrast, the industrial sector, which in most developing countries is labor intensive, reaps large gains from access to the EU and US markets. Therefore, a new leader of a democratizing country can secure political support for reforms by forming a PTA if the industrial sector is large. Finally, we complement this analysis by examining the skill composition of the economy, showing that high skill levels increase the interactive effect of democratization and leader change. This again underscores the importance of the domestic context, which is incompatible with a simple theory of EU and US PTAs as a carrot for reform by reluctant leaders.

Trade Liberalization

A third alternative explanation is trade liberalization. New leaders could be inclined toward liberalizing trade under democratization for several reasons. First, trade liberalization reduces consumer prices (Milner and Kubota, 2005). Second, trade liberalization benefits abundant factors of production. In virtually all democratizing developing countries, labor is the abundant factor. Since most people have little capital, they would benefit from trade liberalization. Could it be that new leaders and democratization induce PTA formation with the European Union and the United States due to the incentive to liberalize trade, period?

This hypothesis can be tested relatively easily. If it is valid, we should see trade concerns being a powerful predictor of PTA formation with major powers. Countries that have a lot of untapped trade potential, perhaps due to geographic proximity or comparative advantage, should be particularly eager to engage in PTA negotiations. By examining whether trade potential predicts PTA formation with the European Union and the United States, this alternative explanation can be rigorously tested.

In general, we do find evidence that trade considerations were important. In fact, they even play a prominent role in our theory: market access to the European Union and the United States is one of the reasons that a PTA generates domestic support for economic reform. Of our cases, South Africa is perhaps the most important testimony to the importance of trade liberalization. South Africa sought enhanced access to European markets for its agricultural products, and the difficulty of agreeing on these policies is perhaps the most important reason that the negotiations lasted for five years. However, we find little evidence that trade considerations were the exclusive impetus for PTA negotiations. In one of our cases, such as US-Colombia negotiations, interviewees went so far as to explicitly recognize that market access was secondary to economic reform.[17]

Trade and Investment Interdependence

Various authors in the literature have noted that the spread of PTAs is driven by trade and investment interdependence (Baccini and Dür, 2012; Manger, 2009; Shadlen, 2008). As pairs of countries form PTAs, third parties form "defensive" trade agreements to avoid trade and investment discrimination. Since the European Union and the United States are major investors and export destinations, these defensive moves could explain why many developing countries are interested in trade cooperation. If this effect proved powerful, it could explain many PTAs that we would otherwise falsely ascribe to democratization and leader change. Therefore, the empirical analysis will present models that account for trade and investment interdependence by applying spatial econometrics.

CHAPTER 4

Design of Preferential Trading Agreements

Neoliberal institutionalists have argued that states design international institutions to solve the international cooperation problems they face (Abbott and Snidal, 1998; Keohane, 1984; Koremenos, Lipson, and Snidal, 2001). Or, as Koremenos, Lipson, and Snidal (2001, 762) put it, "states use international institutions to further their own goals, and they design institutions accordingly." This functionalist reasoning assumes that states are unitary actors. Since our theory focuses on the domestic implications of international institutions, we need to shift the focus from states to individual leaders. While we adopt the premise that international institutions, including PTAs, are designed to fulfill certain goals, we also emphasize the domestic political effects of international institutions. In addition to solving international cooperation problems, we assume, governments design international institutions to advance domestic political goals. Economic reform is one such goal.

Given this premise, we need to identify the PTAs with an institutional design intended to promote economic reform. Therefore, we begin our empirical analysis by examining the institutional design of PTAs. Our theory is built on the notion that the leaders of developing countries reach out to major powers in order to implement economic reforms that are difficult to implement, so it is important to verify that the resulting PTAs are indeed designed in such a fashion that they can promote reform.

The analysis is based on a new and original data set of the institutional design of all PTAs that countries have formed from 1948 to 2009 (Dür et al., 2014). Since our analysis focuses on the 1990–2007 period, we analyze reform provisions during this time; in the next chapter, we show that such reform provisions were largely nonexistent before 1990. Using several key indicators, we verify that recent EU and US PTAs indeed contain a large number of provisions that demand intrusive economic reforms. This is in stark contrast to most other PTAs, which mostly focus on trade liberalization and enshrine few "trade plus" provisions that would prescribe broader microeconomic reform. For the interested reader, we also show that Japanese PTAs are designed similarly to those of the European Union and the United States, whereas China's PTAs are generally more shallow in regard to economic reform.

The remainder of the chapter is organized as follows. First, we provide a historical overview of the PTAs that the European Union and the United States have formed. While important transatlantic differences exist, both economic superpowers are clearly emphasizing the importance of economic reform and governance in partner countries. We also briefly discuss Japan's recent PTAs, noting similarities and differences from those of the European Union and the United States. To contrast the EU and US institutional designs with more shallow PTAs formed by other major powers, we also discuss China's recent efforts to form PTAs.

Third, we analyze original design data on microeconomic reforms. We show that across five important indicators of economic reforms, the European Union and the United States clearly meet the scope conditions of our theoretical argument. We also show that other PTAs do not meet these scope conditions. In sum, this section achieves the first goal of our empirical analysis. We can show that the institutional design of EU and US PTAs makes these treaties conducive to promoting economic reform in partner countries across the developing world.

OVERVIEW

Most extant PTAs focus on a relatively narrow set of trade issues. Governments of sovereign states form such agreements to achieve a limited set of goals, such as expanding trade in certain key industries. For instance, the Tunisia-Turkey PTA signed in 2004 was clearly designed with the main goal of liberalizing trade between these two countries. Despite their geographic proximity, the two countries still imposed high tariffs on each other's products. For 3,401 tariff lines, the prescribed reduction was 12 percent in the year of the ratification and 12 percent for each of the following years. Within six years of entry into force of the agreement, these products were to have no tariff at all. For the remaining 3,000 tariff lines, the reduction was more gradual: 9 percent for the first year, 13 percent for the following years, and a zero tariff within 10 years of the entry into force of the PTA. As these numbers show, trade agreements can improve market access between the two member countries. However, the 35-page treaty says virtually nothing about services, investment, and intellectual property rights. This is a typical PTA that cannot promote broad economic reforms in partner countries.

Against this backdrop, it is remarkable how deep and broad the EU and the US PTAs are, with stringent conditions imposed on the implementation of a wide variety of economic policies. Not only are the trading partners of the European Union and the United States required to reduce their tariffs, but they also must commit to a wide variety of liberalizing policy reforms. These requirements range from investment reform to curtailing discrimination in government procurement. The political and economic significance of these reform provisions reaches well beyond the significance of the tariff cuts.

Few PTAs existed prior to 1990, and many Cold War PTAs were formed for security and geopolitical reasons. Overall, these PTAs had little to do with economic reform. Therefore, we focus on the PTAs during the period of "new regionalism" (Mansfield and Milner, 1999). Already in the second half of the nineteenth century, many European countries began to form trading blocs, and in the interwar period highly discriminatory PTAs diverted trade in ways that contributed to a global recession. The discriminatory PTAs caused problems in the world economy, as global trade flows were disrupted and exporters across the globe went out of business (Kindleberger, 1986). Soon after World War II, the European Community and the European Free Trade Area continued the tradition of regional PTA formation. But it was only in the aftermath of the Cold War that PTAs began to proliferate in the global economy. More important, it was only in the aftermath of the Cold War that the European Union and the United States began to impose stringent reforms conditions on PTA formation.[1]

For our empirical analysis, we adopt a stringent definition of a PTA. Specifically, it must contain (i) provisions for increased market access, (ii) provisions that are legally binding, and (iii) provisions that have a wide scope so that they regulate not only trade issues but also other economic issues. We exclude framework agreements or partial economic agreements from the analysis, since these treaties are usually shallow and mandate tariff reductions in few sectors. Most PTAs in our data set were notified to the WTO. The only exceptions are developing countries that had yet to join the WTO at the time they signed a PTA with the European Union or the United States.[2]

For example, we do not include the 1994 Partnership and Co-operation Agreement (PCA) between the European Union and Russia, as well as with other former Soviet countries. This is a vague agreement that provides a suitable framework for political dialogue and accompanies Russia's transition to a market economy. Similarly, we exclude Interim Agreements between the European Union and post-communist countries because they do not contain detailed provisions on economic reform. To give an example, the EU-Latvia Interim Agreement has only 16 pages, whereas the Association Agreement has 239 pages.

The online Appendix shows the negotiation and signature dates for the European Union and the United States on the date of negotiation for each PTA. To provide a more complete overview, we also include Japan and China.[3] The European Union has been the most active PTA formateur, with 30 agreements in force or in negotiations. Notably, EU PTAs are not limited to the immediate geographic neighborhood of the union: Europe has engaged in PTA negotiations in Africa, Asia, and Latin America. The United States has formed or has begun to negotiate 19 PTAs. However, the number of US PTA partners is larger than this because some of the PTAs, such as CAFTA-DR, are multilateral. Japan has negotiated 10 PTAs, while China has also formed 10 PTAs.

Figure 4.1 shows the number of EU, US, Japanese, and Chinese PTA partners over time.[4] The figure shows how the European Union has been the forerunner in PTA negotiation and formation. With the sole exception of NAFTA,

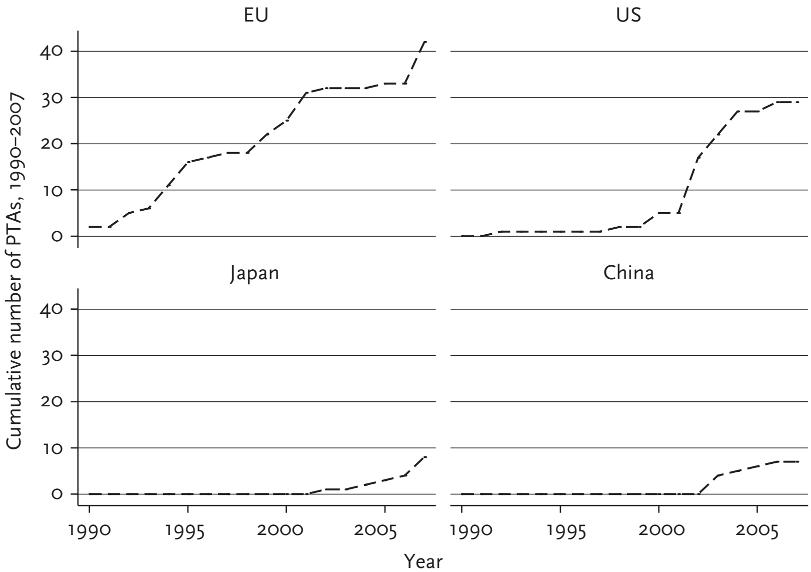

Figure 4.1 Number of EU, US, Japanese, and Chinese PTA Negotiations over Time. For these numbers, each member of each multilateral PTA is counted separately.

the United States only began to form PTAs in the turn of the century (e.g., Jordan and Chile). During President George W. Bush's tenure (2000–2008), in a move toward "competitive liberalization" (Shadlen, 2008), the United States began to create a PTA network. However, the European Union continues to lead in terms of the number of PTA partners. Equally important, neither China nor Japan comes close to the numbers of the European Union and the United States.

As regards the regional PTA distribution, both the European Union and the United States have shown genuinely global interest in PTA formation. The European Union has negotiated a PTA in every region, while the United States has negotiated a PTA in every region except Europe and South Asia. In contrast, Japan and China have mostly formed PTAs in their immediate geographic environs.

The European Union's interest in PTA negotiations manifests itself in what European officials have labeled "Association Agreements." As soon as the Soviet empire began to crumble, so that the eastern side of the Iron Curtain opened itself to international trade and investment, the newly democratized post-communist countries began to seek deeper economic integration with their western neighbors (Vassiliou, 2007). While membership in the European Community was clearly out of reach in the immediate aftermath of the collapse of the Soviet Union, already in 1990 the European Union began negotiations for Association Agreements with the Czech Republic, Hungary, Poland, and Slovakia. Bulgaria and Romania followed suit in 1992, and the Baltic countries began their negotiation on Association Agreements in 1995.

Equally important, the European Union's influence reaches well beyond Eastern Europe. The union has negotiated a series of PTAs in North Africa, the Middle East, the Balkans, and Latin America. It is currently also negotiating with India and the Republic of Korea. The global reach of the European Union's commercial interests is important for our theory, as it provides leaders in many developing countries with a potential opportunity to engage in PTA negotiations with the Europeans. Below, we show that the European Union's active promotion of economic reform through PTA formation has induced tremendous change in the developing world.

Compared to the European Union, the United States is a latecomer in PTA formation. While the United States did negotiate the North American Free Trade Agreement (NAFTA) with Canada and Mexico beginning in 1990, the country did not begin another round of negotiations until 1995 with Vietnam. In 1999 the United States began negotiating a PTA with Jordan, and by 2007 the United States had begun negotiating a total of 17 PTAs. A particularly important period was President George W. Bush's tenure, when the United States engaged in what Robert Zoellick has described as "competitive liberalization." The United States offers an opportunity to any interested developing countries to form a US PTA, subject to conditions pertaining mostly to economic reform. If some developing countries do not accept the offer, then they are left behind (Shadlen, 2008).

While EU and US PTAs are prevalent, it remains to be shown that they generate benefits to domestic constituencies in developing countries, as our argument assumes. Since market access is one of these benefits, it is useful to examine whether EU and US PTAs really enhance it. While we do not have data on all EU and US PTAs, we have sufficiently many fully coded agreements to examine the claim. In particular, we focus on four PTAs: Chile-EU, Chile-US, Colombia-US, and Peru-US. US PTAs in particular appear to be quite liberal for developing countries in terms of market access. Indeed, 50 percent of US tariffs go to zero immediately. Moreover, while fewer than 20 percent of EU tariffs go to zero in the first year of the Chile-EU PTA, almost 40 percent of the tariffs go to zero after 10 years from the signature of the PTA. Although EU and US tariffs are already quite low, the reduction has an important positive effect on the economy of a developing country.

Japan began negotiating PTAs much later, in 2001. Since then, it has negotiated 10 PTAs, beginning with a treaty with Singapore signed in 2002. Notably, Japan's treaties are largely concentrated in the immediate region of the country. There are only two exceptions to this regional focus, namely Mexico and Chile. These agreements appear to have been "defensive" moves in response to similar agreements with the European Union and the United States. As Manger (2009) explains, Japanese investors lobbied for PTA negotiations to avoid discrimination due to the preferential treatment that European and American investors were receiving as a result of their PTAs with Chile and Mexico.

China began negotiating a PTA in 2003 with Panama and Thailand. By 2009 it had signed 10 PTAs, and another PTA was signed with Costa Rica in 2010. As of May 2013, China is currently negotiating PTAs with Australia, Colombia, Gulf Cooperation Council countries, Iceland, Norway, the Southern African Customs Union countries, and Switzerland. Some other PTAs under consideration are with India, South Korea, and Japan. However, Chinese PTAs are very different from agreements signed by the other major economies (Antkiewicz and Whalley, 2004). First, the length of the actual treaties is usually rather short and the text vague (Antkiewicz and Whalley, 2004, 3). Second, Chinese PTAs do not often include dispute resolution mechanisms that provide for conciliation between the parties, though this has started to change slowly. Third, the emphasis of Chinese

PTAs is mainly on market access for manufactured goods through bilateral tariff reduction and elimination (Antkiewicz and Whalley, 2004, 3–4). In sum, although there is heterogeneity in terms of coverage and scope among Chinese PTAs, they are, overall, shallower than the EU and US PTAs. This is not particularly puzzling, given that China is not a liberal market economy. Given the Chinese state's extensive role in the country's national economy, it is not a surprise that China also does not promote economic liberalization abroad through a network of PTAs.

ECONOMIC REFORM INDICATORS

Having provided a concise historical overview of new regionalism, we now turn to the actual data on the design of the PTAs. Here, we face an important challenge. Given that PTAs are very broad economic agreements, it is not immediately clear what the relevant sections and chapters are. How, then, should we select reform indicators for study? Since some PTAs contain hundreds of pages of provisions, with much technical and often obscure detail, it is essential to systematically select our indicators of economic reform provisions and maintain a sharp focus on these indicators throughout the empirical analysis.

Given our interest in microeconomic reform, as detailed in the previous chapter, we opted for five primary economic issues that often appear in a PTA:

1. Intellectual property rights (IPR);
2. Liberalization in services;
3. Foreign direct investment (FDI);
4. Competition policy;
5. Government procurement.

These sectors were chosen to maximize breadth. Beyond the obvious requirement that the economic reform in focus must be of interest to the European Union and the United States, our theory does not generate predictions on exactly what types of reforms leaders pursue. This depends on a wide variety of contextual factors. While we do not develop *ex ante* hypotheses on these factors, our case studies allow us to illuminate this question as well.

We assume that leaders in developing countries generally prefer economic reform. This is not to say that the European Union and the United States never choose to twist developing countries' arms to impose reforms.

For example, Sell (1998) shows that developing countries have often fought with the European Union and the United States on IPR policy. While the European Union and the United States have promoted stringent copyright and patent laws, developing countries have emphasized the importance of free access to pharmaceuticals and similar policies. Our case studies provide some evidence for this approach in the case of IPR legislation, but much less so for the other four reform indicators.

These five sectors leave us with enough empirical variety to conduct a systematic empirical analysis. And yet, the number of sectors is small enough to be manageable within the confines of a single book. In what follows, we outline our selection criteria and explain why these five areas of reform are suitable for our analysis.

In choosing to focus on these five reform indicators, we considered four key criteria. First, does the reform have sufficiently important economic consequences to warrant consideration? We wanted to avoid selecting very narrow reforms, such as those that pertain to a specific industry. For example, testing a general theory against data on fisheries legislation does not seem appropriate. While narrow reform commitments may also be controversial in specific countries, they are not suitable material for theorizing about the role of PTAs in economic reform across a large number of cases.

Second, we only considered politically controversial reforms. We strove to avoid reforms that would not provoke any political controversy, because according to our theory, leaders should not need a PTA to implement reforms that were immediately popular. Had we tested our theory against data on reforms that are mostly uncontroversial, we would have focused on window dressing. For all five forms of reform, we reviewed the literature and searched for evidence and reasons of political controversy. This evidence will be summarized in subsequent text.

Third, we emphasized reforms that could potentially be part of a PTA. This restriction is not particularly consequential, for the previous chapter showed that EU and US PTAs often contain a wide variety of provisions. However, it does exclude some important reforms. One example is health policy reform. If developing country leaders are to reform their health systems, as Chile's Ricardo Lagos wanted to do upon his inauguration, a PTA is not an optimal strategy. Neither the European Union nor the United States has shown any interest in prescribing health policies in PTAs. This is understandable, as the European Union and the United States presumably do not have a direct interest in the healthcare that people in developing countries receive.

Finally, we deliberately emphasized non-trade reforms. That a PTA often requires tariffs reductions is rather obvious and hardly needs to be addressed in a book project. Previous research provides enough material for understanding the politics of preferential trade. This is not to say that a PTA could not have important effects on trade barriers, and indeed our theory itself emphasizes the reduction of trade barriers by the European Union and the United States as a way to build domestic political support for reforms in the partner country. To test our causal argument concerning economic reform, however, it is important to look beyond trade.

All five reform indicators meet these criteria. Our first reform indicator, *intellectual property rights* (IPR), has important consequences for economic activity in industries for which innovation is important (Kanwar and Evenson, 2003; Levin et al., 1987). Stringent IPR laws allow companies to appropriate the profits from innovative activity, but they also raise obstacles to the diffusion of knowledge. While the optimal level of IPR protection is vigorously debated in the literature (Mowery, 1982; Ockwell et al., 2008), a state's complete failure to protect copyrights, trademarks, and patents deprives the private sector of incentives to invest in research and development (Maskus, 2000). Therefore, it seems plausible that leaders often expect political and economic benefits from IPR reform. This is particularly important in view of increasing FDI in innovative sectors, because these sectors ascribe a particularly large premium on stringent IPR legislation.

Yet IPR protection is also politically controversial. For one, stringent IPR protection is costly for companies that have previously relied on "reverse engineering" and copying foreign innovations. They can be expected to politically mobilize against a leader who proposes to increase the stringency of IPR legislation. Companies and industries whose profits depend on replicating foreign designs and innovations cannot survive if stringent IPR rules prevent them from continuing such replication, so they have incentives to depose leaders who promote new IPR rules.

Deere (2008) and Sell (1998) document a deep distributional conflict between industrialized and developing countries over IPR protection. For industrialized countries, the promotion of stringent IPR protection has generally been an important foreign policy goal because, at least historically, most of the profits from patents and copyrights protected by IPR rules accrue to capital owners from industrialized countries. Conversely, many developing countries have chosen not to implement IPR rules because such rules would hurt currently profitable companies in these developing countries. Therefore, a leader in a developing country pursuing IPR reform can be expected to face political opposition.

Thailand is a perfect example of how IPR legislation can become so controversial as to prevent the formation of a PTA. According to Mia Mikic, who coordinates the Asia-Pacific Research and Training Network on Trade of the United Nations, and Alexander Chandra, the South Asia coordinator for the Trade Knowledge Network, the US-Thailand PTA negotiations stalled because of the strong opposition to new IPR rules in Thailand. This issue was particularly controversial for pharmaceutical products, in general, and products to treat HIV, in particular. Groups opposing strict IPR laws argued that the IPR regime in the PTA would have prolonged the data exclusivity of the pharmaceutical companies. In turn, copyright issues would have prolonged the period of high costs for obtaining drugs.[5]

The second reform indicator, *liberalization in services*, is also directly relevant to economic performance and the distribution of payoffs in the domestic political economy. Water, electricity, heating, telecommunications, banking, and airports are examples of services that could be liberalized in a PTA. These sectors are essential for economic growth and citizens' well-being, though again the merits of liberalization can be contested. In developing countries, for example, weak regulatory institutions may prevent governments from ensuring the adequate provision of services to the poor (Kirkpatrick and Parker, 2005).

Liberalization in these services can also be expected to provoke political opposition. Reducing state intervention in a service sector often increases competition, and thus decreases profits to the incumbent providers (Hirsh, 1999). Liberalization may also result in the dismantling of consumer subsidies. This reduces the economic well-being of constituencies who consume large amounts of the service in focus (Murillo and Martínez-Gallardo, 2007). Even if the liberalization of services is in the leader's political interest, it is almost certain that the leader will face at least some political opposition as she attempts to implement liberalizing policies. Those who expect to lose from the liberalization of services have no reason to support such a leader, and if the losses from liberalization are concentrated while the benefits are diffuse, political opposition can be expected to be powerful.

Colombia is a good example of the difficulties that leaders face in liberalizing the service sector (Arbeláez, Flórez, and Salazar, 2006, 31). Since the financial sector is unpopular in the legislature, with congressmen perceiving the sector as predatory, banks and other companies in the financial sector are concerned about the possibility that legislative reforms could be implemented in the free trade negotiations. Perhaps paradoxically, then, policymakers have been worried that reforms to improve the efficiency of the financial sector could be both opposed by this sector and undermined by the legislature.

Our third indicator is *investment liberalization*. Policies that allow foreign capital owners to invest in the domestic economy create lucrative opportunities for capital owners and employees (Büthe and Milner, 2008; Dunning, 1981). They also facilitate technology transfer (Moran, 1999; Saggi, 2002). This allows the host countries to unleash their potential for economic growth. Indeed, investment liberalization is a particularly important economic reform in a world characterized by large technological asymmetries across borders.

Yet investment liberalization is also politically controversial. It creates competition for factor inputs and markets (Kerner, 2009). If the foreign investors begin to market products to domestic consumers, then previously protected domestic incumbents face increased competition and therefore lose profits. Additionally, foreign direct investment may trigger nationalist calls for limiting foreign ownership of capital (Jodice, 1980). Therefore, a leader who attempts to create rules that protect foreign investors can expect stiff opposition. Domestic industries fearing competition from foreign investors and nationalist constituencies have no reason to support such rules, so they mobilize against the leader.

Croatia is a striking example of how controversial investment liberalization can be in developing countries. Ana-Maria Boromisa and Nevenka Čučković, two Croatian economists at the Institute for International Relations (IMO) in Zagreb, argue that FDI and services liberalization were a priority of Racan's government.[6] However, such liberalization faced strong opposition from some industrialists, called "tycoons" in the country, who bought important public companies during the privatization implemented by Franjo Tuđman in the 1990s. In particular, according to Boromisa, groups who opposed this reform used well-known populist slogans such as "you sold Croatia to foreigners."

The fourth reform indicator we consider is *competition policy*. Policies to increase competition have important effects for the economy. They influence the number of companies in different industries, creating competitive pressure to reduce prices but potentially preventing companies from exploiting economies of scale (Williamson, 1975). Competition policy is particularly disruptive in the presence of state enterprises because their operations have been heavily regulated in the past. If they are forced to compete with private companies, especially foreign ones with access to advanced technologies, their ability to maintain profits is compromised.

For these reasons, competition policy also provokes political opposition. The current incumbents stand to lose their oligopoly or monopoly profits if barriers to entry are reduced, so they have a strong material incentive to oppose economic reforms that increase competition. In important industries, the current incumbents can have considerable economic and political clout. After all, they have historically enjoyed high levels of protection, which has in turn resulted in large rents.

Competition policy was a key issue in the EU–South Africa PTA. According to a leading negotiator, the section on competition policy was particularly important for South Africa.[7] It introduces important improvements and changes in regulations related to the ongoing privatization process, which was opposed by the Congress of South Africa Trade Unions and the South African Communist Party. Moreover, South Africa was just developing legislation on competition at the time of the negotiations with the European Union. In this regard, the South African negotiator claimed that "South Africa learned extensively from the EU in terms of competition policy."

Our final indicator is government procurement. If a government creates institutions and rules to prevent discrimination in government procurement, be it against unpopular domestic companies or foreign ones, the efficiency of public projects can be increased (Evenett and Hoekman, 2005). From the perspective of maximizing the efficiency of the public sector, discriminatory and preferential procurement are unambiguously harmful practices. Consequently, a leader who wants to enhance the efficiency of the public sector should prefer such reforms of government procurement rules that increase competition. However, the previous beneficiaries of procurement discrimination have incentives to oppose such reforms. Since they can but lose from increased competition, they have few incentives to support leaders who want to increase competition in government procurement. Additionally, some scholars argue that constraints on government procurement could prevent the state from using its purchasing power to promote non-pecuniary positive externalities, such as environmental pollution, because the government cannot easily discriminate against products produced in environmentally harmful ways (van Asselt, van der Grijp, and Oosterhuis, 2006).

Coming back to the US-Thailand PTA, Mikic states that negotiations failed also due to issues related to government procurement, which is regulated by a complicated multilayer system in Thailand.[8] Indeed, the Thai government did not commit to including arbitration clauses in concessions and government contracts or improving transparency in government procurement. Mikic also notes that Thailand is not a signatory to the WTO Agreement on Government Procurement and that the 2004 Australia-Thailand PTA includes few provisions on government procurement.

RESULTS

Overall, we find that the EU and US PTAs are significantly different from all other PTAs. While EU and US PTAs contain demanding provisions for the five reform areas outlined above, this is rarely true of other PTAs. Indeed, EU and US PTAs are also more stringent than other North-South PTAs.

Japanese PTAs are quite similar to those of the European Union and the United States. They also contain reform provisions, but we exclude them from most of our empirical analyses due to the narrow geographic coverage of Japan's PTA network. Our evidence suggests that Japan is willing and able to promote economic reform in partner countries, but Japan's interest lies in its immediate geographic surroundings. Therefore, Tokyo's global importance as a partner for economic reform is not comparable to the importance of Washington or Brussels.

Equally important, China's PTAs mostly do not demand economic reform. They contain few provisions demanding economic reform, which means they are not suitable for promoting economic reform. The Chinese government's willingness—and perhaps ability—to intervene in trading partners' economic policy is limited. This may reflect China's status as a major exporter of industrial goods; compared to the European Union and the United States, China has less to gain from access to service markets or stringent IPR laws.

We now detail the results for each reform indicator. We first explain how we measured the breadth and depth of the reform indicator, and then summarize the results. To begin with, consider IPR protection. For IPR protection, we counted the number of IPR provisions in each PTA. We included references to multilateral IPR conventions, the existence of enforcement clauses, specific provisions for substantive standards of IPR protection, and references to geographical indications of origin. Given the importance of pharmaceuticals, we also included specific mentions of IPR protection in this sector. Overall, this coding system left us with a count between zero and 12 provisions. Of these, five relate to existing multilateral IPR treaties.

The findings of the analysis are shown in Figure 4.2. This figure shows the statistical distribution of the number of IPR provisions for EU, US, and other existing PTAs.[9] The median number of provisions in other PTAs is one, whereas the median for the European Union is 5.5 and the median for the United States is 12. Japan's is only 4.5, and the median for China is unsurprisingly close to zero, i.e., 0.25. As expected, EU and US PTAs contain institutional potential for implementing and enforcing IPR reform, while other PTAs mostly do not. Indeed, the distribution of the values strongly suggests that the European Union and the United States are largely responsible for a unique subset of PTAs: those that prescribe demanding IPR reforms. Many other PTAs prescribe none, and most contain only one reference, such as a general remark on the importance of IPR protection.

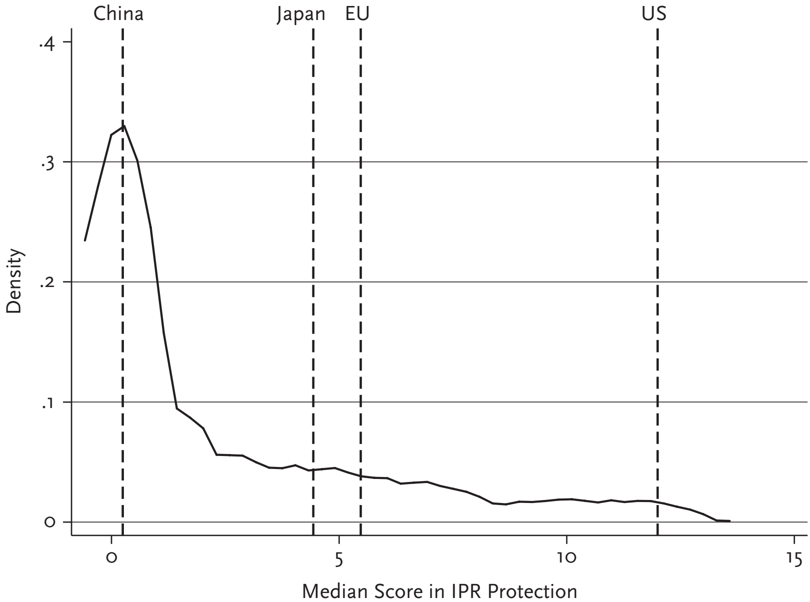

Figure 4.2 Number of IPR Provisions in EU, US, and other PTAs. The *y*-axis shows the relative frequency of the corresponding number of IPR provisions given in the *x*-axis.

Figure 4.3 shows the evolution of such provisions over time. Beginning with the wave of PTAs formed by the European Union in the 1990s, both the European Union and the United States have paid considerable attention to IPR protection in their PTAs. The only exception to this rule is the very first PTA formed by the United States, namely NAFTA. It does not impose specific reform requirements on Mexico. In general, though, IPR protection is a current interest for the European Union and the United States. While the average number of IPR provisions has increased slightly over time, this number has remained relatively high over time. For all other PTAs, the number of IPR provisions has remained stable at low levels through the past two decades.

We now turn to services. We record the existence of service provisions in PTAs as follows. First, we code a PTA as “2” if a full service chapter exists. Such a chapter details the legal obligations of each treaty signatory to liberalize service regulation, so as to increase foreign suppliers’ market access. For instance, the Chile-US PTA (2003) includes a chapter on services (chapter 11). This chapter includes a provision with reference to GATS, a most-favored-nation (MFN) clause, a national treatment (NT) clause, and a provision explicitly granting the right of non-establishment, that is, cross-border trade in services is explicitly allowed. Moreover, services

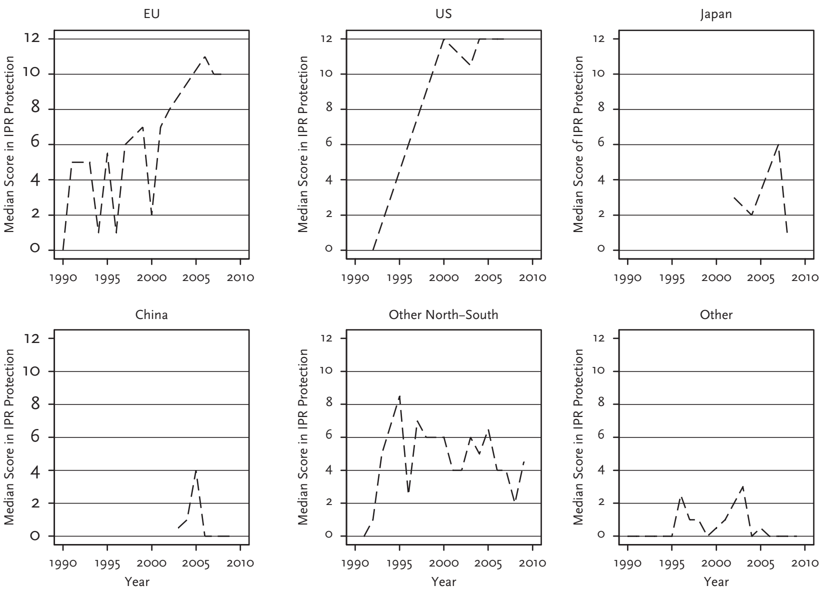

Figure 4.3 Evolution of the Median Number of IPR Provisions over Time. For the EU, US, and Japan, only North–South PTAs are considered.

liberalization follows a negative list approach, that is, all the sectors are liberalized except the ones included in such a list. For instance, services liberalization involves the following sectors: communication, construction, distribution, education, energy, environmental, health, tourism, transportation, and financial sector. Second, we code a PTA as "1" if service liberalization is noted in the PTA as a general aim. For instance, the EU–South Africa PTA (1999) fits into this category. Finally, we code a PTA as "0" if services are not mentioned in the PTA.

The results are reported in Figure 4.4. The figure shows that service provisions are much more common in EU and US PTAs than in most others, and the difference is particularly pronounced for the United States. Indeed, *every* US PTA contains a substantive investment chapter. Interestingly, both China and Japan also commonly include service provisions. In contrast, such provisions are less frequent on other PTAs, and especially so for South-South PTAs.

An interesting observation from this graph is that the European Union rarely includes a full substantive chapter on services in its PTAs. The explanation for this can be found in the European Union *acquis communautaire*, which left investment and services under national competence until the Treaty of Lisbon was adopted. At that time, the European Commission did not have exclusive competence in negotiating provisions on investment and services. Instead, unanimity among EU member states was formally required. There

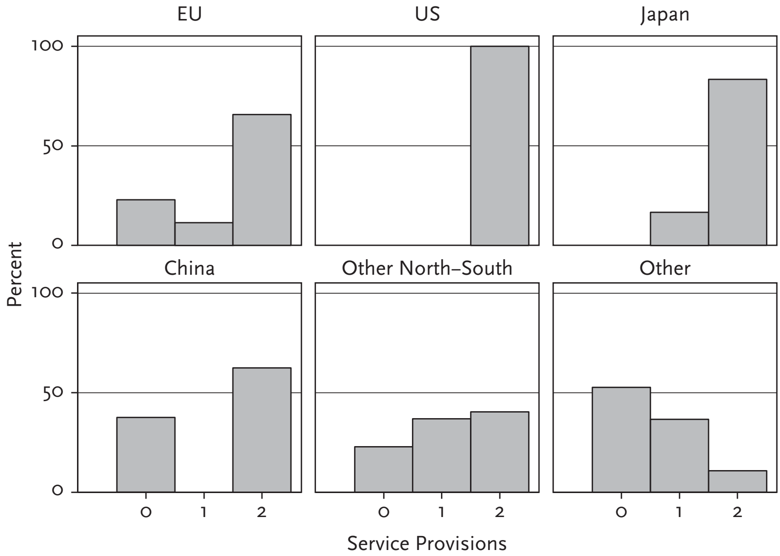

Figure 4.4 Service Liberalization in PTAs.

is a debate among scholars whether diverging interests among EU members, rather than lack of competence, has affected the inclusion of provisions on investment and services into the EU PTAs (Woolcock, 2010, 8). In any case, things changed with the ratification of the Treaty of Lisbon: both services and investment are now under EU competence (Woolcock, 2010, 9). Thus, a member state that is dissatisfied with what the Commission has negotiated on investment and services can no longer unilaterally veto the decision. This should further weaken the impact of conflicting national interests in the negotiation of PTAs and should streamline EU trade policy.

We now turn to investment provisions. We code investment provisions in PTAs as follows. First, we code this variable for a PTA as "2" if a full investment chapter exists. The existence of an investment chapter implies that the PTA contains detailed provisions concerning reforms of FDI liberalization. For instance, the EU-Jordan PTA (1997) includes specific articles on investment (articles 49, 50, 67; annex VI). The agreement includes non-discriminatory provisions, an MFN clause, an NT clause, and provisions on the temporary movement of people and businesses. Second, we code a PTA as "1" if investment liberalization and protection are noted in the PTA as a general aim but no specific chapter exists. For instance, the EU-Lithuania (1995) PTA fits into this category. Finally, we code a PTA as "0" if investment is not mentioned in the PTA.

The findings are reported in Figure 4.5. It shows that investment provisions are much more common in EU and US PTAs than most others.

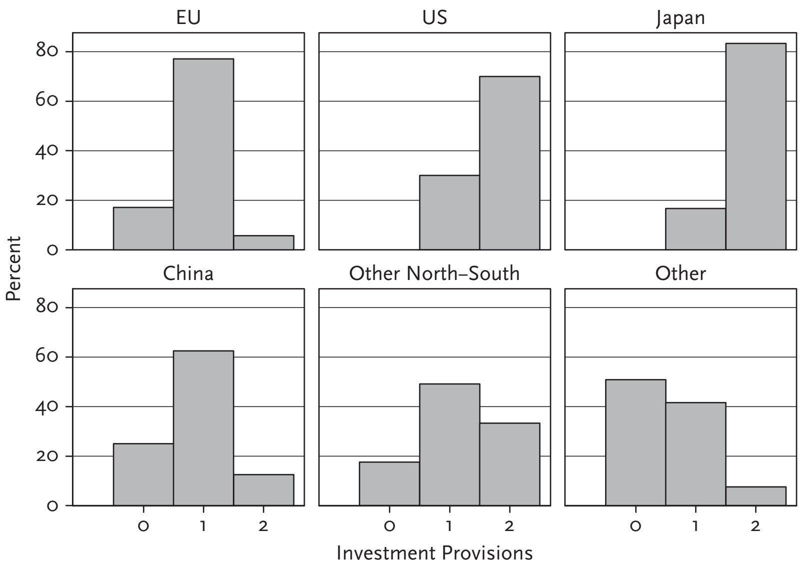

Figure 4.5 Investment Liberalization in PTAs.

Again, every US PTA except one—US-Jordan (2000)—contains a substantive investment chapter. Interestingly, both China and Japan also commonly include investment provisions. They are also somewhat common in North-South PTAs, but rare in South-South PTAs. The EU PTAs frequently contain references to investment, but only two of them contain a specific chapter. The reasons for that were explained earlier.

Next, we analyzed competition policy. Here, the most natural approach based on the distribution of the data is to construct a binary variable. Specifically, we coded the variable "1" if a competition chapter was included, and "0" if not. For instance, the EU-Egypt PTA (2001) includes a chapter on competition (chapter 2). In this chapter, one finds provisions on undertakings to distort competition, on cartels, monopolies, mergers, and acquisitions, on state trading enterprises, and on state subsidies to companies.

The results are reported in Figure 4.6. The figure shows that competition provisions are much more common in EU PTAs than most others. Interestingly, the United States does not seem to include competition policy in PTAs nearly as often as the European Union. This shows that while both the EU and the US treaties contain detailed provisions for economic reform, they do so in view of somewhat different reform goals. Additionally, they rely on different legal instruments. Unsurprisingly, the graph also shows that while Japan heavily emphasizes competition, China does not.

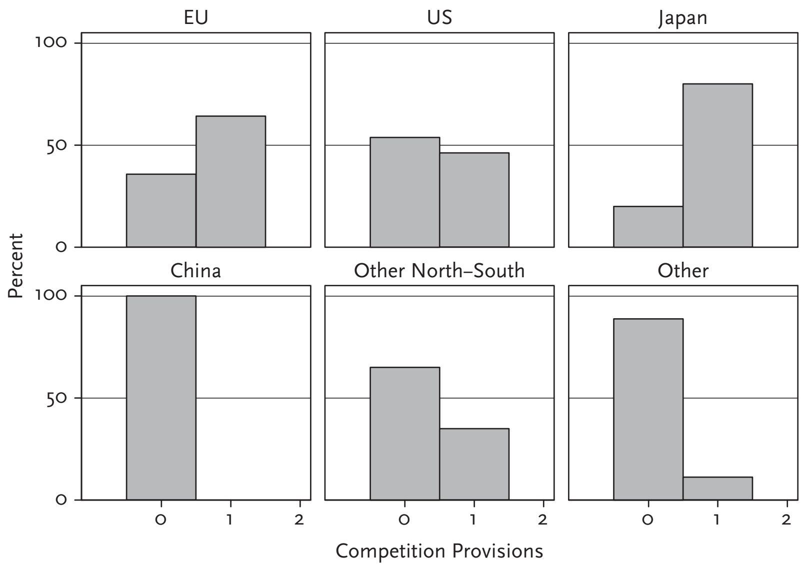

Figure 4.6 Competition Provisions in PTAs.

Competition policy is sometimes included in other North-South PTAs but rarely in South-South PTAs.

Finally, we investigated government procurement. These provisions were coded in the following fashion. First, we code a PTA as "2" if a full chapter on government procurement exists. For instance, the US-Peru PTA (2006) has a specific chapter on government procurement (chapter 9). The scope of public procurement provisions is not limited to goods, but also extended to services. Moreover, chapter 9 includes an NT clause, a transparency provision, and a provision with a reference to the WTO. Second, we code a PTA as "1" if government procurement is noted as an issue but no chapter is dedicated to it. For instance, the EU-Hungary PTA (1992) does not have a chapter regulating government procurement, although article 48 includes an NT clause in relation to that. Finally, we code a PTA as "0" if government procurement is not included in the text.

These results are reported in Figure 4.7. The figure shows that competition provisions are much more common in EU and US PTAs than most others. Interestingly, Japan also emphasizes government procurement relative to most countries, slightly outperforming the European Union. Unsurprisingly, China does not seem at all interested in government procurement. These provisions are also quite rare in other North-South and South-South PTAs.

In sum, the findings confirm our initial intuition: EU and US PTAs are significantly different from others, with the exception of Japan. While there is some variation in stringency—the European Union has relatively

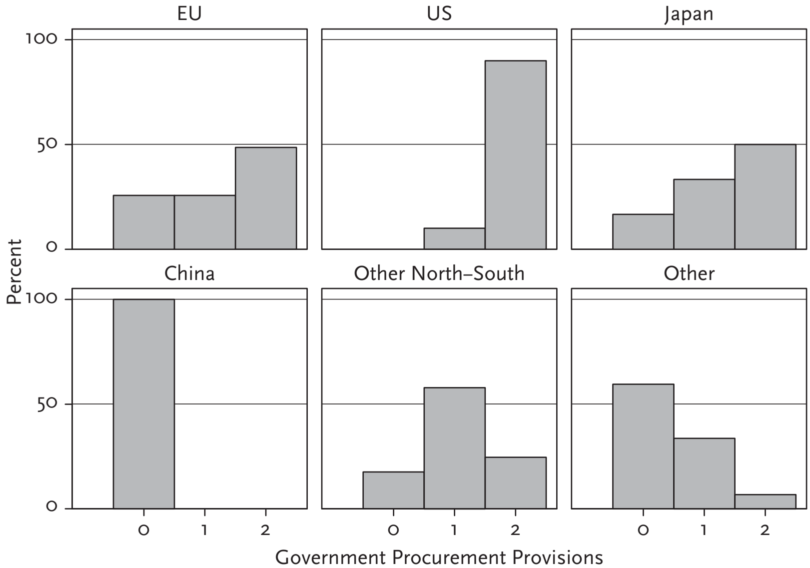

Figure 4.7 Government Procurement Provisions in PTAs.

lax service provisions, for instance, while the United States has few competition provisions—in general these agreements are very stringent and demanding. Japan's agreements are also demanding, but the country's lesser importance as an export market and the small, geographically limited set of PTAs make it somewhat less focal.

Combined with the economic power and global commercial interests of the European Union and the United States, these design features clearly demonstrate that their PTAs are a relevant set for our analysis of PTAs as instruments of economic reform. But do leaders in developing countries really pursue PTA negotiations to overcome political barriers to economic reform? In the next chapter, we provide systematic evidence for our hypotheses: under democratization, new leaders are likely to initiate negotiations with the European Union and the United States for a PTA.

CHAPTER 5

Formation of Preferential Trading Agreements

If our argument is valid, we should see leader changes under democratization produce, relative to other circumstances, a large increase in the probability that a developing country engages in PTA negotiations with the United States and/or the European Union. These are the conditions under which leaders' incentives to engage in PTA negotiations in pursuit of economic reforms are maximized. The association between leader change under democratization and PTA negotiations should hold even when we account for variation in other country characteristics, such as geographic location or economic wealth. Our theory should be able to explain a large number of important PTA negotiations between developing countries and the European Union or the United States, even in circumstances that do not immediately appear conducive to PTA formation.

While we conduct qualitative analyses in two subsequent chapters, this chapter presents results from a statistical analysis to test our theory against global data on PTA negotiations. The global data analysis allows us to ensure that our findings are of general relevance to international political economy, while the case studies offer detail and nuance. We show that leader change under democratization has a large effect on PTA negotiations. We also conduct statistical tests of the alternative hypotheses described in the previous chapter, so as to ensure that our findings are not driven by factors unrelated to the causal mechanism we have posited. To shed further light on the issue, we also discuss specific countries and treaties in view of the statistical results.

The chapter is organized as follows. First, we discuss our data and research design for the quantitative analysis. Some of the technical details of the statistical analysis are relegated to the online Appendix, but the findings reported in this chapter are comprehensible without consulting the Appendix. Second, we present the results from our quantitative analysis and discuss them in light of our argument and the relevant literature. Finally, we consider and reject alternative explanations for our findings. The next chapter will focus on the reform effects of PTA formation, and the chapter following it will summarize the results of several qualitative case studies.

DATA

To test our theory, we analyze the relationship between leader change, democratization, and the initiation of PTA negotiations. In the theoretical part of this book, we argued that leader change should be positively associated with the difficulty of reform, while democratization should, on average, increase a leader's willingness to pursue various economic reforms. Given this, we expect the simultaneous occurrence of leader change and democratization to cause a large increase in the probability of PTA negotiations.

The formation of a PTA is ultimately a decision between two or more countries. Therefore, following Mansfield, Milner, and Rosendorff (2002), we analyze "dyadic" relationships between a developing country and the major power (EU or US). Technically, this means that the unit of analysis in our sample is an "undirected dyad-year." For example, Chile-US 2000 is one observation in our data set. We are interested in predicting the probability that a given developing country initiates PTA negotiations with the European Union or the United States at a given time. We expect leader changes under democratization to produce a large increase in this probability relative to (i) the baseline without leader change or democratization, (ii) the occurrence of leader change without democratization, and (iii) democratization without leader change.

We have data for a large number of developing countries, specifically 140 of them. We classify a country as *developing* if it is included in the upper-middle-income, lower-middle-income, or low-income category according to the World Bank.[1] We include as many countries as possible, given data limitations. With 140 developing countries included, most of the missing countries are very small economies, such as tiny island states. These countries rarely form PTAs with the European Union or the United States at any rate, so excluding them also seems appropriate from a substantive perspective. In total, we have 4,460 dyad-year observations ranging from the year 1990 to 2007.[2]

We limit our attention to years beginning with 1990 for several reasons. First, our theory states that leaders in developing countries can only use PTAs to promote economic reform if there are major powers interested in promoting these reforms. As explained above, neither the European Union nor the United States had a strong interest in microeconomic reforms in developing countries until around the end of the Cold War. The European Union focused on internal integration and barely had a coherent foreign policy apparatus. American companies did not face the kinds of competitive pressure that would necessitate investment in developing countries, as economies of scale and labor costs were not a barrier to profitability. Indeed, the United States formed its first PTA only in 1985, and it was with Israel, a country that had already liberalized its economy to a significant degree. As shown in the online Appendix, the EU PTAs before 1990 had no IPR provisions whatsoever.

In sum, our data set allows us to test the hypotheses. Intuitively, each developing country is assumed to engage in PTA negotiations with the European Union and the United States at a given time with some probability. As soon as PTA negotiations begin with a given major power, this dyad is excluded from the analysis. Our focus is on the interactive effect of leader change and democratization on the estimated probability of PTA negotiations.

EXPLAINING NEGOTIATIONS

Our dependent variable is the probability that a developing country engages in PTA negotiations with the major power (EU or US, separately) in the dyad.[3] We regress this probability on a variety of explanatory variables—the most important, democratization and leader change.

For the empirical analysis, it is essential to focus on PTA negotiations instead of signature or ratification. Since our argument is ultimately about a leader's *initial* decision to pursue economic reform through an international strategy, the timing of PTA negotiations must be measured with great care. Had we focused on PTA signature or ratification instead, as previous studies have done (Mansfield, Milner, and Rosendorff, 2002), we would concentrate on a subsequent "downstream" decision. If this decision was made by a leader who was no longer new, or even a different leader, then our empirical analysis would produce invalid results. Therefore, it was essential for us to obtain detailed data on PTA negotiations.

To code the beginning of PTA negotiations, we opted for the official year that the negotiations started.[4] Of course, we are aware that countries may sometimes hold informal talks before the actual bargaining begins. However, it would be impossible to track systematically this information, given the large number of countries in our data set. Indeed, it seems safe to assume that a large number of countries are continuously engaged in preliminary trade talks on some level. Therefore, it is not clear that such informal consultations capture the reform commitment incentives that we are interested in. Instead, a leader's decision to initiate the official negotiations is a key decision during the process.[5]

To understand this coding, an example may clarify. Mexican president Carlos Salinas sought a PTA with the European Union already in February 1990, though the negotiations were not initiated at that time. This occurred only months before Mexico proposed to begin formal negotiations with the United States on August 21, 1990. That proposal resulted in the formation of NAFTA with the United States and Canada. The formal negotiations began on June 12, 1991. Given this, we would code the initiation of Mexico-US PTA negotiations in 1990. The date of signature would be 1991. Conversely, no Mexico-EU PTA negotiations would be initiated in 1990; in fact, it was only in 1996 that Mexico and the European Union began negotiating a PTA.

No developing country has signed more than one PTA with the European Union or the United States, respectively, over the period of investigation. Thus, a dyad drops from our data set immediately after the first negotiation round begins. For instance, the Mexico-US dyad drops from our data set in 1991, whereas the Mexico-EU dyad drops from our data set in 1996. Our data set contain 71 negotiation onsets.

For completeness, we include both bilateral and multilateral trade agreements, such as the EU–Gulf Cooperation Council PTA and the US–Central American Free Trade Agreement PTA. Since observations are not independent in the case of multilateral negotiations, we also estimate the model without any multilateral agreements. In this case, the number of negotiation onsets decreases from 71 to 46. Finally, we estimate a model excluding ongoing negotiations that have so far failed to produce a PTA. In doing so, we are left with 43 trade agreements. This allows us to verify that our findings are not driven by contentious negotiations with little hope of producing cooperation.

Recall that our argument is weaker for stable democracies with credible political institutions. Stable democracies have had enough time to develop effective political institutions that reduce the importance of individual leaders (Keefer, 2007; Licht, 2010). Therefore, even new leaders may be able to implement economic reforms without facing the major political difficulties we have emphasized earlier. Moreover, stable democracies may have already implemented their preferred economic reforms, so that it is no longer necessary for their leaders to promote liberalization through PTA negotiations with the European Union or the United States.

Given this, we also estimate our empirical model while excluding all stable democracies. We consider a democracy *stable* if it has been continuously democratic for 10 years. By using such a lax criterion for democratic stability, we stack the deck against our theoretical argument, as the set of remaining countries turns out to be quite different from the full sample. A list of the 57 countries meeting these criteria in at least one year can be found in the online Appendix. By removing stable democracies, the number of agreements explained by our analysis reduces to 46.

REFORM DEMAND AND DIFFICULTY: DEMOCRATIZATION AND LEADER CHANGE

Our central explanatory variables are *democratization* and *leader change*, as well as their interaction. All else constant, democratization increases a leader's willingness to implement economic reforms. However, new leaders face particularly severe difficulties in implementing economic reforms. Therefore, the coincidence of democratization and leader change in a given year should increase the probability that PTA negotiations with the European Union and/or the United States are initiated.

In general, democratization refers to political reforms that allow a large number of citizens to participate in the election of national leaders (Huntington, 1991; Przeworski, 1991). While no direct measures of democracy or democratization exist, our main empirical model is based on the simplest possible proxy in existence. Cheibub, Gandhi, and Vreeland (2010) have constructed a data set that assigns a binary value, "yes" or "no," to the existence of competitive elections for each country-year. This simple variable captures the most fundamental feature of democracy: citizens can remove from office leaders whose performance does not satisfy them. In our main model, we code a country-year as undergoing democratization if the value of this binary indicator has changed from "no" to "yes" within the last five years.

Our results do not depend on this particular operationalization. In international relations, another commonly used measure for democracy is the Polity IV score, ranging from -10 (fully autocratic) to 10 (fully democratic). Exploiting the Polity IV score, we also replaced our primary democratization indicator by a variable that equals 1 if a country's democracy score had increased by at least 3 points within the last five years. Similarly, we examined positive changes in a country's Freedom House score. These alternative measures did not change any of our substantive results.[6]

In addition to conceptual ambiguities regarding democratization, the issue of timing is potentially problematic. How long does democratization last? No perfect answer to this question exists. Therefore, we verified the robustness of our findings by replacing the five-year democratization window with alternative three-year and seven-year windows. For all three democratization measures introduced above, our results continue to hold, as shown in the online Appendix.

While we do *not* expect democratization itself to increase the probability of PTA negotiations, we do expect the combination of democratization and leader change to do so. Given this, we need a measure of leader change. In general, leader change occurs when the identity of the person holding a country's highest political office changes. Accurate data for leader changes up to the year 2004 are available from the Archigos data set by Goemans, Gleditsch, and Chiozza (2009). For example, this variable equals 1 if a new prime minister is elected in a parliamentary democracy, a new president is inaugurated in a presidential democracy, or a new dictator seizes power in an autocratic country. Since they indicate leader change by exact date, the measurement is highly accurate. We used primary and secondary sources to fill in leader changes in the remaining years for our data set, 2005–2007.

What is a *recent* leader change? In our primary empirical model, we adopt a conservative approach. For any country-year that did not negotiate a PTA, we only consider leader changes in that year. For any country-year that did negotiate a PTA, we only consider leader changes within the 12 months preceding the official date of negotiations. Since we have both the exact date on which any given leader assumed power and the date on which official PTA negotiations began, coding at this level of detail is possible. This measure is a stringent test of our hypothesis because it allows leaders to engage in PTA negotiations within a short period of time.

Again, it is not clear that this coding of leader change is optimal. For this reason, we also replicated our models allowing for two-year and three-year windows of leader change. These robustness tests allow us to account for the possibility that leader change produces PTA negotiations with some delay. As discussed later and shown in the online Appendix, our main result survives this change.

Two further issues concerning leader change warrant a brief digression. First, we unfortunately do not have detailed data on the nature of leader change. Ideally, we would distinguish between those leader changes that leave the same political party in power and those leader changes that produce a more fundamental change in the composition of the ruling coalition. While we cannot address this issue in the quantitative analysis, the qualitative case studies that follow allow us to scrutinize this issue in great detail.

Second, it is important to note that the fate of the previous leader is itself *not* relevant to our analysis. Leaders may lose office for various reasons, ranging from illness to losing elections to a military coup. Regardless of why the previous leader lost power, a new leader faces uncertainty and difficulties in the implementation of economic reform. Consequently, we do not attempt to examine how the previous leader's fate would influence subsequent outcomes.

Given our large data set, it is important to examine patterns of leader change and democratization in the sample. In the online Appendix, we show the number of leader changes and democratizing countries in the sample over time. The number of leader changes has somewhat decreased over time. Particularly interesting is the drop in 2007; it may reflect unusually good economic performance across the world. As to temporal trends, the number of democratization countries peaked in the early 1990s and has remained relatively stable every since.

For additional insight, the online Appendix also shows the countries with the highest number of leader changes in the data set, along with democratization events and PTA negotiations in these countries. The maximum number of leader changes is found in Nepal, a country that has undergone a violent civil war. Interestingly, leader changes are also common in Eastern Europe (Bulgaria, Latvia) and Latin America (Bolivia, Ecuador). Most countries with multiple leader changes also democratized and engaged in PTA negotiations. These descriptive patterns are consistent with our theoretical expectations, and below we show that they indeed hold when we account for possible confounders.

ADDITIONAL EXPLANATORY FACTORS

In addition to our primary explanatory variables, we need to account for other important influences on PTA negotiations. *Domestic economic factors* are one class of such influences (Baier and Bergstrand, 2004). To our statistical models, we include the developing country's GDP, per capita GDP, and annual economic growth. For example, major powers may have a stronger interest in liberalizing trade with wealthy and growing economies. Therefore, it is important to account for possible wealth effects.

Previous research on PTA formation also underscores the importance of *political factors* (Gowa, 1994; Mansfield, Milner, and Rosendorff, 2002; Mansfield, Milner, and Pevehouse, 2008). Given this, we include a country's regime type. To ensure consistency with our democratization measure, we use the Cheibub, Gandhi, and Vreeland (2010) binary measure (democracy or autocracy). As Mansfield, Milner, and Rosendorff (2002) argue, democracies may have stronger incentives to form trade treaties with other countries due to electoral considerations. To capture security considerations, we also control for alliances with the European Union and the United States (Gowa, 1994). Finally, to avoid conflating the effects of leader change with a country's general turnover patterns, we control for the *previous* leader's tenure (Keefer, 2007). In an expanded model, we also control for executive constraints and a measure of political stability.

Another set of influences we account for are *international factors*. First, we include the distance between a developing country and the major power (EU or US). Second, in an expanded model, we also account for IMF and World Bank programs, as well as the logarithm of bilateral aid given by the European Union or the United States.[7]

Finally, we include three variables that accounts for the interdependence among observations. First, we add the lagged number of PTAs negotiated by other countries in a region with the European Union and the United States (Mansfield, 1998). Second, we include two spatial lags that capture trade diversion and FDI diversion faced by countries excluded from trade agreements (Baccini and Dür, 2012; Manger, 2009). How are these two variable built? Let us begin with trade diversion. If country *A* trades a lot with country *B*, and country *B* forms an agreement with country *C*, which is a direct competitor of country *A*, then trade diversion from country *A* is substantive. Therefore, we expect country *A* to seek a trade agreement with country *B* to level the playing field with country *C*. This variable helps account for the fact that observations are not independent in our analysis. For instance, if Costa Rica starts negotiating a PTA with the United States, El Salvador is likely to do the same, since these two countries export similar goods to the United States.

The variable FDI diversion captures a similar mechanism for investment. Assume that country *A* and country *C* are large FDI exporters, and country *B* attracts a large amount of FDI. If country *B* and *C* form a PTA, country *A*'s investors are put at a disadvantage relative to country *C*'s investors. For instance, country *A*'s investors might face higher tariffs on intermediate goods and weaker protection against expropriation compared to country *C*'s investors, which benefit from the PTA. Accordingly, we expect that country *A* seeks a PTA with country *B* to level the playing field with country *C*'s investors. Trade diversion comes from Baccini and Dür (2012), whereas

FDI diversion come from Baccini and Dür (2014). The correlation of both variables with treaty diffusion variable above are low, suggesting that they capture a different mechanism. Further details on how these two spatial variables are built can be found in the online Appendix.

Descriptive statistics and data sources for all variables used in the analysis are given in the online Appendix. Already this description shows that our theoretical expectations have some *prima facie* plausibility. Leader change is much more common in countries that at some point engage in PTA negotiations, while democratization is equally common in both. Similarly, the simultaneous occurrence of leader change and democratization is more common in countries that at some point engage in PTA negotiations.

FINDINGS

Statistical analysis of large global data sets present several major challenges. In particular, it is important to verify that the results are sufficiently robust to small variations in the data and statistical techniques used. Otherwise, it would be difficult to argue that the data really provide evidence in support of the hypotheses. Given this, we analyzed a variety of different data sets and statistical models. We summarize and discuss here the most important theoretical results. The interested reader finds the technical details in the online Appendix.

To begin with, we estimated seven statistical models of the effect of leader change and democratization on PTA negotiations. The first model is our main model. It contains the full data set, with all EU and US PTAs included as positive observations. The second and third models present results without multilateral PTAs and excluding all stable democracies from the data set, respectively. These models are intended to ensure the robustness of our findings to the exclusion of observations that are not ideal for our test: multilateral PTAs are not really independent observations, and stable democracies have institutions that reduce the importance of leader experience and tenure for policy formation (Keefer, 2007; Licht, 2010). When stable democracies are excluded from the analysis, the standard of comparison also changes, as the effect of democratization is now evaluated relative to autocracies only; in the main model, the comparison was relative to autocracies and established democracies.

The fourth model excludes all cases of ongoing negotiations, the idea being that some of them may end up failing. The next two models expand the main model with additional control variables, and the final model adds the further diffusion controls—trade and investment interdependence—to the regression equation. To foreshadow, leader change has a positive and statistically significant effect on PTA negotiations in all seven models. This effect is larger under democratization. In none of the models does democratization have a positive and statistically significant effect on PTA negotiations without leader change.

Table 5.1 shows the results. For ease of interpretation, we report hazard ratios instead of coefficients. In all models, the effect of leader change is larger with democratization than without democratization. For example, in the full sample the effect is four times as large under democratization than without it. To be sure, the confidence intervals around the estimated effect of leader change under democratization are wide. This is because the event of PTA negotiation is rare in the data set. We have more than 4,400 observations and only 71 positive observations. Therefore, confidence intervals are bound to be rather wide for purely statistical reasons.

The empirical results have several notable features worth discussing in brief. First, the coefficient in the fourth model is much larger than in the first model. This indicates that if we exclude ongoing—potentially failed—negotiations from the analysis, the effect of leader change and democratization is amplified. This is consistent with our theoretical argument: governments with a genuine interest in economic reform through PTA negotiations have no incentive to hold out and fail to agree on outcomes. In the next chapter, we will examine the consequences of these failed negotiations in some more detail.

Second, the results are also strengthened if we exclude multilateral PTAs. This is in concordance with our theory, because it indicates that bilateral PTAs in particular are driven by the combination of leader change and democratization. A key element of our theoretical argument is the leader's central role, so it is important to verify that multilateral PTAs are not driving the results here. The individual leader of a developing country cannot decide on behalf of other developing country leaders to engage in multilateral negotiations, so it is intuitive that the need to pursue economic reform in difficult circumstances would have a stronger effect if we focus only on bilateral international institutions.

Furthermore, the results are somewhat weaker if we exclude stable democracies. The reason is that few stable democracies actually form PTAs with the European Union and the United States, and thus this exclusion ignores many cases of failed PTA formation. This works against the effect of leader change and democratization, as this combination cannot by definition occur in a stable democracy. The fact that stable democracies do not form PTAs is reassuring because according to our theory they have the least need for a PTA—their domestic institutions enable credible commitment to economic reform even in the absence of a PTA. Finally, the results do not

Table 5.1. MAIN RESULTS: EFFECT OF LEADER CHANGE ON THE PROBABILITY OF PTA NEGOTIATIONS, WITH AND WITHOUT DEMOCRATIZATION

Variables	(1) Full	(2) Bilateral	(3) No stable	(4) Not ongoing	(5) Full	(6) Full	(7) Full
Democratization, no leader change	1.06 (0.63)	1.66 (1.17)	1.01 (0.61)	1.89 (1.31)	1.07 (0.60)	2.20 (1.25)	1.08 (0.66)
Leader change, no democratization	2.22* (0.66)	2.29 (0.88)	2.45 (0.97)	2.33 (0.92)	1.84 (0.56)	1.89 (0.62)	2.21* (0.66)
Leader change and democratization	**5.56*** (2.54)	**6.81*** (3.64)	**5.18*** (2.73)	**8.09*** (4.83)	**5.73*** (2.74)	**7.54*** (4.37)	**5.81*** (2.74)
Controls	Main	Main	Main	Main	Extended	Extended	Main
Diffusion variables	no	no	no	no	no	no	yes
Region fixed effects	yes	yes	yes	yes	yes	yes	yes
Negotiation onsets	71	46	48	43	68	56	71
Observations	4,458	4,563	3,466	4,559	3,818	3,206	4,420

The table reports hazard ratios. The results are shown for the full sample, for the sample without stable democracies, and for the sample excluding multilateral agreements. Robust standard errors clustered by dyad in parentheses; * $p < 0.01$.

change if we add variables capturing the trade and investment diffusion mechanisms, though both relevant variables are statistically significant at the conventional level, as shown in the full table provided in the online Appendix.

Table 5.2 provides a list of countries with simultaneous leader change and democratization. The left column shows instances of PTA negotiations and signature that coincide with the simultaneous occurrence of leader change and democratization.[8] This column shows that our model captures a large number of PTA negotiations, and especially so for the European Union. While some of these are post-communist countries, the European Union also has negotiated a large number of PTAs with democratizing countries' new leaders elsewhere in the world. Moreover, our findings also capture two important US negotiations, namely Mexico (1990) and Peru (2003).[9]

The right column, which shows countries that simultaneously underwent democratization and experienced leader change but did not initiate PTA negotiations during that time, is perhaps even more informative. In particular, it emphasizes the importance of major power interest. Most of these countries are very poor African or Asian economies. Given their poverty, it is not altogether surprising that the European Union and the United States have little interest in engaging PTA negotiations. This is insightful

Table 5.2. COUNTRIES WITH LEADER CHANGE UNDER DEMOCRATIZATION

EU and/or US PTA	No EU or US 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
	Taiwan

The left column shows instances of PTA negotiation and signature, whereas the right column shows instances without PTA negotiation and signature.

given that our argument emphasizes the importance of major powers' willingness to support economic reform in a developing country through institutionalization. In this sense, the negative cases are consistent with our theoretical expectations. We would not expect the international approach to economic reform to be available to developing countries that are not of interest to the European Union and the United States.

Regarding control variables, distance, GDP, and executive constraints are important for understanding PTA negotiations. Of these variables, distance and GDP are conventional economic factors that influence the lucrativeness of PTA formation (Baier and Bergstrand, 2004). The negative effect of executive constraints is also in line with findings reported in Mansfield, Milner, and Pevehouse (2008). This suggests that our model not only reflects the interactive effect of leader change and democratization, but also captures other important influences on PTA formation.

In sum, the results provide robust empirical support for our theoretical argument. The combination of leader change and democratization has a substantively large and statistically significant effect. As a large number of additional statistical models shows in the supplementary online Appendix, the results also are very robust to changes in model specification and variable measurement. For example, we model interdependence across observations within a region in different ways.[10] We have argued that democratization increases the demand for economic reform while new leaders find reform implementation difficult, and in view of this argument the data show strong support for our theory.

OTHER PREFERENTIAL TRADING AGREEMENTS

Models 8–11 in Table 5.3 show the results for the main models when we include Japanese PTAs. The findings are similar to the ones shown in Table 5.1. Specifically, the effect of leader change is always larger with democratization than without democratization. The hazard ratio for leader change with democratization differs from those of leader change alone and democratization alone in a statistically significant fashion. This is true in the main models, with and without diffusion variables, and in the extended models. There is evidence that Japanese PTAs are also used by leaders in a democratizing country to lock in reform.

This result squares with the fact that the design of Japanese PTAs is similar to the design of the EU and the US PTAs, as shown in Chapter 4. Japanese PTAs include detailed provisions on IPR, investment, services, and government procurement, which produce the lock-in mechanism

Table 5.3. OTHER COUNTRIES: JAPAN, CHINA, NORTH-SOUTH (EXCLUDING THE EU, THE US, AND JAPAN), AND SOUTH-SOUTH DYADS

Variables	(8) Full	(9) Bilateral	(10) No stable	(11) Not ongoing	(12) Full	(13) Full	(14) Full
Democratization, no leader change	1.36	2.42	1.23	1.88	3.80	3.21*	0.79*
	(0.73)	(1.17)	(0.69)	(0.94)	(3.24)	(1.55)	(0.08)
Leader change, no democratization	2.05*	2.39	2.22	2.44*	2.76	1.31	0.97
	(0.57)	(0.73)	(0.79)	(0.72)	(1.27)	(0.45)	(0.07)
Leader change and democratization	**5.75***	**5.42***	**5.02***	**8.71***	**1.88**	**1.44**	**0.50***
	(2.60)	(2.51)	(2.65)	(3.85)	(1.79)	(0.87)	(0.09)
Controls	Main	Main	Main	Main	Extended	Extended	Extended
Japan	yes	yes	yes	yes	no	no	no
China	no	no	no	no	yes	no	no
North-South (excluding EU, US, Japan)	no	no	no	no	no	yes	no
South-South	no	no	no	no	no	no	yes
Region fixed effects	yes	yes	yes	yes	yes	yes	yes
Negotiation onsets	90	74	63	75	28	71	2,595
Observations	6,839	6,789	5,285	6,756	2,227	11,108	296,342

The table shows the effect of leader change on the probability of PTA negotiations, with and without democratization. For Japan, the results are shown for the full sample, for the sample without stable democracies, and for the sample excluding multilateral agreements. For China and the other dyads, the results are shown for the full sample. The table reports the hazard ratio.
Robust standard errors clustered by dyad in parentheses; * $p < 0.01$.

sought by new leaders in democratizing countries. Moreover, this result casts doubt on the competing argument that the European Union and the United States form PTAs with developing countries to reward their efforts to democratize. Unlike the European Union and the United States, Japan does not have a clear foreign policy agenda aiming to promote democratic regimes in the international system.

Models 12 and 13 in Table 5.3 show no effect for Chinese PTAs and PTAs signed between other North-South dyads—excluding the European Union, the United States, and Japan. This result is also in line with our theory. First, we have already shown that Chinese PTAs do not include provisions to promote reform. This is true also for the other Northern countries such as Australia, New Zealand and, to a lesser extent, the European Free Trade Association (EFTA). Second, China and the smaller Northern countries may lack the ability to enforce such agreements, thus rendering them unable to provide any reform effects for new leaders in developing countries.

Finally, leader change with democratization has a *negative* effect on the probability of forming a South-South PTA, which means that the probability of PTA formation decreases when democratization and leader change coincide.[11] This result is hardly surprising. South-South PTAs rarely include microeconomic reform provisions. Moreover, the enforcement of such PTAs is usually weaker than that of North-North PTAs and North-South PTAs. As such, South-South PTAs do not help new leaders implement microeconomic reform under democratization.

APPLES AND ORANGES?

Countries differ significantly in their political and economic characteristics, so it is also important to verify that we are not comparing apples to oranges. For example, if poor African economies do not engage in PTA negotiations while wealthier Latin American countries do, it is not clear that comparing the effects of leader change and democratization in a sample containing both groups is meaningful. To address this concern, we replicated our analysis using a "matching" technique (Ho et al., 2007). The idea of matching is to first divide the countries in the sample into two subgroups, "treated" and "untreated," and then systematically drop observations until the two subgroups are comparable in view of covariates that could influence PTA negotiations. In our case, the "treated" group comprises countries that have experienced leader change under democratization, while the "untreated" group comprises countries that have not. By ensuring that these groups are mostly similar in regard to their political and economic characteristics, we can better isolate the effect of leader change under democratization on the probability of PTA negotiations.

Specifically, this analysis excludes countries that do not have a match in the other group with regard to the following covariates: PTA diffusion, distance, GDP, GDP growth, GDP per capita, the previous leader's tenure, and trade with the European Union and the United States. If we exclude country pairs that differ significantly along these criteria, our main results continue to hold, as shown in the online Appendix. The effect of leader change continues to be much larger during democratization than otherwise. Indeed, this figure is quite similar to the one without matched sample. The most important change is that the confidence intervals surrounding the effect of leader change under democratization become less wide. This suggests that matching actually strengthens our results. By comparing apples to apples instead of apples to oranges, the estimated effect of leader change under democratization becomes stronger.

ALTERNATIVE EXPLANATIONS

We next consider some alternative explanations for our findings. First, since PTAs are nominally trade agreements, one may wonder if the European Union and the United States form them simply due to trade interests unrelated to broader economic reform. If this were the case, then we would expect trade concerns to explain PTA negotiations. While this hypothesis does not, in and of itself, contradict our hypotheses, it is important to verify that it cannot substitute for concerns about economic reform.

To test this alternative hypothesis, we estimated a standard gravity model of bilateral trade between the European Union or the United States and each developing country in our data set. Gravity models are widely used in economics to predict trade flows between countries. Roughly speaking, gravity models assume that different factors, such as market size, wealth, and distance, are complementary factors (Feenstra, 2004). They offer a simple, elegant, and accurate way to predict trade flows between different pairs of countries.

Using our gravity model, we then recorded the difference between the amount of trade that the gravity model predicts and the true amount of trade. This difference, often called "missing trade," can plausibly be ascribed to political factors and policies, such as tariffs, that impede trade between two countries. The difference is *not* explained by the standard gravity model, so it must stem from factors other than those emphasized by conventional trade theory. If the reason that developing countries engage in

PTA negotiations with the European Union and the United States is to increase aggregate trade flows, then missing trade should explain PTA negotiations. Low overall levels of trade should not be nearly as relevant if they are driven by fundamental factors, such as small country size or a high distance—there is nothing a PTA can do to address these concerns. However, a PTA could presumably remove the "missingness" of trade through liberalization. After all, in this telling, the primary goal of PTA negotiations would be to remove policy barriers to international trade. A PTA could reduce missing trade by allowing traders to exploit previously unused potential, as the PTA reduces tariffs and commits countries to continual trade cooperation.

If the standard trade hypothesis held, countries with a large gap between the predicted amount of trade and the true amount of trade—missing trade—should have strong incentives to engage in PTA negotiations. We took the estimated amount of missing trade between a developing country and the European Union or the United States, depending on the dyad, at a given time, and used it as a predictor of PTA negotiations. Contravening the trade liberalization hypothesis, the coefficient for this gap was *not* statistically significant in the model. Indeed, many prominent cases cannot be explained with reference to missing trade, as shown in the online Appendix.

Our statistical analyses also undermine the interpretation that the European Union and the United States are forming PTAs through brute force or by using "go it alone" power, as some scholars of power politics would say (Gruber, 2000; Shadlen, 2008). Suppose, indeed, that the European Union and the United States would exploit weak new leaders under political turmoil by forcing them to engage in PTA negotiations. If this were the case, then not only democratization but also autocratization should promote PTA negotiations with the European Union or the United States. After all, autocratization also produces highly vulnerable new leaders. They should also be vulnerable to external pressure, and so we should see leader change under autocratization promoting PTA negotiations.[12]

Figure 5.1 shows the results when we examine the interactive effect of leader change and autocratization. Now, we plot the substantive effect of leader change (without autocratization), autocratization (without leader change), and both autocratization and leader change.[13] As the figure shows, leader change under autocratization has no effect on the probability of PTA negotiations. The effects are not statistically distinguishable from zero. These results provide very little support for the view that the European Union and the United States force PTA negotiations on new and vulnerable leaders.

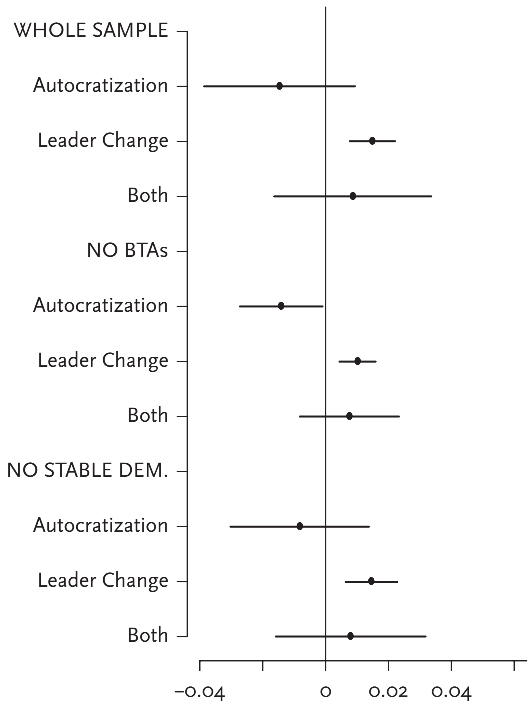

Figure 5.1 Effect of Leader Change on the Probability of PTA Negotiations. The results are shown for the full sample, for the sample without stable democracies, and for the sample excluding multilateral agreements. The 90% confidence interval is shown.

Another alternative explanation that warrants a discussion pertains to the role of economic crises. Perhaps an economic crisis causes all of the following: democratization, leader change, and PTA negotiations. In this case, the real causal mechanism would be crisis, while the apparent interactive effect between democratization and leader change on PTA negotiations would be nothing more than a spurious correlation. To account for this possibility, we estimated our models such that we excluded all cases of leader change and then examined the role of democratization, economic crisis, and their joint effect. We found that the effect of a crisis without leader change is very weak. These results are shown in Table 5.4. They show that in the absence of leader change and democratization, economic crises themselves do *not* induce developing countries to engage in PTA negotiations. While economic crises may well increase demand for economic reform, as several scholars have argued (Weyland, 2002; Pop-Eleches, 2009), they do not seem to induce PTA negotiations themselves. This finding has a ready interpretation in our theory because we have argued that leaders implement economic reforms through domestic means unless there are factors that impede a domestic approach to reform.

Table 5.4. ECONOMIC CRISES AND PTA NEGOTIATIONS		
Variables	(15) Full	(16) Full
Democratization (no leader change)	1.04	
	(0.62)	
Leader Change (no democratization)	2.34*	
	(0.68)	
Leader Change and Democratization	**5.80***	
	(2.69)	
Crisis	0.56	
	(0.22)	
Democratization (no leader change)		1.32
		(0.46)
Crisis (no leader change)		0.36
		(0.19)
Democratization and Crisis (no leader change)		1.87
		(2.16)
Controls	Main	Main
Region fixed effects	yes	yes
Negotiation onsets	71	71
Observations	4,458	4,458

Robust standard errors clustered by dyad in parentheses; * $p < 0.01$.

Next, previous studies show that economic cooperation in general, and the formation of PTAs in particular, can be also explained with reference to geopolitical considerations (Gowa, 1994; Mansfield and Milner, 2012; Mattli, 1999). In particular, there is evidence that the United States signed several PTAs with an eye on security issues and to support key military allies. For instance, Rosen (2004, 51) argues that "the US-Israel and US-Jordan FTAs are clear examples of the use of trade policy—specifically bilateral trade agreements—as a mean of pursuing foreign policy objectives." Similarly, Robert Zoellick, at that time the US Trade Representative, acknowledged at the signing ceremony of the US-Bahrain PTA that "for more than half a century, the United States has come to count on a partnership with Bahrain. Over the last decade, that alliance has become even more crucial. Since 1995, Bahrain has been home to the US Navy's Fifth Fleet. And in the years since 9/11, Bahrain has been a valued ally in the War on Terror."[14]

To test the geo-strategic argument quantitatively, we use three different binary variables. The first variable scores "1" if a developing country contributed to the International Security Assistance Force (ISAF) in

Afghanistan after 2001.[15] The second variable scores "1" if a developing country had troops in or supported operations in Iraq after 2003.[16] Since there is high correlation between the coalition for the Afghanistan war and the coalition for the Iraqi war, we include these two variables in separate models, respectively in Model 17 and Model 18.

The third variable scores "1" if a developing countries is member of the United Nations Security Council. In line with previous studies on foreign aid (Kuziemko and Werker, 2006), the rationale for including this variable is that the European Union and the United States might buy these countries' votes in the Security Council by agreeing to form a PTA.[17]

Table 5.5 shows the results of our baseline models when we include these two variables. The interaction term between leader change democratization remains positive and statistically significant. Both the variables capturing US allies in the Afghanistan and Iraqi wars are statistically significant. Moreover, our results hold even when we drop Middle East and North African (MENA) countries, whose PTAs might be explained more by security concerns than by economic issues (Model 14). In sum, there is no evidence that accounting for geo-strategic interests, even as they are clearly important, would reduce the importance of leader change and democratization in the formation of EU and US PTAs.

Another possible hypothesis is that the European Union and the United States use their PTAs to reward democratization. If this were the case, then democratization would promote PTA formation even, and perhaps even in particular, *without* leader change. Table 5.1 above, which

Table 5.5. GEO-STRATEGIC ISSUES AND PTA NEGOTIATIONS

Variables	(17) Full	(18) Full	(19) Full
Democratization, no leader change	1.31	1.23	1.07
	(0.77)	(0.72)	(0.63)
Leader change, no democratization	2.23*	2.19*	2.95*
	(0.65)	(0.64)	(0.95)
Leader change and democratization	**6.89***	**6.49***	**5.16***
	(3.26)	(3.00)	(2.57)
Controls	Main	Main	Main
MENA included	yes	yes	no
Region fixed effects	yes	yes	yes
Negotiation onsets	71	71	52
Observations	4,458	4,458	4,021

Robust standard errors clustered by dyad in parentheses; * $p < 0.01$.

contains our main results, shows that this is not the case. Although the hazard ratio is higher than unity in the models, it is never statistically significant. This is in stark contrast to the large effect that leader change, both with and without democratization, has on the probability of PTA formation.

Finally, the European Union and the United States could use PTAs as "carrots" to promote economic reform, without regard to the developing country leader's preferences and domestic interests. In this case, the European Union and the United States would select PTA partners based on their own interest. The new leader's ability to use the PTA to promote economic reforms should be irrelevant. Even if there is an interactive effect of leader change and democratization, it might be accidental and not related to the leader's political incentives.

We test this alternative explanation in two ways. First, we examine the industrial composition of the economy. We multiply democratization, leader change, and their product term by the percentage of the economy that is industrial, with data for the new variable from the World Development Indicators. If our theory is valid, a high industrial share should *magnify* the positive interactive effect of democratization and leader change. Most developing countries specialize in light industry, such as textiles, and this type of industry can reap large benefits from enhanced export access to the EU and US markets. This is readily seen in the data: the correlation between industry share and returns to capital as a share of the total in our data is −0.34, significant at the $p < 0.01$ level. This shows that industry in developing countries is, on average, much less capital intensive than agriculture and services. A PTA with the European Union or the United States creates export opportunities for the industry, and so the leader can use the PTA to create domestic political support for reform.

The regression tables are shown in the online Appendix, and in Figure 5.2 we present the marginal effect of leader change and democratization on PTA formation. The figure shows how much the probability increases if a country democratizes with a leader change. As the figure shows, the effect is statistically insignificant for low levels of industrial production but increases rapidly for higher values of the industry. The expected effect is higher than 10 percentage points at the highest levels of industry in the data, and even negative for the lowest. In the online Appendix, we provide similar graphs for the shares of agriculture and services, finding that agriculture does not modify the interactive effect of democratization and leader change, while services reduce the effect.

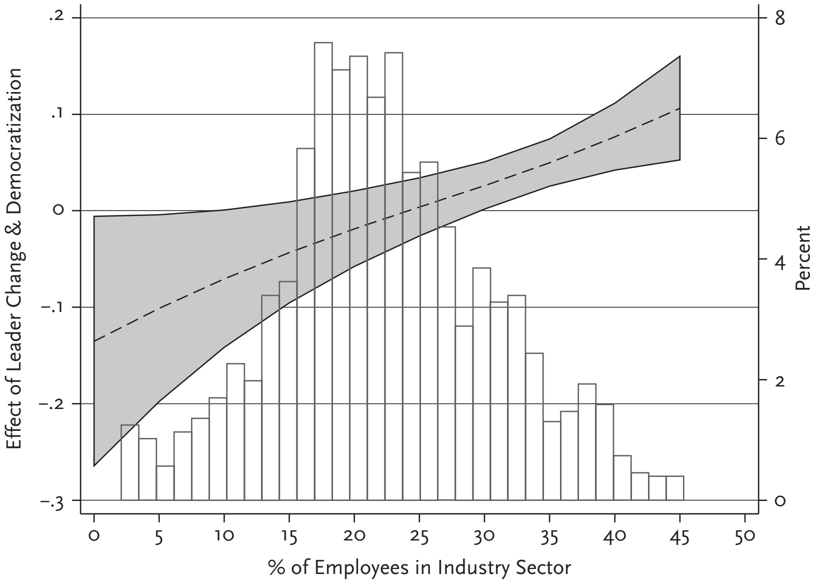

Figure 5.2 Effect of Leader Change and Democratization at Different Levels of Industry. The upper panel gives the effect and the lower the histogram of the conditioning variable. The 90% confidence interval is shown.

The second test we conduct focuses on skill levels. In considering the incentives of a new leader under democratization, it is important to evaluate the role of skill composition. The majority of the people employed in the industrial sector have a secondary education in developing countries. Indeed, the correlation between percentage of employees in the industry sector and the percentage of employees with secondary education is 0.54, significant at the $p < 0.01$ level. Moreover, people with tertiary education have many labor market opportunities, including working for American or European companies that invest in the country upon PTA formation. The group that may contain a large number of losers is those with low level of primary education. Therefore, we expect high education levels to allow a new leader under democratization to use a PTA to garner political support.

The regression output is again in the online Appendix. The lower panel of Figure 5.3 shows the marginal effect of leader change under democratization on the probability of PTA formation at different levels of tertiary education. This effect increases rapidly with the percentage of people with a college degree. At the highest levels, the effect is approximately 8 percentage points, while the expectation is zero at the lowest levels. The online Appendix shows similar graphs for secondary education (positive but weaker effect) and for primary education (negative effect).

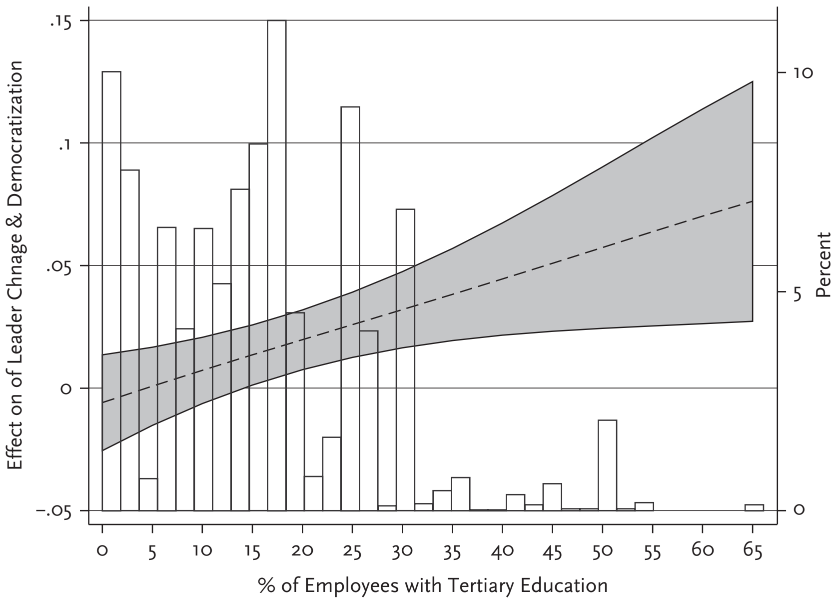

Figure 5.3 Effect of Leader Change and Democratization, Conditional on Tertiary Education. The upper panel gives the effect and the lower the histogram of the conditioning variable. The 90% confidence interval is shown.

SUCCESSFUL AND FAILED NEGOTIATIONS

To shed further light on the statistical findings, we now exploit the fact that some PTA negotiations have failed. If our theory is valid, we should see leader change and democratization predict successful negotiations particularly well. Both the major power and the developing country's leader should be able to successfully conclude the negotiations because they have a mutual interest in economic reform. If we compare successful and failed negotiations in the data set, this pattern should emerge.

Table 5.6 shows the successful and failed PTA negotiations for the European Union. The upper sub-table shows that for successful PTA negotiations, by far the largest category is the one of leader change under democratization. Remarkably, there are no cases of democratization without leader change that would have resulted in PTA negotiations. In contrast, the only case of a thus-far failed PTA negotiation between the European Union and a partner country is Ukraine (2007). By far the largest category of failed PTA negotiations is that without leader change and without democratization. These findings suggest that some of the multilateral PTA negotiations, such as that between the European Union and the Gulf

Table 5.6. EU PTA NEGOTIATIONS

Successful EU negotiations		
	Democratization	No Democratization
Leader Change	Albania, Bulgaria, Estonia, Croatia, Hungary, Lithuania, Latvia, Mexico, Poland, Romania, Slovenia, South Africa	Bosnia-Herzegovina, Algeria, Chile, Macedonia, Turkey
No Leader Change		Egypt, Jordan, Lebanon, Morocco, South Korea, Syria, Tunisia
Failed or ongoing EU negotiations		
	Democratization	No Democratization
Leader Change	Ukraine	Costa Rica, Honduras, Paraguay
No Leader Change		Argentina, Bahrain, Brazil, El Salvador, Guatemala, India, Kuwait, Nicaragua, Oman, Panama, Qatar, Saudi Arabia, United Arab Emirates, Uruguay

The upper sub-table includes the successful negotiations, and the lower sub-table includes the ongoing or failed negotiations.

Cooperation Council, have failed because they are not sufficiently carefully tailored according to different partners' interests.

Table 5.7 shows the same data for the US PTAs. The evidence for the United States is somewhat weaker in the case of successful PTA negotiations. The combination of democratization and leader change is associated with two important PTAs, namely those with Mexico and Peru, but most PTAs do not fit this pattern. In particular, and mostly unsurprisingly, few Middle Eastern countries and members of the multilateral DF-CAFTA treaty fit this pattern. However, the evidence concerning failed PTA negotiations

Table 5.7. US PTA NEGOTIATIONS

Successful US negotiations		
	Democratization	No Democratization
Leader Change	Mexico, Peru	Chile, Colombia, Costa Rica, Dominican Rep., Guatemala, Honduras, Jordan, Nicaragua, Vietnam
No Leader Change		Bahrain, Morocco, Oman, Singapore, El Salvador, Panama
Failed or ongoing EU negotiations		
	Democratization	No Democratization
Leader Change		Bolivia, Ecuador, Botswana, Lesotho
No Leader Change		Malaysia, Namibia, Qatar, South Korea, South Africa, Swaziland, Thailand, United Arab Emirates

The upper sub-table includes the successful negotiations, and the lower sub-table includes the ongoing or failed negotiations.

accords better with our expectations. No case of a failed PTA negotiation features democratization, and the cases are evenly split between those featuring leader change and those not featuring it.

In sum, the successful cases show that the effect of leader change under democratization is strong for both major powers. However, it is considerably stronger for the European Union. This is so for two reasons. First, many post-communist countries negotiated an Association Agreement with the European Union in the aftermath of the collapse of the Soviet Union. Second, the European Union negotiated a series of other PTAs in the 1990–1995 period that also saw the third wave of democratization. Nonetheless, it is important to note that even for the United States, the three PTAs included are a substantial proportion of all PTAs concluded. They are also all bilateral, which is particularly impressive given that the United States has only negotiated 14 agreements.

Since successful PTA negotiations often follow leader change under democratization but failed negotiations do not, it is useful to discuss the reasons for failure in the negative cases. Why did these negotiations fail, and can we learn something from them? We conduct detailed case studies of successful PTA negotiations in the following chapters, so here we focus on the failed negotiations. One important case of failed negotiations is EU-Mercosur. Launched in 1999, negotiations between the European Union and Argentina, Brazil, Paraguay, and Uruguay were intended to reduce tariffs in agricultural products, which was important for the Latin American countries because the European Union was the Mercosur countries' primary export market for agricultural products, and a variety of manufactured goods that the European Union exported to Mercosur, such as machinery and chemicals.[18]

First and foremost, the negotiations failed because the European Union was dissatisfied with the Mercosur's opposition to services liberalization, while the Mercosur found the European Union's proposal for liberalizing trade in agricultural goods insufficiently ambitious: "The main sticking point was that Mercosur members demanded reductions in EU farm subsidies and quotas that constrain their exports of grains, beans, and beef, while European producers wanted Mercosur to lower its tariffs on industrial goods and to provide better patent protection and improved access for financial and other services" (Congressional Research Service, 2011, 10). According to this interpretation, the negotiations failed because the Mercosur countries were not interested in economic reforms but liberalization in agricultural trade. The interpretation is consistent with our theory: if a central function of PTA negotiations between major powers and developing countries is to promote economic reform, then developing countries' opposition to economic reform can be expected to result in either no negotiations at all or, as in this case, failed negotiations.

In other cases, negotiations failed because a leader change *followed* the onset of negotiations. In Latin America, Bolivia and Ecuador illustrate how leader changes after the onset of negotiations can derail talks. Although Bolivia had initially participated in the trade negotiations between the Andean Pact and the United States only as an observer, in April 2005 Bolivia's President Carlos Mesa announced that the country was to seek official negotiations with the United States on a trade pact.[19] However, Mesa resigned in June 2005 and was replaced by the Movement for Socialism's Evo Morales, who has not expressed any interest in negotiation with the United States.

In Ecuador, years of difficult negotiations with the United States also did not result in a deal. In April 2005, Ecuador's president Lucio Gutierrez was impeached by the country's Congress. Negotiations with the United States continued until the leftist PAIS Alliance's candidate, Rafael Correa, won the second round of presidential elections in November 2006. During his tenure, “negotiations for a bilateral trade agreement… have been suspended indefinitely in the wake of the dispute with the U.S. firm Occidental Petroleum. U.S. officials have expressed concerns about Correa’s populist tendencies, his ties with Hugo Chávez of Venezuela, and his state-centered economic policies” (Seelke, 2008, 6).

In Thailand, the downfall of Thaksin Shinawatra, the country’s prime minister from 2001 to 2006, led to the collapse of negotiations with the United States. On the one hand, Thaksin’s government was the one to push for a highly unpopular free trade agreement with the United States.[20] On the other hand, the coup that ousted Thaksin produced economic and political instability that complicated bilateral talks between Thailand and the United States (Chanlett-Avery, 2008, 2). This case shows that while leader change can be a powerful impetus for initiating PTA negotiations, it is also a potential barrier to concluding previously initiated negotiations.

In sum, this chapter has shown that the combination of democratization and leader change, which we have argued represent reform demand and difficulty, respectively, are a powerful predictor of EU and US PTA negotiations in the developing world. The findings are robust in accounting for a wide variety of other important factors, such as economic crises and geo-strategic interests. But, it remains unclear whether EU and US PTAs produce the expected reform effects or not. We tackle this question quantitatively in the next chapter.

CHAPTER 6

Economic Reform and Preferential Trading Agreements

In the previous chapter, we provided evidence for the argument that leaders form international institutions to implement economic reforms that face domestic resistance, and to credibly commit to these reforms. But, do these international institutions have the expected effects on economic reform? In this chapter, we aim to answer this question through a statistical analysis of the effects of PTA negotiations and signature on liberalization. In the next two chapters, we then examine cases for qualitative evidence on the causal mechanisms through which PTA formation has helped leaders in developing countries implement reforms.

The evidence considered in this chapter shows that EU and US PTAs have promoted ambitious reforms that clearly break with the past in the three microeconomic reforms under consideration: IPR protection, privatization, and service liberalization. Using various statistical methods, we investigate PTA-negotiating countries and compare their reform patterns with a "matched" sample of non-negotiating countries that are comparable along various political and economic dimensions. The evidence is much weaker for capital account liberalization, the one macroeconomic reform under consideration. We also explore the effects of WTO membership and IMF programs, finding that the multilateral trade regime has also promoted IPR protection, while the effects of the IMF on microeconomic reform are weak. The final sections of this chapter explore causal mechanisms, showing that the European Union and the United States not only are capable of enforcing their treaties, but also offer direct support to their partners in the form of adjustment assistance.

In conducting the analysis, we face several major empirical challenges. First, what should we count as significant reform? This is a difficult issue because the significance of a certain reform at a given time depends on the country's history of economic reform. For example, incremental trade liberalization that follows a similar historical trend would hardly constitute evidence for a PTA's reform effects. In contrast, the same amount of incremental trade liberalization could be a significant departure from a previous, stable pattern of protectionism. Conventional regression techniques have difficulties in handling these issues, so our empirical analysis is based on a more flexible empirical strategy for identifying "structural breaks" in a country's economic reform time series. Every country is assumed to follow a different historical pattern of economic reform, and we focus on identifying significant departures from that historical pattern. If these departures often coincide with PTA negotiations and signature, then a strong association can be said to exist between PTA formation and economic reform.

Second, which PTAs should we consider? A conventional approach would focus *only* on those PTAs that coincide with the combination of leader change and democratization. While these PTAs are particularly important for our theory, it is essential to recognize that much can also be learned from *other* PTAs. Even without democratization and leader change, many leaders face demand for economic reform in difficult political environments. Accordingly, this chapter reports findings on the relationship between PTA negotiations and reform using the same sample as the previous chapter: all EU and US PTAs negotiated during the 1990–2007 period.

To understand this logic, remember that while we have argued that democratization and leader change are key reasons that PTA negotiations occur, we have not claimed they are the *exclusive* drivers of reform. It seems plausible that many other PTA negotiations are driven by the leader's need to reform in difficult circumstances. Even in the absence of leader change and democratization, we would expect PTA negotiations to be related to the need to liberalize. Therefore, we would expect many PTA negotiations to induce economic reform, even if they did not coincide with leader change under democratization.

Finally, which specific economic reforms should we analyze? As we have shown with the design data, PTAs have potential for producing substantial changes in a wide range of economic policies. Analyzing all, or even most, of them would clearly be beyond the scope of a single book. Based on the literature on the politics of PTA formation and economic reform, as well as practical considerations of data availability, we identified four economic reforms that PTA negotiation and signature could promote: IPR, privatization, investment liberalization, and capital account liberalization. Of these, the last is a macroeconomic reform that one would expect to show weaker results. The following section provides the details of the data.

It is important to emphasize that the purpose of this analysis is to uncover an *association* between PTA formation and economic reform. We cannot directly establish causality, because economic reforms could also influence PTA formation. Therefore, we conduct qualitative analyses of the causal mechanism below. Establishing a positive association between PTA formation and economic reform is, in and of itself, both important and a major challenge. We use statistical techniques to show that there is a clear association between PTA formation and economic reform; the qualitative analysis that follows then provides direct evidence for the causal mechanisms.

ECONOMIC REFORMS

As stated above, we consider three microeconomic (IPR protection, privatization, and investment liberalization) and one macroeconomic (capital account openness) reform. Of these, we expect strong PTA effects on the three microeconomic reforms.

The first economic reform indicator that we considered is IPR protection. As discussed in Chapter 4, IPR protection is a central component of the institutional design of almost every EU and US PTA. If American and European companies are to invest in a developing country, they want assurances that their innovations will be protected by patent legislation and that copyright infringements be prosecuted (Sell, 2003). Improved IPR legislation is also an essential step toward higher economic growth through increased value added and innovation, at least in countries that have previously relied on weak IPR legislation (Maskus, 2000).

Measuring IPR protection is not easy because a wide variety of possible indicators exist. For our purposes, it is particularly important that the measure captures a broad swath of IPR reforms. Additionally, data should be available for a large number of countries and years. For these reasons, we use a global data set provided by the World Intellectual Property Organization (WIPO) providing the annual number of new legislative acts pertaining to IPR protection.[1] For each, the data set provides new legislative acts enacted by the 184 members of the WIPO. While this measure cannot capture qualitative differences between different legislative acts, it has the major advantage of being available for a large number of countries. In the qualitative analysis, we are also able to examine the details of IPR reform in select countries. Therefore, the quantitative and qualitative analyses complement each other.

Figure 6.1 provides a graphical illustration of IPR reform trends. The left panel shows the number of new IPR legislations for countries that did not negotiate a PTA at any time. The right panel shows this number for countries that negotiated a PTA. As the figure shows, a clear upward trend can be detected both for countries that negotiated and did not negotiate a PTA.

The second reform indicator we use is privatization. In general, PTAs rarely contain explicit requirements to privatize specific state enterprises. However, in the case of the European Union and the United States, PTAs often proscribe subsidies to companies and prescribe liberalization in key services, such as banking and infrastructure. In practice, both requirements mean that maintaining state enterprises is increasingly difficult. Without subsidies, funding the operation of state enterprises is very difficult for a government. In liberalized service markets, state enterprises face increased competition from highly productive multinational corporations, and this increases the government's incentive to privatize. Under intense competition and without the possibility of subsidizing state enterprises, the value of maintaining control of the economy decreases while the cost increases.

For privatization, the World Bank maintains a comprehensive data set recording a country's annual revenue from privatizing state assets of at least US$1 million. The data set covers 101 developing countries and the years 1988–2008. The data come from the Private Participation in Infrastructure (PPI) Database of the World Bank.[2] This data set allows us to quantify the total value of privatization in the national economy, and

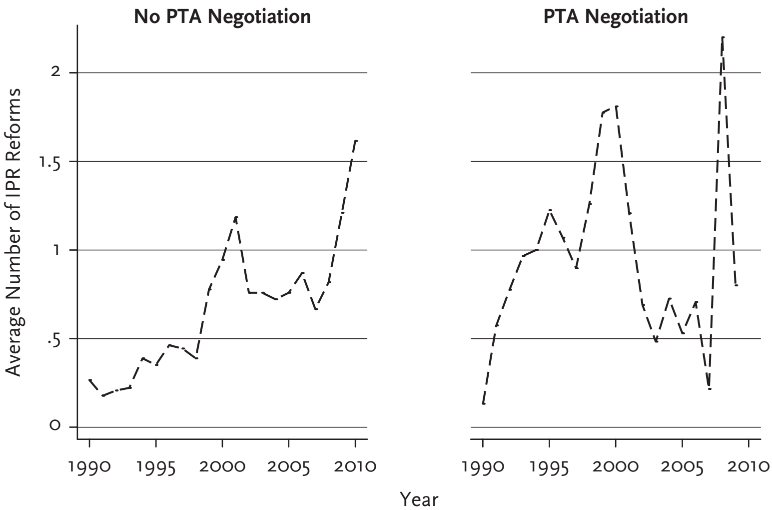

Figure 6.1 Intellectual Property Rights over Time.

use this total value to identify salient "jumps" in privatization as a form of economic reform. We would expect PTA negotiations and signature to produce such jumps in a country's privatization trajectory, as the government begins to reduce state intervention in the production of goods and services. If PTAs significantly reduce leaders' ability to maintain state enterprises, then PTA negotiations and signature should be associated with increased efforts to privatize.

Figure 6.2 provides a graphical illustration of privatization reform trends. The graph shows a clear difference between countries that did and did not negotiate a PTA at some point. In the early 1990s, countries that at some point negotiated a PTA privatized many state enterprises. In later years, countries that have not negotiated a PTA have begun to privatize at a faster pace than the other group of countries. At first sight, then, it seems that PTA-negotiating countries have privatized earlier than other countries. Below, we examine whether the more aggressive privatization trend in countries that negotiated a PTA was associated with the PTA or not.

Our third reform indicator is the "investment profile" variable provided in the *International Country Risk Guide*.[3] This variable is based on an expert survey of different countries' policies with regard to foreign direct investment (FDI). It comprises sub-components related to expropriation, contract enforcement, the difficulty of profit repatriation, and payment delays due to inadequacies in the legal system. Given that Büthe and Milner (2008) emphasize the importance of PTA formation for FDI inflows in developing countries, we can use the investment profile variable to examine this

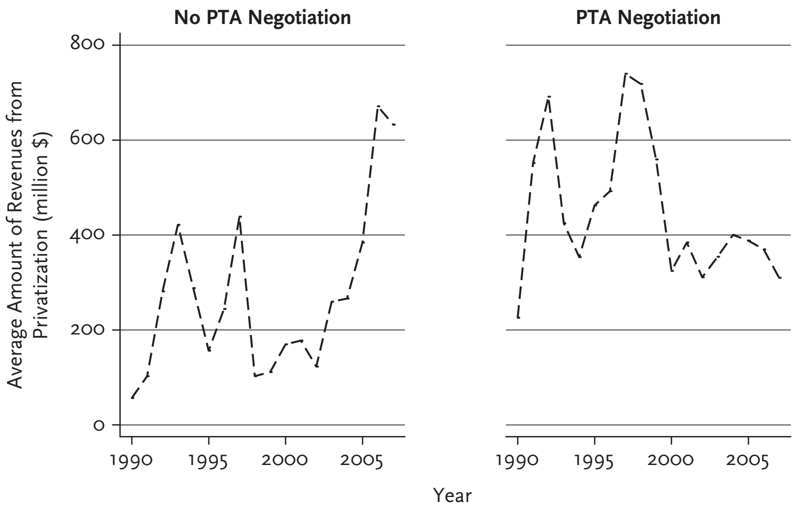

Figure 6.2 Privatization over Time.

logic. Further, FDI is particularly important for our theory because it is one mechanism through which the government can transfer value to domestic constituencies. As shown in the online Appendix, a clear difference exists between countries that did and did not negotiate a PTA. While both groups have improved their investment profile over time, the initial level was higher for countries that negotiated a PTA at some point in time. Equally important, the improvement in the investment profile for PTA-negotiating countries has been particularly fast.

While these three indicators are useful, they do not capture the possibility that PTA formation also results in macroeconomic reform. To capture this possibility, we use the Chinn and Ito (2008) measure of capital account liberalization. This measure is a composite index of the difficulties of transferring capital in and out of a given country. For example, it records the presence of multiple exchange rates and restrictions on current account transactions. The measure allows us to examine the possibility that the changes that a PTA mandates in the financial sector induce governments to liberalize capital movements.

The online Appendix also provides a graphical illustration of changes in capital account openness. Not only was the initial level of capital account openness higher for countries that negotiated a PTA at some point, but it has also increased over time more rapidly. Another notable fact is that the change in capital account openness seems to have been remarkably smooth, which suggests that structural breaks should be relatively rare in the data. Later, we show that this is indeed the case, both for PTA-negotiating and non-negotiating countries.

RESEARCH DESIGN

Armed with the data on the four different reforms listed above, we now discuss our empirical strategy for examining PTA effects on economic reform. To test the hypothesis that a PTA can induce economic reforms, we exploit two different forms of variation in economic reform. The first is *temporal*: Does the timing of major economic reforms in a country negotiating a PTA accord with our expectations? Specifically, we examine whether major economic reforms were implemented during PTA negotiations and immediately after signature. The second is *cross-national*: Do we also see major economic reforms in developing countries that never negotiated an EU or US PTA? By exploring both temporal and cross-national variation, we are able to scrutinize our reform hypothesis in multiple ways.

The analysis has two steps. First, we consider only those countries that do negotiate a US or EU PTA at some point during the time frame of our study. In this analysis, we focus on timing. If our argument is valid, we should see major economic reforms occurring either already during PTA negotiations—that is, before the treaty has entered into force—or soon after the signature. Using the statistical technique discussed below, we examine whether we see major economic reforms during PTA negotiations or within five years of signature.

Second, we examine countries that do *not* negotiate an EU or US PTA. In this analysis, we focus on average economic reform performance relative to countries that negotiate an EU or US PTA. This test is conducted using a "placebo" technique. For each non-negotiating country, we randomly draw a time frame that is equal to the mean length of PTA negotiations plus five years (that is, seven years in total)—this is the length of the time period that we used to identify the effect of EU and US PTAs on reform for PTA-negotiating countries. If our argument concerning PTA effects is valid, we should see far fewer major economic reforms in the non-negotiating countries.

For this second part of the empirical analysis, it is essential to account for the fact that non-negotiating countries are in many ways different from negotiating countries. For example, non-negotiating countries are on average less developed and geographically far removed from the European Union and the United States. This might reduce their incentive to implement economic reforms. Without a proper empirical strategy, this heterogeneity could bias our estimates: if non-negotiating countries are different from negotiating countries, their inability to implement economic reforms could have very little to do with the PTA.[4]

To deal with this issue, we adopt a "matching" approach to including countries in the set of non-negotiating countries. If we are to compare negotiating and non-negotiating countries, it is useful to exclude those non-negotiating countries that are very different from all negotiating countries. Unless negotiating and non-negotiating countries are relatively similar, we cannot compare outcomes in a meaningful sense.

Our matching method reduces imbalance in our data, and thus sharpens our estimate of the impact of PTAs on economic reform. Specifically, matching is a technique that creates balanced sub-samples: each treated unit is paired with a similar control unit. In our specific case, by using matching, we are able to create two sub-samples, one of countries that negotiate a PTA ("treatment" group) and one of countries that did not ("control" group). These sub-samples are similar in terms of many possible confounding variables, such as economic size, per capita income, and distance from the European Union and the United States.[5] The technique excludes unmatched observations from the analysis, so as to avoid comparing "apples with oranges."

After we have created these two balanced sub-samples, we are able to compare the liberalization performance of developing countries with an EU and/or US PTA to the liberalization performance of developing countries without an EU or US PTA. If we still find that the treatment group is significantly more likely to reform than the control group, we can be more confident that the increased likelihood of reform is associated with the PTA, as opposed to other variables associated with the PTA.

We should note that matching is an effective non-parametric way to control for the selection problem on observables, that is, to deal with omitted variables without imposing functional form assumptions. However, matching does not help to solve a selection problem on the unobservables.[6] While these selection problems are important, they should not be allowed to overshadow a major strength of matching: as Gilligan and Sergenti (2008, 90) note, with matching "inferences are based entirely on data. None of the results flow from arcane functional form assumptions or implausible arguments about valid instruments."

From the description above, it is evident that the selection of variables to match the treated group with the control group is a particularly important and sensitive choice. This choice must be ultimately driven by theoretical considerations (Ho et al., 2007). In this case, we used the covariates that were statistically significant in the formation stage. Specifically, we selected leader change, democratization, GDP per capita, GDP, distance, and diffusion.

Some of these variables are usually included in the gravity model, which represents the baseline model in predicting the formation of PTAs. For instance, previous studies show that the distance between two countries, the size, and the level of development of countries affect their probability of forming a PTA (Baier and Bergstrand, 2004). Furthermore, previous studies show that the proliferation of PTAs in the last two decades is also driven by concerns about trade diversion faced by countries excluded from PTA cooperation (Mansfield, 1998; Manger, 2005; Baccini and Dür, 2012). These studies operationalize trade diversion as "spatial interdependence" among countries.

For illustration, several countries excluded from the matched sample are shown in Table 6.1. This table testifies to the power of our matching technique. It shows that by matching, we can exclude 30 countries from the data set. Intuitively, most of the excluded countries quite different from the standard candidates for PTA negotiations. Many are very poor African

Table 6.1. COUNTRIES EXCLUDED THROUGH MATCHING

Afghanistan	Burkina Faso	Laos
Albania	Burundi	Latvia
Angola	Comoros	Madagascar
Armenia	Ecuador	Mali
Azerbaijan	Estonia	Nepal
Bahamas	Fiji	Peru
Belarus	Gabon	Slovenia
Belize	Gambia	Suriname
Benin	Haiti	Zambia
Bosnia Herzegovina	Kenya	Zimbabwe

countries, with little prospect of PTA formation with the European Union and the United States. Others are small islands in the Caribbean. Yet others are Central Asian autocracies, such as Azerbaijan, that have generally implemented few economic reforms since the demise of the Soviet Union. As to countries that do engage in PTA negotiations, some are also excluded. These are Estonia, Latvia, Peru, and Slovenia.

Figure 6.3 shows the reduction of the unbalance for two covariates looking at their distribution before and after matching. As appears evident from

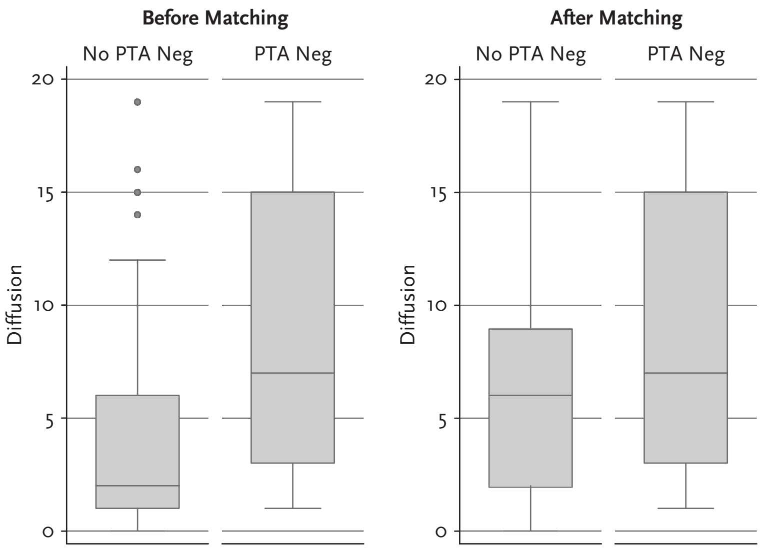

Figure 6.3 Improving the Balance Through Matching. In each box plot, the horizontal line in the middle shows the median, while the gray area covers 75 percent of all observations. The figure shows that matching reduces imbalance on these covariates.

the box plots, the reduction of the unbalance is substantive for the majority of the covariates, and no covariate is more unbalanced after matching than before matching. More important, the overall L_1 balance measure, which captures imbalance with respect to the full joint distribution, drops significantly from 0.97 to 0.81. Both tests confirm the need for a matching strategy.[7]

We conceptualize economic reforms as *events*, and we choose our statistical technique in view of explaining the event of major economic reform. The difficulty of doing so lies in the fact that what constitutes major economic reform in a country depends on the country's history of economic reform. One country's major economic reform is another country's basic trajectory. To account for the importance of the context, we analyze *structural breaks* in economic reform data. Instead of conducting traditional regression analyses, we treat each country's economic reform data as a separate time series and try to identify large shifts toward more liberal policy.

This approach has the major advantage of being *flexible*. Conventional regression analyses depend on stringent assumption concerning the data, and the economic reforms we analyze rarely if ever meet these assumptions. Given this, it is safer to let the data speak for themselves than to the data in a regression model. In statistical jargon, our estimation technique is "non-parametric" because it does not depend on *ex ante* assumptions concerning the properties of the data set. For example, our statistical technique does not require that we set an arbitrary threshold for major economic reform. Instead, we allow the economic reform data themselves reveal deviations from historical trends. Such deviations are then coded as major economic reform without discretionary decisions concerning thresholds.

The technique that we use to conduct the analysis is called "rolling regression." Rolling regressions are very simple estimates that allow us to detect a jump or a break in a trend variable, that is, a variable that increases or decreases over time. Moreover, rolling regressions allows us to check if such a break in the data is statistically significant. This allows us to rule out the possibility that the break is a random event.[8]

The idea of our rolling regression is that a country's economic policy at time t should, in the absence of a structural break, be easy to predict based on time. If a variable increases regularly from one year to another, a linear time trend variable is a good fit of the estimation. Our reform variables are good examples of trend variables. For example, many countries passed new IPR laws every year.

When a trend variable has an unusually larger value in time t compared to time $t - 1$, the linear time trend variable is unable to predict such a jump. In this case, the linear time trend variable is not a good fit of the estimation.[9]

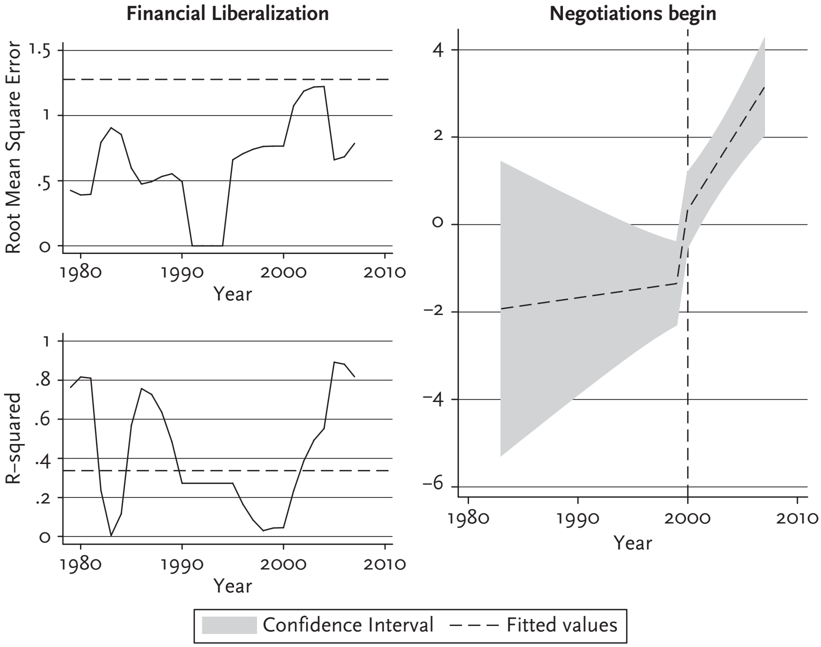

Figure 6.4 Rolling Regression of Capital Account Openness in Chile. For comparison, the differing time trends before and after PTA negotiations are also shown. On the right, the 90% confidence interval is shown.

To understand how the rolling regression is used, let us consider a real example. Figure 6.4 shows the pattern of capital account liberalization in Chile. On the right, we show the time trend of capital account liberalization before and after PTA negotiations. Clearly, this panel shows that the beginning of the negotiations was associated with a sharp departure from the previous trend. On the left, we show the results from rolling regression. The upper panel shows the root mean square error (RMSE) while the lower panel shows the fit, or R^2. While the R^2 does not fall below the dashed line, the RMSE does suggest that a structural break is present. It is maximized between the beginning of negotiations and signature. In the year of signature, it is only slightly above the conventional $\alpha = 0.05$ significance level.

For another example, consider South Africa's privatization record (Figure 6.5). Again, the graphical illustration is clear: the beginning of PTA negotiation is associated with a dramatic change in the time trend of privatization. In this case, the RMSE does not provide evidence of a structural break. However, the R^2 does. For the first estimated year, 1997, the value of the R^2 is well below what it should be if the linear prediction from past performance was correct.

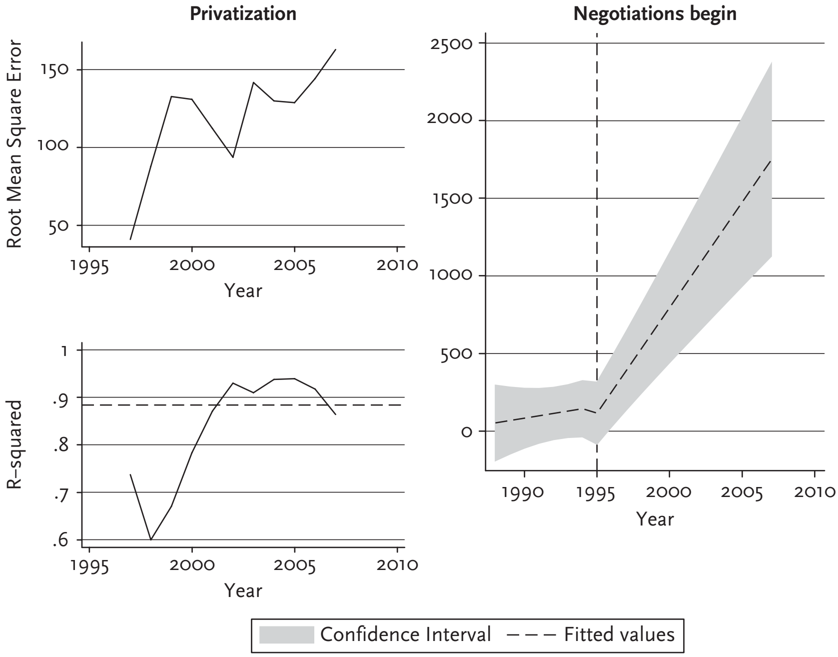

Figure 6.5 Rolling Regression of Privatization in South Africa. For comparison, the differing time trends before and after PTA negotiations are also shown. On the right, the 90% confidence interval is shown.

FINDINGS

We present the findings in two steps. First, we discuss our findings concerning the timing of reforms within the set of countries that do negotiate an EU or US PTA at some point. This test allows us to verify that our theoretical expectations are valid. Second, we compare the frequency of reforms during PTA negotiations to the frequency of reforms in countries that do not negotiate an EU or US PTA at any time.

To summarize, we find that EU and US PTAs have had powerful effects on IPR protection, privatization, and investment liberalization. In PTA-negotiating countries, these microeconomic reforms tend to occur either during negotiations or following signature and showed a clear break with past performance, with rapid changes in performance. Moreover, in a matched sample of structurally similar countries that did *not* negotiate a trade treaty with the European Union or the United States, the pattern of reform was not nearly as impressive.

To build intuition, we begin with some examples. Figure 6.6 shows IPR reforms for four dyads: EU-Algeria, EU-Poland, US-Jordan, and US-El Salvador. The *x*-axis shows the year and the *y*-axis shows the number of

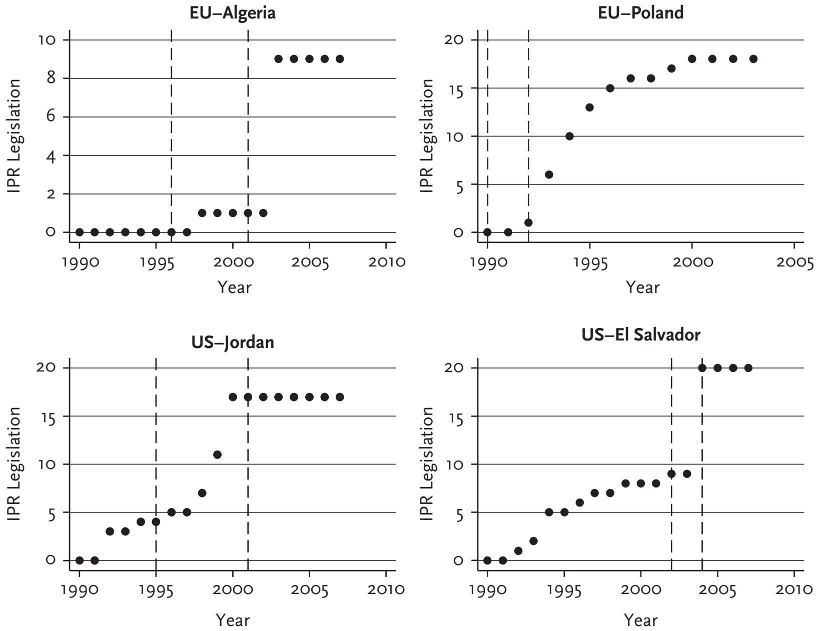

Figure 6.6 IPR Reform in Algeria, Poland, Jordan, and El Salvador. In each graph, the first vertical line indicates negotiation onset and the second vertical line signature. For all four countries, the rolling regression detects a structural break.

IPR legislations enacted in that year. In each graph, the first vertical line indicates negotiation onset and the second vertical line indicates PTA signature. For all four countries, the rolling regression detects a structural break. Algeria and Poland implemented major IPR reforms following EU PTA signature, while Jordan and El Salvador implemented them during negotiations with the United States.

Another example is provided in Figure 6.7. This figure shows privatization trends for four dyads: EU-Macedonia, EU-South Africa, US-Costa Rica, and US-Oman. In Macedonia, South Africa, and Costa Rica, major privatization efforts followed PTA signature with a major power.[10] In Oman, privatization coincided with the onset of PTA negotiations with the United States.

A summary of the overall results is presented in Table 6.2. To begin with, consider reform patterns among countries that engage in PTA negotiations at some point. The table shows that these countries' economic reforms often coincide with PTA negotiations and signature. For countries that negotiate an EU PTA, we have data on at least one economic reform indicator for 22 dyads. The results are telling: of these countries, 19 show a structural break for at least one indicator. For countries that negotiate a US

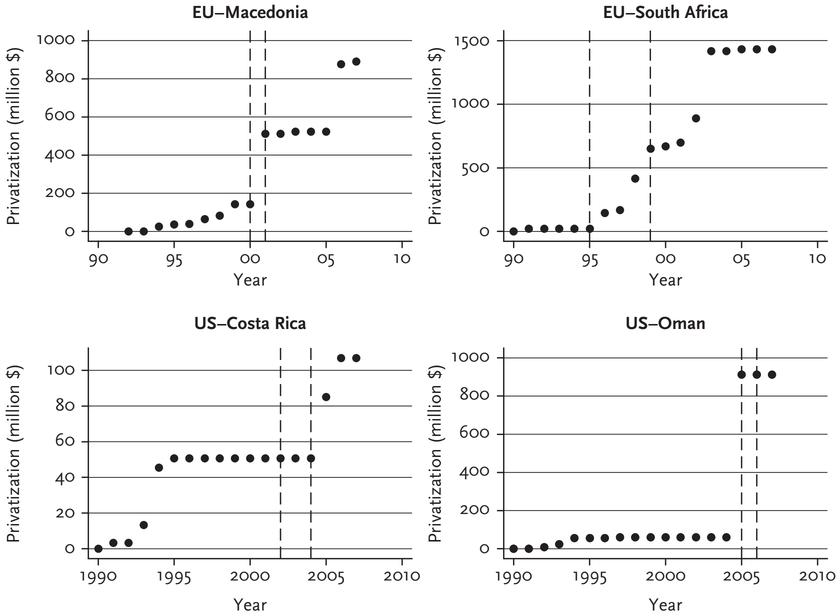

Figure 6.7 Privatization in Macedonia, South Africa, Costa Rica, and Oman. In each graph, the first vertical line indicates negotiation onset, and the second vertical line indicates signature. For all four countries, the rolling regression detects a structural break.

PTA, the results are somewhat weaker. However, even here, 11/18 dyads implement at least one major economic reform either during PTA negotiations or upon signature.

Let us now compare these frequencies with countries that do not form a PTA. Recall that for these countries, we randomly chose a seven-year time-frame. This is the median combined length of negotiations and a five-year period following signature. In this data set, we have data for 42 dyads. Of them, only 20 show a structural break in at least one reform indicator. Overall, this is much less than for the European Union and somewhat less than for the United States. These findings are consistent with our theoretical expectations.

Consider next specific reforms in the four sectors under consideration. Table 6.2 shows that of the three reforms, privatization has been the most prevalent. However, the rates for countries negotiating an EU or US PTA have been much higher. IPR and investment profile have also changed substantially. Of the four reforms, structural breaks in capital account openness have been the least frequent. But again, the frequency is much higher for countries negotiating an EU or US PTA. In sum, the results are as expected for all four reform indicators.

Table 6.2. SUMMARY OF STRUCTURAL BREAKS IN ECONOMIC REFORM DATA			
Reform	EU	US	Non-PTA
IPR	0.41	0.58	0.13
Privatization	0.50	0.58	0.31
Capital Openness	0.13	0.11	0.04
Investment Profile	0.45	0.37	0.22
Any	0.86	0.61	0.48

The fractions indicate the frequency of reform structural breaks among EU PTA countries, US PTA countries, and non-negotiating countries. If we compare the frequency of reform in the combined EU/US PTA and non-PTA groups, the difference is statistically significant at the conventional level for all four reform indicators.

Table 6.3 shows the leading reformers among PTA-negotiating and other countries. For this table, a leading reformer is defined as a country that has at least two structural breaks in the data within the specified time-frame: negotiations and a five-year grace period for negotiating countries, and a seven-year window for other countries. As the table shows, there are nine such countries among PTA negotiators. Of these, we present qualitative case studies of Chile and South Africa in Chapters 7 and 8. In contrast, there are only four such countries among those that do not negotiate a PTA at any point. Only one of them, Jamaica, has implemented three major reforms during the time period of investigation.

Equally notable, the countries that negotiate a PTA and thus implement major reforms are quite diverse. They can be found on all continents, and their economic sizes vary substantially. Some are autocracies, while others are democracies. Some negotiate with the European Union, others with the United States, and yet others with both. This lends credence to our

Table 6.3. BEST REFORMERS

Top Reformers with PTA	Number of Reforms	Top Reformers Without PTA	Number of Reforms
Algeria	3	Burkina Faso	2
Chile	4	Jamaica	3
Colombia	2	Russia	2
Egypt	3	Senegal	2
El Salvador	2		
Jordan	3		
Poland	2		
South Africa	2		
Vietnam	2		

argument concerning the importance of PTA negotiations and signature for economic reform.

These results show the existence of a strong positive association between PTA negotiations and economic reform. Additional insight can be found in the cases of *failed* PTA negotiations. Many developing countries have failed to conclude their PTA negotiations with the European Union and the United States. If our theory is valid, then we would not expect economic reforms for these countries during the negotiations. After all, the purpose of the PTA negotiation was to enable economic reform. If the PTA negotiation fails, economic reforms should also fail—provided they are directly related to the PTA, as our theory suggests.

The reform record for countries that have participated in failed negotiations is shown in Table 6.4. The table shows the beginning of negotiations,

Table 6.4. SUMMARY OF ECONOMIC REFORMS DURING FAILED NEGOTIATIONS

Major Power	Developing Country	Negotiation	Leader Change	Democratization	No.	Reform
EU	Argentina	1999	no	no		no
EU	Brazil	1999	no	no		yes
EU	Bahrain	2002	no	no		no
EU	Kuwait	2002	no	no		no
EU	Oman	2002	no	no		yes
EU	Paraguay	1999	yes	no		no
EU	Qatar	2002	no	no		no
EU	Saudi Arabia	2002	no	no		yes
EU	Ukraine	2007	yes	no		no
EU	United Arab Emirates	2002	no	no		yes
EU	Uruguay	1999	no	no		yes
US	Bolivia	2003	no	no		no
US	Botswana	2002	no	no		no
US	Ecuador	2003	yes	no		yes
US	Malaysia	2006	no	no		no
US	Lesotho	2002	no	no		no
US	Namibia	2002	no	no		yes
US	South Africa	2002	no	no		yes
US	Swaziland	2002	no	no		no
US	Thailand	2004	no	no		no
US	United Arab Emirates	2004	no	no		yes

records the occurrence of leader change and democratization, and indicates whether any major economic reforms were implemented during the negotiations. The first notable fact is that none of the failed negotiations was initiated by new leaders under democratization. This suggests that these PTA negotiations were initiated for other reasons. Another notable fact is the relatively rarity of reform. Of the 21 cases, only eight saw any major economic reform. This frequency is much lower than that for successful negotiations. This, again, is consistent with our theoretical expectations.

Another finding worth noting is the similarity between the countries that fail to negotiate the PTA and the set of non-negotiating countries. Many of the failed negotiations occur in the Middle East, as the European Union and the Gulf Cooperation Council failed to conclude the negotiations they initiated in 2002. Another notable case is the PTA negotiation between the United States and the South African Customs Union. Mostly due to South Africa's intransigence, this negotiation has also failed to produce a PTA. Few of the African partners have implemented major economic reforms in any of the four sectors during the time period of investigation.

ANOTHER TEST: DIFFERENCE-IN-DIFFERENCES

The previous section has demonstrated that structural breaks in our reform indicators are more frequent during years of PTA negotiations or following signature. In this section, we implement a difference-in-differences analysis on all our matched cases. To mitigate bias from nonlinear and heterogeneous PTA effects, we exclude observations that are unmatched. This is not only the correct specification for dealing with selection bias on observables, but it is also a hard test of our hypothesis that PTAs promote reform.

In summary, we find evidence of reform effects for all four reform indicators under consideration, regardless of whether we focus on the negotiation period or the years following ratification. This is exactly as in the structural breaks test, except that the evidence for reform in capital account openness is stronger. This may stem from the fact that the rolling analysis best captures rapid and decisive reforms, whereas the difference-in-differences estimator also identifies slow but consistent policy changes.

Our dependent variables are the four aforementioned reform indicators. The main independent variables are two dummies and their interaction. Specifically, we use a treatment variable that scores 1 for countries that negotiate a PTA at some point in time and 0 otherwise. For instance, Croatia is in our treatment group since it started negotiating a PTA with the European Union in 2000. Conversely, Ghana is not in our treatment group since it negotiated no PTA between 1990 and 2007. Moreover, we include a dummy, referred to as the post-treatment variable, that scores 1 from the year in which a country starts negotiating a PTA with the European Union or the United States and 0 in the previous years. The analysis is also replicated so that the period variable scores 1 only upon signature. For instance, for Croatia the period variable scores 0 between 1990 and 1999 and scores 1 since 2000. Finally, we interact these two dummies to obtain the post-treatment effect of PTAs on reform. However, since we use country fixed effects, the treatment variable is collinear with country dummies. As such, we are left only with the dummy period to capture the impact of negotiating a PTA with the European Union and/or the United States on reform.[11]

We also include a few control variables to account for confounding factors. Specifically, we include GDP, GDP per capita, regime type, and membership in the WTO, which have been already discussed. We also include year fixed effects to control for general temporal trends. Finally, since we are interested in estimating the effects of PTAs on reform, we use the country-year as unit of analysis, rather than the dyad-year. This is a conservative choice. In doing so, we avoid duplicating observations in the control group, since countries that do not sign a PTA would appear twice in a dyadic setting, such as EU-Ghana-1990 and US-Ghana-1990, and so on. In any case, it turns out that our results are very similar if we use dyad-years.

We use the logarithmized number of IPR legislation to mitigate the impact of outliers. Thus, all our variables are continous and we estimate them with Ordinary Least Squares (OLS). Results are reported in Table 6.5. The post-treatment coefficient is always statistically significant at the conventional levels. This is true both if we look at the post-negotiation period and at the post-signature period (except for IPR legislation). These findings square with those from the rolling regression and further validate our effort to link the presence of a PTA with the European Union and the United States with the probability of implementing reform.

OTHER PREFERENTIAL TRADING AGREEMENTS

As we did in the first stage of our analysis, we now turn our attention to PTAs formed by other important actors rather than the European Union and the United States. To summarize, we find that neither Japanese nor Chinese PTAs are as effective in promoting reform as their EU and US counterparts.

Table 6.5. DIFFERENCE-IN-DIFFERENCES, EU AND US PTAS

	IPRs	Privatization	Kaopen	Investment	IPRs	Privatization	Kaopen	Investment
	Negotiation				Signature			
Post-treatment	0.08*	0.58**	0.25***	0.37***	0.05	0.81***	0.43***	0.55***
	(0.04)	(0.14)	(0.08)	(0.14)	(0.05)	(0.16)	(0.11)	(0.16)
Controls	yes	yes	yes	yes	yes	yes	Yes	yes
Country FE	yes	yes	yes	yes	yes	yes	yes	yes
Year FE	yes	yes	yes	yes	yes	yes	yes	yes
R^2	0.88	0.86	0.68	0.77	0.88	0.87	0.77	0.69
Observations	1,868	1,651	1,673	1,444	1,868	1,651	1,673	1444

OLS models with country fixed effects and year fixed effects.
Robust standard errors in parentheses.
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 6.6. DIFFERENCE-IN-DIFFERENCES, JAPANESE AND CHINESE PTAS

	IPRs	Privatization	Kaopen	Investment	IPRs	Privatization	Kaopen	Investment
	Japan				China			
Post-treatment	–0.10	0.10	–1.60***	–0.0002	–0.03	–0.10	–1.09***	–0.24
	(0.07)	(0.50)	(0.29)	(0.62)	(0.09)	(0.13)	(0.27)	(0.36)
Controls	yes	yes	yes	yes	yes	yes	yes	yes
Country FE	yes	yes	yes	yes	yes	yes	yes	yes
Year FE	yes	yes	yes	yes	yes	yes	yes	yes
R^2	0.88	0.86	0.77	0.68	0.88	0.86	0.77	0.68
Observations	1,868	1,651	1,673	1,444	1,868	1,651	1,673	1444

OLS models with country fixed effects and year fixed effects.
Robust standard errors in parentheses.
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 6.6 reports the results of the difference-in-differences for PTAs signed by Japan and China with developing countries. The effect of these PTAs on reform is quite weak for both Japan and China. The only indicator for which the variable post-treatment has a positive and statistically significant effect is investment under Japanese PTAs. Other than that, Japanese PTAs seem considerably less effective than EU and US PTAs. For Chinese PTAs, we find even less evidence of reform effects. The only indicator with a positive coefficient for the post-treatment period is investment liberalization, and even here conventional levels of statistical significance are not reached.

The poor performance of Japanese PTAs is somewhat puzzling. There are two possible explanations. First, Japan has formed PTAs with a relatively small number of countries. Some of these countries, like Chile, Mexico, and Vietnam, have already signed a trade agreement with the European Union and/or United States before forming a PTA with Japan. Put simply, there are only few cases in which Japanese PTAs could affect reform in developing countries. Second, the poor performance of Japanese PTAs in terms of reform seems to imply that the enforcement mechanism is effective only for the European Union and the United States, which can credibly threaten to retaliate in case of non-compliance.

The poor performance of Chinese PTAs does not come as a surprise, given their shallow design. Interestingly, services and investment are the sectors that include the larger number of provisions in Chinese PTAs compared to, say, competition and government procurement. Thus, the finding on investment reinforces the claim that the design of PTAs matters for inducing developing countries to reform.

Table 6.7 shows the results of the difference-in-differences estimations for North-South PTAs and South-South PTAs. For North-South PTAs we exclude EU, US, and Japanese PTAs from the analysis. For South-South PTAs we use the deepest agreements signed by each developing country with another developing country during the time span of our study. Presumably, the deeper the agreement, the larger the effect on reform. Put simply, this is a conservative choice to give full credit to South-South cooperation. Neither North-South PTAs nor South-South PTAs have an effect on reform. The variable post-treatment is never statistically significant at the conventional level, except for capital openness, where the coefficient is negative for both North-South and South-South PTAs.

This is a crucial finding for our study. EU and US PTAs are very different animals compared to the other PTAs. First, they include a large number of provisions on reform, which are largely excluded from other PTAs. Second, the actual effect of EU and US PTAs on reform greatly outperforms the effect

Table 6.7. DIFFERENCE-IN-DIFFERENCES, NORTH-SOUTH PTAS (EXCLUDING EU, US, AND JAPAN) AND SOUTH-SOUTH PTAS

	IPRs	Privatization	Kaopen	Investment	IPRs	Privatization	Kaopen	Investment
	North-South Dyads				South-South Dyads			
Post-treatment	0.17*	–0.66**	0.41*	0.29	–0.11**	–0.02	–0.27***	–0.09
	(0.09)	(0.33)	(0.24)	(0.28)	(0.05)	(0.13)	(0.08)	(0.18)
Controls	yes	yes	yes	yes	yes	yes	yes	yes
Country FE	yes	yes	yes	yes	yes	yes	yes	yes
Year FE	yes	yes	yes	yes	yes	yes	yes	yes
R^2	0.88	0.86	0.77	0.68	0.88	0.86	0.77	0.68
Observations	1,868	1,651	1,673	1,444	1,868	1,651	1,673	1444

OLS models with country fixed effects and year fixed effects.
Robust standard errors in parentheses.
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

of other PTAs on reform. In other words, if a developing country forms a PTA with the European Union or the United States, it moves far from the status quo compared to a scenario in which it had formed a PTA with some other countries.

OTHER INTERNATIONAL INSTITUTIONS: THE IMF AND WTO

Thus far, we have focused on the effects of PTA negotiations and signature on economic reforms. However, many other international institutions could also promote economic reform. Examining the role of other international institutions is important for two reasons. First, our theory would predict that these institutions have similar, if perhaps weaker, effects. Second, we need to verify that accounting for these institutions does not dissipate the effects of PTA negotiation and signature.

We focus here on the WTO and the IMF. These are major multilateral organizations that could plausibly demand economic reforms. In particular, the WTO can impose conditions on accession, while the IMF can condition lending on economic reform. It is important to evaluate these institutions' role in promoting economic reform, both to ensure that they are not the real cause behind changes seemingly produced by PTAs and to examine whether our theory applies to other, different international institutions as well.

To foreshadow the results, we find relatively strong effects of WTO accession on IPR protection, which makes sense in light of the centrality of the IPR agenda in multilateral trade negotiations (Helfer, 2009). IMF programs, in contrast, seem not to promote any of the reforms under consideration. This could stem from the IMF's role in dealing with countries in economic crisis and the ensuing emphasis on stabilization.

Consider first the WTO. If a developing country is to join the WTO, it must negotiate with the current members and implement economic reforms they demand (Langhammer and Lücke, 1999). In principle, WTO accession is similar to PTA negotiations. However, WTO accessions can be difficult because the candidate must negotiate with multiple countries, and this can significantly increase the duration of the negotiations. For a developing country leader in need of a quick victory, this is a problem. At the same time, the WTO does have powerful regulations on some issues, such as IPR and foreign direct investment. We now examine whether WTO accession negotiations induce economic reforms. Equally important, we examine whether accounting for WTO accession washes away our findings concerning PTA negotiations and signature.

Let us start by analyzing the countries that entered the WTO after 1995. We focus on the WTO, as opposed to the General Agreement on Tariffs and Trade (GATT), because with the formation of the WTO, the Trade-Related Aspects of Intellectual Property Rights (TRIPS) and Trade-Related Aspects of Investment Measures (TRIMS) agreements on IPR and investment came into force. Such agreements regulate IPRs and investment, which are directly related to our reform indicators. Conversely, the GATT did not include any regulations on trade-related issues. Similar to our approach to PTAs, we are only interested in exploring the effect of the WTO on reforms that are explicitly addressed in provisions found in the rules of the international institution.

The online Appendix lists the countries that entered into the WTO between 1995 and 2007, based on data from Pelc (2011). We conduct two analyses. First, we run a rolling regression for each indicator of reform. We do not consider these countries that have already entered into a PTA negotiation with the European Union or the United States. The rationale for this is that countries cannot implement the same reform twice since we look for a structural break in our trend variables. For instance, we do not consider Eastern European countries, since they had already implemented major reforms as a consequence of PTAs signed with the European Union when they accessed the WTO.[12]

Table 6.8 summarizes the results. There is strong evidence that the WTO affects reform in developing countries seeking accession. Reform occurs usually during the negotiation period, in the year of the signature, and to a lesser extent after accession to the WTO. In line with our argument about the importance of the design, the strongest effect is for investment and IPR protection, which are directly regulated by the WTO. The caveat is that we have data on investment for only three countries: Armenia, China, and Ecuador—all three improve investment protection. Regarding privatization, we have data for only six countries: Armenia, China, Ecuador,

Table 6.8. SUMMARY OF STRUCTURAL BREAKS IN ECONOMIC REFORM DATA

Reform	WTO	Non-WTO and Non-PTA
IPR	0.78	0.13
Privatization	0.50	0.31
Capital openness	0	0.04
Investment profile	1	0.22
Any	0.72	0.48

The fractions indicate the frequency of reform structural breaks among countries that access the WTO (1995–2007), and countries that did not access the WTO and did not have PTAs with the EU or the US. If we compare the frequency of reform in the WTO and non-WTO groups, the difference is statistically significant at the conventional level for all four reform indicators.

Georgia, Kyrgyzstan, and Nepal. We detect a structural break only for Armenia, Georgia, and Kyrgyzstan. Finally, there is no effect of WTO accession on capital openness. This result is not surprising, given that the WTO does not regulate this issue.

Next, we run a difference-in-differences estimation. Results are shown in the online Appendix and confirm that WTO accession increases IPR legislation. The post-treatment variable is positive and statistically significant at the conventional level. Conversely, we find no effect for the other indicators. Capital openness aside, the non-effect for investment and privatization can be explained by the low number of countries for which data were available and that did not negotiate a PTA with the European Union and the United States before accessing the WTO. Simply put, there are so few positive observations that detecting effects in the data is difficult.

Another powerful international organization worth considering is the IMF. While almost all countries of the world are members, the IMF offers loans to countries that agree to participate in an IMF program. As Stone (2011) and Vreeland (2003) argue, the IMF requires that countries implement economic reforms in exchange for their loans. Therefore, it seems plausible to expect that participation in an IMF program could induce economic reform.

Using data from Vreeland (2007), we examined whether being in an IMF program induces economic reform. First, similar to our WTO analysis, we implemented the rolling analysis for countries that had negotiated a PTA with the European Union or the United States. We found no support for the reform hypothesis. We had 24 dyads for which the developing country had been in an IMF program during PTA negotiations or within five years of signature. Of these, 17 implemented at least one economic reform, giving a frequency of 0.71. However, of the remaining 16 dyads for which we had data, 12 also implemented at least one economic reform, giving a frequency of 0.75.

Again, we continue by running a difference-in-differences estimation. Results are shown in the online Appendix. The variable post-treatment is never statistically significant at the conventional level. This non-effect is only surprising for privatization, which is a crucial element of the IMF conditionality.[13] Conversely, there are no reasons to believe that the IMF should impact IPRs or investment protection, since such policies are not part of the IMF conditionality. Since IMF programs are orthogonal to reform in IPRs and investment, these results could even be interpreted as placebo tests. Finally, we find no effect of IMF programs on capital openness, which is consistent with the intuition that this policy is rarely influenced by international institutions. In sum, the IMF underperforms both

PTAs and the WTO when it comes to reform. This result is consistent with previous studies that find weak evidence for the claim that the IMF has a positive effect on growth and other economic indicators (Dreher and Vaubel, 2004; Przeworski and Vreeland, 2000).

If IMF programs specify economic reform, why were there no effects? One plausible reason could be that the IMF focuses on macroeconomic stabilization. With the exception of capital account openness, our reforms are mostly about microeconomic policy. Given this, it is perhaps not so surprising that IMF programs do not show such a strong association. While the IMF should be able to promote economic reforms through conditionality, it seems plausible that the IMF's focus is on different types of reforms from those sought through PTA formation. This observation suggests that there may be a certain, rather functional division of labor among international institutions: while the IMF focuses on macroeconomic stability and fiscal sustainability, trade institutions, including both the WTO and PTAs formed by major powers, implement microeconomic reforms. In our view, this division of labor warrants further research by international political economists.

TREATY ENFORCEMENT

The theory suggests that the ability of the European Union and the United States to enforce treaties is important for reform implementation. However, testing the credibility of enforcement is difficult because if the developing country has strong incentives to comply, the European Union and the United States need not carry out their credible threat (Simmons, 1998). To evaluate the role of enforcement, we need to find a setting in which the developing country has relatively strong incentives not to comply. This is challenging because our theory predicts that leaders form PTAs to implement reforms they prefer, and this implementation is backed by the powerful European Union and/or United States. In what follows, we propose a suitable test and show that both the European Union and the United States are in a position to enforce the PTA obligations of their treaty partners.

Among the four reform indicators, the best candidate for analyzing enforcement upon non-compliance is IPR legislation. In the case studies presented in the following chapters, we found evidence that while developing country leaders and domestic constituencies did not object to implementing most of the reforms specified in their EU or US PTA, the implementation of the IPR provisions was controversial. IPR regulations are a high priority for the European Union and the United States (Sell, 2003), but developing countries have much less to gain from these regulations. Patents and copyright may slow down technology transfer (Maskus, 2000), and IPR regulations limit access to inexpensive, generic drugs.

We start by considering US enforcement. The main vehicle of IPR enforcement in the United States is the Special 301 legislation, a bill that allows the federal government to impose trade sanctions on countries deemed not to have a sufficiently stringent level of IPR rules. Since the annual Special 301 reports pay particular attention to countries that have formed a PTA with the United States, we can examine these countries' appearance on the Special 301 list and the description of their performance from the American perspective to analyze PTA enforcement.

We analyzed data on 28 US PTA partners.[14] For every partner, we read the annual Special 301 reports written *after* the PTA was signed. We sought information about the partner country in focus. In particular, we examined whether their performance was deemed to have worsened or improved over time. Importantly, we also checked if the change in IPR policy was connected with the PTA, as determined by American officials.

Information was available on 15 out of 28 partners. Of these, 12 had improved some of their IPR policies and 2 (Chile, Mexico) had worse performance in certain IPR sectors. More important, in 14 cases the Special 301 reports suggested that the United States used PTA obligations to determine whether the partner should be on a "priority watch list"—candidates for trade sanctions—or not. This shows that the United States has used Special 301 to enforce its bilateral trade agreements. In 11 cases of the 12 that had improved, the positive change was explicitly tied to PTA compliance. Again, this shows that the United States has used PTA obligations to change IPR policies in developing countries.

Another approach to evaluating US enforcement is NAFTA. Although investment is generally not a very controversial topic in US PTAs, NAFTA's two decades provide enough material to evaluate the enforcement of those rare cases where non-compliance was suspected. The treaty's Chapter 11 regulates investment and allows firms and individuals to sue the member states for non-compliance with liberal investment rules. During NAFTA's time, there have been 13 cases of investment disputes against Mexico; of these, 10 were initiated by American corporations.[15] In 5 cases, the tribunal awarded compensation to the claimant, and Mexico has either settled or complied with the award in every one of the cases. This again shows how the United States has a legal mechanism for enforcing the investment chapter of the PTA.

For the European Union, it is more difficult to find systematic data on enforcement. A typical EU PTA comes with an Association Council that is responsible for the implementation of the treaty, and the decisions and reports of these councils are often vague, especially when compared to the US Special 301. In recent years, however, the European Union has also started to systematically monitor IPR enforcement. Since 2006, the European Union has published a biannual report on IPR enforcement in trade partner countries, including those with an association agreement.[16] The reports list "priority countries" that require particular attention by the European Commission. Of the EU PTA partners, Turkey, Chile, and South Korea appear on the list in at least one of the surveys.

In each case, there is evidence that the European Union is using the PTA to enforce IPR protection in the partner country (European Commission, 2013). The European Union threatened Turkey with trade sanctions in 2003 due to poor IPR enforcement in the pharmaceutical sector, specifically referring to the rules of the EU-Turkey PTA.[17] More recently, the European Union has also established an IPR working group with Turkey to improve IPR enforcement in the country, again in the context of the EU-Turkey PTA. In Korea, the EU PTA is being implemented by several working groups and committees, and there is also a high-level, continuous "Intellectual Property Rights Dialogue" between European and Korean officials. In Chile, the EU PTA is the legal basis for enforcing changes in IPR legislation, and the European Union is again using various working groups and committees to ensure that Chilean officials implement legislation to meet their contractual obligations. Moreover, the European Union participates in training IPR officials.[18]

Finding direct evidence on enforcement is difficult because our theory predicts that developing countries have incentives to comply. Since the threat of enforcement is credible and effective, the European Union and the United States need not actually implement sanctions. By investigating the IPR field, and to a lesser extent investment, we have been able to show that actual enforcement occurs when necessary. The United States, in particular, and the European Union, to a lesser extent, systematically apply legal methods and sanctions to ensure that trade partners comply with their obligations.

CONSOLIDATION

Do the reforms that developing countries implement during PTA negotiations and following signature survive? If they do not, the long-term effects of PTA formation on economic reform is limited. Given this, it seems useful to examine the *consolidation* of economic reforms following PTA negotiations. By consolidation, we refer to the idea that when economic reforms are implemented, they also survive over time. We now demonstrate that this is the case for both the European Union and the United States, with remarkably few exceptions. The only (partial) exception is IPR reform, which is perhaps the most controversial microeconomic reform a developing country can implement.

The analysis of democratic consolidation is inherently difficult for several reasons. First, some of the economic reform data we have used do not lend themselves to the analysis of consolidation. For example, a reduction in annual privatization proceeds may not reflect failure of consolidation. It could be that all state enterprises that a liberal government would privatize have already been privatized. Similarly, it seems implausible that governments would continue to pass more and more IPR laws until the end of history.

In spite of these limitations, we were able to examine the issue of reform consolidation in three different ways. First, for our measure of capital account openness we can simply examine decreases in capital account openness following the signature of an EU or US PTA. Second, we can similarly examine decreases in the International Country Risk Guide (ICRG) investment profile of a developing country. Finally, although our IPR measure does not itself allow an analysis of reform consolidation, we can exploit the fact that the US Trade Representative annually lists countries with "suspicious" IPR policies under the Special 301 legislation, as described earlier.

The results of this analysis are provided in Table 6.9. The table shows the list of reform consolidation failures. For capital account openness and investment profile, consolidation failure is defined as a decrease in the value of the indicator, temporary fluctuation notwithstanding.

For IPR, consolidation failure is defined as a country's appearance on the Special 301 list after the signature of a US PTA. The table is constructed using countries that had a structural break in the relevant reform data. After all, reforms that were never implemented cannot fail to consolidate.

Table 6.9 shows that instances of consolidation failure are quite rare. As to IPR, Chile and Mexico have appeared on the Special 301 list. In the

Table 6.9. CASES OF FAILURE OF REFORM CONSOLIDATION

IPR (Special 301)	Capital Openness	Investment Profile
US-Chile		EU-Mexico
US-Mexico		

case study of Chile, we return to this issue in Chapter 8. As to investment profile, the value of the indicator for Mexico clearly decreased in spite of forming an EU PTA. For capital openness, none of the handful of cases in our data set showed clear evidence of consolidation failure.[19]

Of these failures, perhaps the most notable issue is IPR reform. In the qualitative case studies to follow, we also find evidence that developing countries' preferences regarding IPR reform are often inconsistent, and even hostile. For example, our case studies of Chile and South Africa suggest that while these developing countries had a strong interest in many reforms, including privatization and FDI liberalization, they were not as enthusiastic about IPR reforms as the European Union and the United States. Therefore, it is perhaps not surprising that this particular reform indicator is more susceptible to reversal than the others.

EASING THE PAIN OF ADJUSTMENT: EU AND US FOREIGN AID

What role do the European Union and the United States play in the interplay between PTAs and economic reform? While we analyzed enforcement earlier, we now examine another policy instrument: foreign aid. In a previously published article (Baccini and Urpelainen, 2012), we have examined whether EU and US PTAs increase inflows of foreign aid to developing country partners. Extensive empirical analyses show a strong positive effect of PTA formation on foreign aid, and this effect is particularly pronounced in sectors that are directly relevant to the economic reforms that EU and US PTAs demand. Here, we illustrate these findings.

Specifically, we examine whether the European Union and the United States provide foreign aid to their PTA partners. We begin by analyzing overall patterns of foreign aid. We then zoom in and focus specifically on industries that are directly relevant to PTA formation. In particular, we show the effect of PTA formation on privatization foreign aid and trade adjustment foreign aid.

For overall patterns of foreign aid, we used bilateral net inflows data from the OECD Development Assistance Committee.[20] These data capture the totality of foreign aid given by the European Union and the United States to their developing country partners. If our theory about economic reforms is valid, we should see the European Union and the United States increase their foreign aid to developing country partners, so as to facilitate the full implementation of economic reforms. However, this effect should disappear over time because it is only needed to ease the pain of adjustment in the short run.

Figure 6.8, shows these aid inflows for four countries. As the figure shows, in each case foreign aid increased substantially in the five years

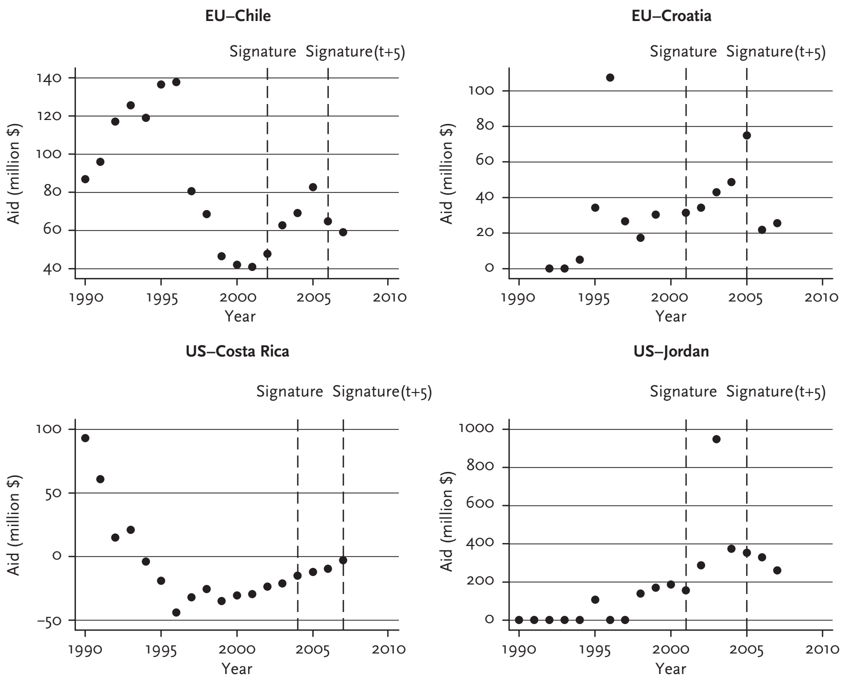

Figure 6.8 PTA Signature and Foreign Aid.

following signature. Equally important, no such increase was observed prior to signature—one would not expect implementation assistance during the negotiation period, because if the European Union and the United States had promised foreign aid already during the negotiation period, then developing countries would have fewer incentives to implement early economic reforms.

While overall aid patterns are a good first cut, it could be that the bilateral foreign aid focuses on sectors that are not very relevant to the PTA. In this case, variation in overall foreign aid would not constitute useful evidence for our theory. Given this problem, we also examined sectoral foreign aid based on data from the AidData 2.0 project.[21] The AidData project has the very useful feature of providing data on specific projects, so it is easy to accurately measure annual flows for projects in different sectors. In the online Appendix, we illustrate our findings for two important sectors: privatization and trade adjustment. Both are directly relevant to economic reform.

For privatization, we consider four cases: EU-Bosnia, EU-South Africa, US-Colombia, and US-El Salvador. In these four cases, foreign aid targeted to a directly relevant sector increased substantially. In particular, neither the European Union nor the United States continuously provides assistance for privatization. However, during negotiations and following signature, they seem to have implemented discrete privatization projects in their partner countries. This is strong evidence for our theory, and these effects apply to the broader data set, as the regressions presented in our other project show. The online Appendix also shows foreign aid for trade adjustment in four cases: EU-Lebanon, EU-Macedonia, US-Costa Rica, and US-Morocco. Again, foreign aid targeted to a directly relevant sector increased substantially. The European Union and the United States generally offer little money for trade adjustment, but following PTA signature this changes. This is what our theory predicts.

Qualitative evidence also suggests that both the European Union and the United States strategically use foreign aid to promote economic reforms in PTA partner countries. In the Western Balkans, the EU Community Assistance for Reconstruction, Development and Stabilisation provides aid to reinforce "democracy and the rule of law" and "promote social development and structural reform," so as to "implement the obligations in the Stabilisation and Association Agreements" that the European Union has formed with democratic market economies, and indeed potential membership candidates, such as Croatia, in the area.[22] Similarly, in 1995, as Israel and Tunisia signed the first Association Agreements in the Mediterranean area, the European Union established a Euro-Mediterranean partnership program. Formed on the basis of Association Agreements between the European Union and individual Mediterranean countries, the program has allocated approximately EUR 20 billion in "financial and technical assistance for implementation of the Association Agreements and key social and economic reforms."[23] Such coordination of foreign aid and PTA formation is an integral element of our theoretical argument.

The United States has invested particularly large sums to facilitate economic reform in Latin American democracies under a PTA. According to Congressional Research Service (2007, 9), the US Trade Representative coordinates with aid agencies and the recipient country government already during PTA negotiations to ensure that external assistance will be available to support the implementation of the anticipated PTA. In the case of the Dominican Republic–Central America Free Trade Agreement (DR-CAFTA), for instance, Congressional Research Service (2005) notes that the United States has used foreign aid to promote the implementation of environmental and labor standards. Additionally, Congressional Research Service (2005) writes that recipient governments have used the promise of external assistance in response to domestic critics who worry about the effect of reforms on democratic accountability. Indeed, Congressional Research

Service (2007, 15) anticipates that "[a]s the United States enters into more FTA negotiations with developing countries, USAID will likely respond to greater demand for assistance with participation in trade negotiations and implementation of trade agreements." Since 1999, the United States has provided more than US$10 billion in trade-related assistance as "a critical part of the… strategy to enable developing countries to negotiate and implement market-opening and reform-oriented trade agreements and to improve their capacity to benefit from increased trade." Indeed, the US Trade Representative specifically recognizes that the main aid agencies participate in all PTA negotiations with developing countries: "USAID and USDA, their field missions, and a number of other U.S. Government assistance providers actively participate in these working groups and committees so that the TCB needs identified can be quickly and efficiently incorporated into ongoing regional and country assistance programs."[24]

CHAPTER 7

Explaining Economic Reform in Croatia and South Africa

In the previous two chapters, we showed that our theory can shed light on why leaders in developing countries engage in PTA negotiations with the European Union and the United States. Moreover, the chapters showed that there is a strong association between PTA formation and economic liberalization in developing countries. In this and the next chapter, we complement the quantitative analysis with four qualitative case studies. The main advantages of qualitative analysis are that it allows us to identify causal mechanisms, trace the real processes of PTA negotiations and economic reform, and evaluate the importance of other relevant factors, such as economic crises. As Levy (2008) argues, case studies are particularly useful when used in conjunction with statistical analysis.

All four cases are positive observations: developing countries that successfully negotiated a PTA with the European Union and/or the United States. These developing countries are Croatia, South Africa, Chile, and Colombia. Analyzing cases known to be positive is appropriate given that our goal is to examine causal mechanisms. The statistical analysis already showed that there is an association between PTA negotiations and leader change under democratization. Given this, it is no longer necessary to use the cases to examine correlations between the independent and dependent variables. It is more important to examine the posited causal mechanisms in those cases in which such causal mechanisms should, according to the theory, be present.

In addition to focusing on positive observations that are consistent with our theory, the case selection was based on a few other considerations.

First, we wanted to have countries from the major PTA regions: Africa, Europe, and Latin America. Since the European Union and the United States have negotiated few PTAs in Asia, the choice of the above three regions gives a good view of the influence of these two powers in various regions. Second, we chose the cases to ensure we have a balance of EU and US PTAs. Chile has formed a PTA with both, Croatia and South Africa have a PTA with the European Union, and Colombia has a PTA with the United States. Third, we chose negotiations that began at different times, ranging from South Africa (1995) to Chile and Croatia (2000), as well as Colombia (2004). Fourth, we deliberately chose not to study cases that have been extensively analyzed in the past, especially NAFTA (Cameron and Tomlin, 2000; Chase, 2005; Manger, 2009). Finally, among the EU agreements we chose one post-communist country (Croatia) and others with different histories (Chile, South Africa) to see if these historical contingencies were important.

In this chapter, we examine two countries, Croatia and South Africa, that were undergoing a democratization process at the time of the PTA negotiations. In each country, a leader change had also occurred immediately before such negotiations began. If our theory is valid, these positive observations should exhibit the causal mechanisms that underpin our theory. Democratization should create demand for economic reform, and the new leader should face difficulties in the implementation of liberal economic reforms. These difficulties should be related to a lack of credibility and domestic political opposition. To deal with the difficulties, new leaders should engage in PTA negotiations with the European Union and/or the United States. In these negotiations, the developing country's negotiators should not oppose economic reforms, but instead should embrace them.

In conducting case studies, it is always important to keep in mind the *counterfactual*. We can never really see how the case would have played out if the primary explanatory variables, democratization and leader change, would not have been present. However, much can be learned from qualitative analysis when the counterfactual—what the outcome would have been without democratization and leader change—is clearly specified. According to our theory, the outcome without democratization and leader change would have been the following:

1. Croatia and South Africa would *not* have engaged in PTA negotiations.
2. Croatia and South would *not* have tried to implement extensive microeconomic liberalization.

3. Even if Croatia and South Africa had tried to liberalize, they would have largely failed due to domestic political opposition and a lack of credible commitment.

These counterfactuals guide our inquiry by focusing our attention to the causal relationship between democratization, leader change, PTA negotiations, and finally, reform.

To complement these two case studies, in the next chapter we examine PTA negotiations and reform in Chile and Colombia. In these case studies, we see leader changes without democratization: both Chile and Colombia were already established democracies when they negotiated a PTA with the European Union (Chile) and the United States (Chile, Colombia). Since our general theory leaves open the possibility that the demand for reform arises from reasons other than democratization, these two case studies allow us to examine whether our argument can also shed light on why non-transitional democracies engage in PTA negotiations with the European Union or the United States. Even in the absence of democratization, our theory points to the importance of political opposition and the leader's lack of credibility. By relaxing the democratization requirement and maintaining a sharp focus on new leaders, we can investigate the explanatory power of the more general form of our theory. We will return to these cases in the next chapter.

We begin by presenting the Croatian case, emphasizing in particular the role of the EU PTA in Croatia's long overdue liberalization. In this case, the politically (civil war and authoritarian rule) and economically (poor economic performance and mis-governance) tumultuous 1990s resulted in democratization, but the new democratic government faced considerable obstacles to liberalization. An EU PTA allowed the government to push through key reforms, and only a few years later, Croatia was among the most successful economies in the Balkans.

We then present the South African case, with an emphasis on the simultaneous importance and difficulty of liberalization during President Nelson Mandela's rule in the post-apartheid era. Due to the black majority's political empowerment upon democratization, the new government's main challenge was to redistribute while liberalizing to generate economic growth. However, the Mandela cabinet was inexperienced and faced domestic political opposition to liberalization. The EU PTA allowed Mandela to enhance his credibility while distributing gains to important constituencies, such as agricultural exporters. In introducing each case, we will summarize the most important features in a table. Table 7.1 reports relevant information for the sitting presidents of Croatia and South Africa in the time period under discussion.

Table 7.1. CROATIA AND SOUTH AFRICA: SITTING PRESIDENTS AND THEIR RESPECTIVE PARTIES

	President	Year of Election	Partisanship	Parties in the Government	% of votes
Croatia	Stjepan Mesić	2000	Left	Croatian People's Party, Croatian Peasant Party, Liberal Party, Istrian Democratic Assembly	56
South Africa	Nelson Mandela	1994	Left	African National Congress, South African Communist Party (SACP), Congress of South African Trade Unions (COSATU)	62.7

CROATIA: REFORMING FOR EUROPE

When the Socialist Federal Republic of Yugoslavia disintegrated in 1992 amid a civil war, Franjo Tuđman had been president for two years. Until December 10, 1999, the day of President Tuđman's death, Croatia was an authoritarian country. At that time, Croatia finally became a parliamentary democracy. But, democratization was not easy for Croatia: nationalist fundamentalism, serious economic hardship, and the legacy of a bloody internal conflict cast a dark shadow on the young democracy's future.

Things turned around in Croatia soon after Tuđman's death. After a decade of stupendous economic growth beginning at the turn of the millennium, Croatia was a stalwart among the Balkan countries. Ready to join the European Union, Croatia's economic and political reforms were a genuine success story. How was Croatia able to transform itself from a stagnating dictatorship into an economically prosperous liberal democracy? In this case study, we show that the Stabilization and Association Agreement with the European Union, a PTA model specifically designed for the Balkans, was an instrument to carry out important reforms. The negotiations began in February 2000, the treaty was signed in October 2001, and the treaty entered into force in February 2005. In the meantime, Croatia also submitted an official application for EU membership on February 21, 2003.

We found strong evidence that the EU PTA promoted privatization, capital liberalization, and liberal regulations on FDI. We show that these reforms were opposed by key interest groups, especially a politically sponsored class of new entrepreneurs, who benefited from the nepotistic privatization implemented by Tuđman in the 1990s. Moreover, we show that the decision of forming a PTA was strategically taken by the newly elected Croatian government, which could only rely on a highly fractionalized majority and was under pressure to reform a deeply troubled economy. In exploring this case, we rely upon primary and secondary sources. Moreover, we interviewed two Croatian economists for additional qualitative insight into the case.

While we found much of evidence for the importance of economic liberalization, we found little evidence that gaining access to the EU market was the main goal of Croatia's government. This was because Croatia was already enjoying privileged market access to the European Union since the 1990s. Table 7.2 summarizes the main results provided by this case study.

Demand for Reform

There is a broad consensus that the year 2000 represented a turning point for Croatia (Bicanic and Franicevic, 2003; Ivan and Iov, 2010). The change for the better began with the parliamentary and presidential elections held in February of that year. The Croatian Democratic Union Party (HDZ) came to power, along with a new coalition government ruled by Ivica Račan, leader of the Social Democratic Party (SDP). Elections brought two major novelties in Croatian politics. First, for the first time in the history of this state, a coalition government led Croatia. Second, Stjepan "Stipe" Mesić's election to the presidency was a rupture with the past regime, since he was a longtime opponent of Tuđman, having left his party in 1994. Moroever, Mesić's political record left no doubt that he was a committed "democratic reformer" (Vlahutin, 2004, 24). For instance, Mesić had often criticized the former president for failing to implement serious policies of privatization in the late 1990s.[1]

The main reforms that the new president and the prime minister implemented were the following: (i) bringing Croatia into the NATO Partnership for Peace; (ii) ending political harassment of the media; (iii) suspending financial aid to Croatian separatists in Herzegovina; (iv) cooperation with the Hague International Criminal Tribunal for Former Yugoslavia; and (v) launching economic reforms, with a particular focus on decentralization and administrative reform.

Why was Croatia's government under pressure to reform? Although each reform has a specific rationale and a specific goal, the economic crisis that hit Croatia in the late 1990s was the main reason that drastic economic reforms

Table 7.2. SUMMARY OF FINDINGS: CROATIA

	New Leader	Democratization	Economic Crisis	
Demand for reform	Mesić promised economic and political reform as a sign of discontinuity from Tuđman's era	Civil war, nepotism, corruption during Tuđman's era: public expectations for improved governance	Low consumer demand, low industrial production	
	New Leader	Divided Government	Previous Reform	Specific Problems
Difficulty of reform	Mesić's lack of experience and credibility	High government fractionalization with six parties in the coalition, new leader's lack of reputation	Failed record of previous reform due to lack of transparency and of a politicized bureaucracy	Low inter-regional and inter-institutional cooperation due to large regional diversity, ethnic fragmentation, war
	Reform	Credible Commitment	Side Payment	
Role of PTA	Privatization capital account FDI protection	218-page long treaty, 21 chapters, provisions regulating investment, services, and IPRs	Aid (CARDS program) and FDI from the EU	

need to be implemented. The crisis did not involve only the real economy, but also the banking system. As Čučković (2002) writes, several important banks—Dubrovnik Bank (Banka Dubrovnik), for instance—experienced a major crisis of solvency in 1997 and 1998. The crisis grew worse by the lack of transparency and openness of the Croatian economy. In particular, Čučković (2002, 232) claims that "the major causes of the banking crisis were the great intertwining of equity an control relations between banks and firms, the owners of the banks being at the very same time their major debtors… several private banks, which had mainly served as private corporate holdings, had to go into bankruptcy for this reason, bringing about a great crisis of solvency in the entire banking system."

Collusion between firms and banks was very much the result of Tuđman's privatization. According to Čučković (2011, 7), the main beneficiaries of privatization process "were not employees and citizens but some expatriate businessmen and selected enterprise managers, a politically sponsored class of new entrepreneurs." This class of new entrepreneurs used its political ties to acquire shares with loans from state-owned banks. Such loans were supposed to be repaid by company profits or by mortgaging company assets. This type of privatization was possible because democratic institutions were weak in the 1990s, and thus were unable to effectively limit political interference with the privatization process.

Politically, the result of this privatization process was the "tycoonization" of the economy and the "development of a rather crony and predatory brand of the Croatia's capitalism in that decade which emerged behind the curtains of war and was directly sponsored by the political elites" (Čučković, 2011, 7–8). Economically, the effect of this close connection between political actors and market actors was the creation of a weak and inefficient economic system.

Difficulty of Reform

In the case of Croatia, reform difficulties have four sources: (i) Mesić's credibility as a new leader; (ii) a fractionalized government; (iii) the failed record of previous reform; (iv) problems generated by the civil war in the 1990s; and (v) ethnic fragmentation. We examine each in turn.

First, in line with our theory, the "new leader" feature should be associated with the difficulty to reform. Is there any evidence of such an association in the case of Mesić? According to Grbesa (2004), Mesić faced a credibility issue as a new president. On the one hand, Mesić was a charismatic leader who personalized Croatian politics as never before, used a very effective language to communicate with the press and voters, and presented himself as a people's leader. On the other hand, Mesić did not have the same political experience and credibility as his main opponent, Dražen Budiša, who was the leader of Croatian Social Liberal Party and was predicted by media to score a landslide victory. Although Mesić was not new to politics, having served as a representative of Croatia on the Yugoslav collective presidency in the 1980s and as speaker of the Croatian Parliament in 1994, Budiša was perceived by the business community as a technocrat, more competent in economic issues than Mesić was (Grbesa, 2004).

Using content analysis on the main Croatian newspapers (i.e., *Jutarnji list, Večernji list*, and *Novi list*) during the electoral campaign, Grbesa (2004, 64) finds that Budiša was more likely to be mentioned as a reliable candidate, "while Mesić was apparently more often referred to as untrustworthy or inconsistent." Conversely, Grbesa (2004, 64) notes that "the communication skills of Stjepan Mesić were assessed positively in 13.6% of cases and negatively in only 2%. On the contrary, negative remarks about Budiša's communication skills were observed in 10.9% of articles compared to extremely low score of positive remarks (0.7%)."

There is another aspect that should be taken into account in relation to Mesić and his new leadership. Mesić could not rely on an organized and loyal party, as he campaigned as "citizen-politician, people's ombudsman: I am one of you and they are the government" (Grbesa, 2004, 68). That was in striking contrast to his main opponent Budiša, who could rely on strong party support and on a solid winning coalition (Grbesa, 2004, 68). Thus, due to this combination of low credibility and weak party support, the new leader Mesić faced large difficulties in his efforts to reform.

Second, as noted earlier, the governing coalition was composed of six parties that had different positions on economic policies and political issues. According to the government fractionalization indicator given in the Dataset of Political Institutions (Beck et al., 2011) ("govfrac"), Croatia scored 0.68 in 2000. These differences among the coalition partners led to internal conflicts, blackmailing, deliberate politicization of particular reform policies, and ultimately, frequent deadlock in the decision-making process.

For instance, according to Čučković, while there was a general consensus on reform among the government parties, the Peasant Party, which was a single-issue party and represented narrow agricultural interests, "often opposed the process of liberalization."[2] In addition, the opposition party, which was more cohesive than the governing coalition, was able to capitalize on the governing coalition's difficulties. Therefore, it is not surprising that the government lost public support and that there was a feeling of missed opportunities for change among voters (Bicanic and Franicevic, 2003).

Third, and probably most important, Croatia also had a record of failed reform. The Tuđman era was disappointing in terms of policy changes. As discussed above, privatization was used as an instrument of patronage rather than as a tool for opening the market and boosting economic growth. The aforementioned "tycoonization" of the Croatian economy was a serious obstacle to reform. On the one hand, according to Čučković (2011, 8), the "tycoon class" of political entrepreneurs represented "a vested interest in resisting and blocking additional democratic and economic reforms." Čučković confirmed this claim also in the interview: "tycoons were against liberalization and reform because they were afraid of losing market power."[3] On the other hand, since privatization was implemented in a cronyist fashion, there was an "exceptionally unfavorable perception of privatization by the broader public" (Čučković, 2011, 8). As Čučković (2002, 234) notes: "the general public perceives the chosen model as unjust and inequitable, because it did not make it possible for all actors to participate in the process under the same conditions. This has undermined the economic, social and public legitimacy of the model." As a consequence of this, Račan's government had to invest in neutralizing the unpopularity of the privatization process through official audits and by combating illegal and criminal privatization cases.

Fourth, the war fought within Croatia's borders in the 1990s made reforms difficult to implement. Indeed, the failure of reform in the 1990s can also be explained by the loss of material resources and human lives caused by the war (Ivan and Iov, 2010). The conflict slowed down economic growth, destroyed infrastructure, and caused a capital flight from the country (Moore and Vamvakidis, 2007). This limited the government's room to maneuver.

Fifth, Croatia is a country in which inter-regional and inter-institutional cooperation remained minimal for decades. Trust between state institutions and private economic agents has always been low in the region, and the war in the 1990s did not help to improve things. In such an environment, economic reform—especially decentralization policies that require the introduction of principles of subsidiarity and solidarity—are difficult to achieve. As Ivan and Iov (2010, 107) summarize, "the idea of cooperating in order to find solutions to similar problems has no tradition here [Croatia], and this affects a lot of fields such as the environmental domain, transport infrastructure, energy or social problems." In sum, although the will to reform was genuine and reform was necessary to re-launch a sluggish economy, the difficulties that had to be overcome were large and were deeply rooted in History.

Croatia's Reforms in a New Millennium

For the purpose of this study, economic reform is the most interesting policy change implemented by the new Croatian leaders, and we will therefore focus on that. The administrative reform aimed to improve both the structure and the functionality of the public administration. In particular, as Koprić (2001, 8) argues, reform was inspired by market principles and was aimed at "transposing the values, practices and instruments from the private sector management into the public sector management." Practically speaking, that meant "an active involvement of the citizens in the public administration field, the promotion of transparency, efficiency and coherence in taking applicable and responsible measures"(Ivan and Iov, 2010, 100). The final goal of the reform was the simultaneous achievement of modernization and Europeanization. Europeanization, in particular, implied reaching EU standards on transparency, decentralization, and policy coordination.

Decentralization is another important reform that the new leadership implemented (Ivan and Iov, 2010, 101–105). The amendments made to the Constitution in April 2001 (articles 66–71) created the necessary conditions for starting the decentralization process. In 2001, the Croatian Constitution was amended in several ways, including the introduction of the principles of subsidiarity and solidarity, as well as the introduction of the principles of local and regional self-government. Moreover, in June 2001 the Law on Local and Regional Self-Government transferred some competencies from the central public administration to the regional and local public administration. The decentralization process concerned crucial sectors such as education, health, social protection, urban affairs, and infrastructure.

Finally, the decentralization process had an impact on economic development policy. As Fröhlich (2006, 5) notes, Croatian decentralization was "composed of a set of governmental measures targeting the economic growth support and the improvement of life conditions by improving the local and regional potential." Such development policies tried to achieve three main goals: (i) diminishing the development inequalities among regions; (ii) homogenizing policies in different sectors at a regional level; and (iii) stimulating inter-regional cooperation, focusing on long-term socioeconomic development. Although the Commission (2007) on the progresses made by Croatia on the public administration and decentralization highlighted inefficiencies and inadequate organization, scholars agree that Croatia has been by far the most successful country in the Western Balkans to implement free-market reform (Massari, 2005).[4]

Among the reforms that we explored in the empirical analysis, privatization was a priority in Račan's agenda. In their detailed overview of policy changes implemented during the 2000s, Čučković, Jurlin, and Vučković (2011) argue that the privatization of public utilities and of the Croatian oil and gas company INA was among the most important and controversial reforms. The privatization of public utilities in Croatia began with Croatian Telecom Privatization Act in 1999. Specifically, the government sold 35 percent of the state company's assets to Deutsche Telecom. However, only two years later, the Parliament adopted amendments to the Croatian Telecom Privatization Act (2001) allowing the sale of an additional 16 percent. As such, Deutsche Telecom gained a majority stake (51 percent) of the company in 2001. As Čučković, Jurlin, and Vučković (2011, 13) notes, "this could be considered as a turning point with regard to ownership transformation which had a substantial effect on the corporate governance and business performance of the company in the post-privatization period. It is worth mentioning that HT is still the only privatized public utility company in Croatia with dominant foreign ownership."

The Parliament began the privatization of INA by enacting the Law on Privatization in April 2002. The Law allowed the sale of the first 25 percent plus one share to a foreign investor. This privatization was not easy to implement since INA historically had been under the heavy influence of politicians who used to appoint the top management (Čučković, Jurlin, and Vučković, 2011, 31–32). Indeed, as Čučković, Jurlin, and Vučković (2011, 32) note, "it [INA] was often used as a 'cash machine' for government and the ruling party, the HDZ. Such a situation in turn affected the privatization plans, which as shown above were much delayed, compared to the CEE transition countries." Why was this privatization necessary? In addition to the labor productivity gains, Čučković, Jurlin, and Vučković (2011, 38) argue that "one of the important motivations for privatization and bringing in a strategic foreign investor was the need for advancing capital investments in both exploiting and refining of oil and gas in order to keep up with the competition on the market."

Another important reform concerns the implementation of strict regulations to attract FDI. Two Croatian economists interviewed by the authors in January 2012 confirmed that FDI liberalization, in general, and services liberalization, in particular, were a priority of Račan's government. Unsurprisingly, such liberalization met with opposition.

As mentioned in Chapter 4, Ana-Maria Boromisa, Croatian economist at IMO, argued in the interview that there was strong opposition from some industrial interest groups to allowing inflows of FDI to Croatia. The aforementioned populist slogan "you sold Croatia to foreigners" demonstrates effectively the difficulties to open Croatia economy to foreign investors.[5]

Finally, the government had to attract capital to bolster economic growth and to make Croatian companies internationally competitive. This reform was particularly necessary given the highly corrupted process of privatization carried out by Tuđman in the 1990s and discussed above. Indeed, as Čučković (2002, 232) points out, "the new private property elite mainly arrived at substantial or even dominant holdings in the market without any capital, according to the discretionary decisions of the powerful political elite of the former government and via opaque and irregular (often criminal too) takeovers of privatized firms." As mentioned, these bad policies were responsible for the stagnant economic growth of the last part of the 1990s. Račan's government implemented important policy changes also in this regard. As Šonje (2004) writes, in a very detailed overview of the financial system, Croatia improved both the banking sector and the financial sector during the 2000s, though it still lags behind in the area of capital market and openness to international financial flows.

The Role of the Preferential Trading Agreement

Did the EU PTA promote these reforms? Several scholars argue that the PTA with the European Union was a crucial tool to overcome the aforementioned domestic obstacles and to implement policy changes (Bicanic and Franicevic, 2003; Ivan and Iov, 2010). For example, according to Vlahutin (2004, 26), the PTA was a "tool for preventing conflicts and as a catalyst in the transition and development process which contained everything from democracy consolidation activities to economic reforms." Although part of the agreement was dedicated to stabilization issues and post-conflict situation management such as economic reconstruction, many provisions were included in the PTA deal regarding trade liberalization, pro-market regulations, regulations improving transparency, and rule of law.

Interviews with Croatian experts clarify the importance of political versus economic goals. In forming a PTA with Croatia, Čučković argues, the European Union was mainly interested in political conditionality. Specifically, the European Union required the following from Croatia: (i) solving the refugee problem; (ii) cooperation with the International Court of Justice;

(iii) media freedom; and (iv) better neighbor relations.[6] Conversely, Croatia was mainly interested in economic issues, and reforms in particular. In line with the other cases, in the aforementioned interview Čučković confirms that the timing of the negotiations was crucial for Croatia. Put simply, the Croatian government used the EU PTA to implement reforms that would have otherwise been implemented only much later.

The PTA is a 218-page-long document with 21 chapters. The depth of the PTA, as measured in the Dür et al. (2014) data set, scores 0.39, a standard deviation above the mean of the PTAs signed since 1990. For instance, the PTA includes provisions that set a strict deadline for acceding to multilateral conventions on IPR protection, such as the Rome Convention, the Paris Convention, and the Bern Convention. Moreover, the chapter on government procurement contains several provisions that go beyond the WTO. Furthermore, the PTA explicitly mentions that provisions on dispute resolution are binding and that sanctions in case of non-implementation can be applied. The only sector that the EU PTA does not regulate strictly is investment, as the European Commission lacked the official competence to regulate investment issues prior to the Treaty of Lisbon.

To answers the question of which specific reforms the EU PTA enabled in Croatia, interviews are again useful. First, regarding market access in the EU, Boromisa argues that "there was a general consensus that the PTA was not particularly helpful for Croatia. Indeed, Croatia was already enjoying unilateral (asymmetric) market access to the European Union without facing the competition of EU products. Indeed, the PTA forced Croatia to reduce its tariffs and to allow EU products to the Croatian market. The real deal for Croatia was trade-related sectors and the reform coming from these sectors."[7]

Second, Čučković argues that many sectors were affected by the PTA with the EU. In particular, according to Čučković, the PTA produced reforms in the following sectors: (i) regulations on FDI protection; (ii) the financial market, in general, and capital liberalization, in particular; (iii) privatization of the banking sector; (iv) labor market; (v) liberalization of the shipbuilding industry.[8] The first three reforms are clearly related to the indicators used in the empirical analysis. The importance of the Croatia-EU PTA for some specific sectors is confirmed by other authors. According to Šonje (2004, 81), "four years after the signing of the SAA, Croatia has to enable free portfolio investment and transactions relating to financial loans in a period of up to one year. The other conditions are already met in Croatia (convertibility on current account, freedom of direct foreign investment, free commercial loan transactions with a maturity period of longer than a year)."[9]

The previous two paragraphs highlight the importance of the credible commitments that the EU-Croatia PTA enabled. Is there evidence of domestic side payments from the agreement? Consider, first, European foreign aid to Croatia. Aid allocated by the European Union increased from US$31,520,000 to US$74,890,000 in the five years following the signature of the PTA. As in the case of Chile, aid allocation was targeted in those sectors that were directly regulated by the agreement, such as trade liberalization and the provision of social services.

For instance, through the Community Assistance for Reconstruction, Development and Stabilisation (CARDS) program, approved by the European Commission in 2000, Croatia received EUR 262 million. Between 2001 and 2004, the funds were invested to implement economic reforms, to bolster economic growth, and to promote sustainable development in different political and economic areas. In 2003 alone, "almost 1.5 million euro were invested through the CARDS program for the implementation of the decentralization process of the public administration in Croatia, with special attention to improving the quality of the public services at the local level" (Ivan and Iov, 2010, 103).

The Croatian experts interviewed by the authors confirmed that the European Union allocated aid and gave technical support to the Croatian government as direct consequence of the formation of the PTA. Boromisa confirmed that "the EU provided technical support as well as financial support to implement economic reforms, especially in the public administration."[10] Moreover, according to Boromisa, "the PTA gave the opportunity to obtain some guidelines on how to implement these reforms. For instance, which reform needed to be implemented was clear, but the sequence of these reforms was not. This was an important know-how received from the EU." Finally, Boromisa acknowledged that also the World Bank played an important role in providing financial and technical support to the Croatian government.

Let us now explore the role of FDI. The inflow of FDI from EU countries to Croatia increased substantially in the last decade. For instance, FDI from Italy was three times higher in 2003 than in 2000, whereas FDI from the UK doubled from 2001 to 2003. Finally, Croatia also experienced a large inflow of FDI from the rest of the word. Indeed, total FDI inflows to Croatia were almost five times as high in 2005 as in 2000. This increase is larger than the one experienced by Slovenia, which already had joined the European Union in 2004—a unique economic success story in the Balkans.[11]

What were the interests of the European Union in forming a PTA with Croatia? A first set of interests are related to trade. In 2007, EU-Croatia trade was at EUR 418.2 million. EU exports to Croatia reached EUR 13.2 billion

(38 percent of GDP). The exports were primarily composed of industrial goods (62.8 percent), including principally machinery (18 percent), textiles products (8.2 percent), transportation equipment (5.1 percent), and chemical products (8.6 percent).[12] Trade relations are particularly important the neighboring EU countries, such as Austria, Germany, and Italy. Moreover, there are geo-strategic interests that led Brussels to form a PTA with Croatia. Indeed, the PTA was intended also to stabilize this country after the war that took place in the 1990s (Papadimitriou, 2001). The European Union acted in concert with NATO's Partnership for Peace to stabilize the Balkans in the early 2000s (Massari, 2005). The PTA was an integral part of a broader foreign policy strategy that dealt with the repatriation of refugees and other problems in the southeastern part of Europe (Ivan and Iov, 2010, 97).

In addition to emphasizing the importance of the EU PTA, the experts interviewed confirmed that the accession to the WTO also played an important role in helping the Croatian government to implement economic reforms. However, Croatia accessed the WTO on November 30, 2000. The negotiations for entering the WTO already had begun in the second half of the 1990s, during a time at which Croatia's record of reform was quite unimpressive. Of course, we need to acknowledge that in forming a PTA with the EU, Croatia's ultimate goal was to gain access to the EU. When interviewed, Boromisa argued that there was general consensus that Croatia could enter into the European Union with Bulgaria and Romania, since Croatian macroeconomic indicators were better than those of the other two countries. Other scholars do not seem to share this view, however. For one, Čučković (2002, 2–3) claims that:

> continued regional instability in [the] Western Balkans especially in the 1990s (Bosnia, Federal Republic of Yugoslavia, Macedonia) which was protracted even to present days (Serbia, Kosovo) further contributed to Croatia lagging behind the most of CEE countries in terms of transition and integration.... Most of the international and independent domestic analysts... considered Croatia as a fragile and not fully consolidated democracy.

In any case, both Croatian experts we interviewed acknowledge that the formation of the PTA with the European Union was a crucial stepping-stone. Moreover, Riegert (2011, 1–2), a representative of the European Union to Croatia, acknowledged that the PTA

> provided the framework for political dialogue, promotion of trade and economic relations, and a mechanism for the implementation, management and monitoring of socioeconomic 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.

Indeed Croatia became the 28th member of the European Union on July 1, 2013.[13]

To summarize, the Croatian case is consistent with our theoretical expectations. The combination of democratization and leader change created a situation wherein the new government was under heavy pressure to reform, not least due to the Croatian people's preference for EU membership, but the new leader's fractionalized government was not in a position to force major microeconomic liberalization. The EU PTA enhanced the government's credibility and created domestic side payments through the provision of European foreign aid and increased FDI. In a few years, a country troubled in the 1990s by a civil war and a corrupt dictatorship became one of the great Balkan success stories.

SOUTH AFRICA: FROM APARTHEID AND AUTARKY TO THE WORLD ECONOMY

From the 1948 enactment of apartheid laws to the referendum in March 1992 that dismantled them, South Africa's political system was based on the ideology of apartheid, or the rule of a white minority over a black majority. In the 1994 general elections, South Africans elected their parliament under universal adult suffrage for the first time. The African National Congress (ANC) won the election, and Nelson Mandela became the first black president of South Africa. This historical event, matched with the democratization and reconciliation process that took place at the end of the 1990s, was unprecedented and transformed the richest and most important African economy into a modern democratic state.

Nelson Mandela embodied all the novelties and hopes of the new era. A man who spent more than 27 years in the South African jails (prisoner number 466/64), and who was a living symbol for the black community, came into power at the age of 76. Mandela's comrades, who shared with him imprisonment or exile during apartheid, became ministries, members of the cabinet, and trade unions leaders. It is safe to claim that in no other country the turnover from a political leadership to another one was more radical and dramatic than in South Africa.

While South Africa and the rest of the world celebrated the historical event, Mandela's newly elected government faced a difficult challenge. South Africa had been economically stagnant for a decade, and the newly empowered black majority demanded immediate action to improve its miserable living conditions. This combination of economic stagnation and demand for redistribution presented a difficult dilemma: "was there a way in which growth and redistribution in South Africa could complement each other" (Hirsch, 2005, 1)?

In this section, we show that President Mandela's government was able to exploit PTA negotiations with the European Union to promote economic reform in South Africa. In particular, the case provides evidence for the importance of credibility: from the very beginning, Mandela's government suffered from a troubling lack of reputation for competent and committed liberalization. The road from an illegal resistance movement to a successful economic reformer was a rocky one, and external commitments to a demanding liberalization schedule were helpful in this regard. Thus, our case again shows the combined effect of democratization and leader change: while the political empowerment of the black majority created demand for redistribution and the dismantling of policies that favored the white minority, Mandela's new government was not powerful enough to implement its preferred policies.

South Africa engaged in PTA negotiations with the European Union already in September 1995. However, due to disagreements about trade liberalization, the negotiations proved much more difficult than those in our other cases. The PTA was finally signed in Pretoria, South Africa, in October 1999. The full entry into force had to wait until May 1, 2004.

In what follows, we show that while Mandela's government and the European Union disagreed on the trade liberalization schedule, they both had a strong interest in liberalizing South Africa's economy. The EU PTA negotiations allowed Mandela to promote economic reforms that were expected to generate economic growth. The shadow of Europe greatly enhanced the credibility of Mandela's liberalization program, and thus alleviated concerns in South Africa's business community and elsewhere.

The South African case also allows us to situate the role of trade liberalization in a broader context. In our other positive cases, we found little evidence for trade liberalization concerns. This was not so in South Africa, a country that expected large profits from increased agricultural exports to Europe. Interestingly, South Africa's insistence on trade liberalization actually *impeded* the PTA negotiations. In the meantime, South Africa and the European Union were able to agree on a number of economic reforms. Table 7.3 summarizes the results provided in this case study.

Demand for Reform

Nelson Mandela gained power after South Africa's first democratic elections in April 1994. Mandela's party, the ANC, won a landslide victory, receiving almost two-thirds of all votes. Still, Mandela and his government faced daunting economic challenges: severe poverty, extreme income inequality, and economic stagnation. Two economic indicators reported by Hirsch (2005, 2) help summarize the severity of the situation in South Africa. First, the average per capita income of whites was about 9.5 times higher than the average per capita income of Africans. Second, South Africans were on average 15 percent poorer in 1993 than in 1984 due to a 10-year economic crisis. It is hard to imagine an economically less conducive beginning for Mandela's tenure.

In his 100-day speech to Parliament, Mandela listed the priorities of his government: (i) implementing socioeconomic programs to alleviate poverty; (ii) boosting economic growth to create employment; (iii) reforming the institutions to improve the efficiency and effectiveness of governance; and (iv) implementing educational programs to generate human capital.[14] A quote by Faizel Ismail, a leading South African negotiator in the EU talks, clarified the priorities of the first post-apartheid government in the following fashion: "Mandela's man was focused on reconciliation, whereas Mandela's president was focused on economic reform."[15]

We have so far focused on the actions of the head of South Africa. However, the importance of Manuel Trevor and his advisors, Iraj Abedian and Maria Ramos, cannot be overlooked in the case of South African economic reforms.[16] Trevor was trade minister between 1994 and 1996, and he was finance minister between 1996 and 1999. The Growth Employment and Redistribution (GEAR), which was a crucial economic strategy during Mandela's era, came out of the Department of Finance, which became the most powerful ministry in Mandela's government. Importantly, under Trevor's appointment in the late 1990s, such a ministry implemented the most conservative fiscal policies, which irked the left.

Why was the government under pressure to reform? According to Ismail, the main reason was that during the apartheid era, South Africa was isolated by the international community's economic sanctions. Thus, South Africa developed a strategy based on import substitution, which resulted in a near-autarkic economy. According to Ismail, this had a particularly large negative effect, especially on the black majority.

Table 7.3. SUMMARY OF FINDINGS: SOUTH AFRICA

	New Leader	Democratization	Economic Crisis	
Demand for reform	Mandela used economic reform to redistribute resources to the black majority and to end economic isolationism	Relatively smooth democratic transition from apartheid	Stagnant economy for a decade, 1985–1995	
	New Leader	Divided Government	Previous Reform	Specific Problems
Difficulty of reform	Lack of political experience: "young and inexperienced leaders who spent previous years [the 1980s] hidden in the bush" (Ismail interview)	Opposition from the left wing of the government coalition, i.e., COSATU and SACP	No attempt of reforming during apartheid's era, autarkic economy	Skepticism in the international community about Mandela's willingness to reform
	Reform	Credible Commitment	Side Payment	
Role of PTA	Privatization FDI protection tariff reduction	361-page long treaty, 109 articles, provisions regulating investment, services, and IPRs	FDI from the EU and, to a lesser extent, aid from the EU	

Second, Mandela's government needed to use reforms as a leverage to redistribute resources. We find strong evidence that redistribution policies and democratization were closely related issues in the first years in which Mandela was in office. According to Morgenie Pillay, deputy director of International Trade in Services at the Department of Trade and Industry, redistribution policies were heavily demanded by the large black majority.[17] In this respect, Mandela's government was under heavy political pressure to reduce income inequality at the beginning of his mandate. Moreover, according to Pillay, income redistribution was one of the main electoral pledges made by Mandela's party. Finally, Pillay claims that, for some politicians, income redistribution was an ideological and normative issue that allowed them to clearly leave behind the apartheid era.

Third, the aforementioned economic crisis was a big incentive to reform. According to Alan Hirsch, a leading expert of South Africa's economic reforms, there was a real fear of South Africa losing its sovereignty to the IMF or to global banks if it became too deeply indebted, even though the external debt was relatively low, that is, 5 percent.[18] Finally, there was a fear that mistakes in economic policy could lead to further declines in growth and employment.

Difficulty of Reform

Mandela's government faced two obstacles to liberalization. On the one hand, the market did not believe in the ANC's willingness to implement pro-market policies due to their socialist background and political divisions. This lack of credibility is crucial for our theory since it is directly associated with the presence of a new political leadership replacing the old "white" elites. On the other hand, the left wing of Mandela's governing coalition did not react enthusiastically to the proposed strategy, which was perceived as too unbalanced toward capitalist policies. In particular, the Congress of South Africa Trade Unions (COSATU) and the South Africa Communist Party (SACP) were against reforms and trade liberalization, as confirmed by Pillay in the interview. Let us now analyze both concerns in detail.

First of all, the response of the establishment to ANC's Reconstruction Development Program (RDP) was generally negative. For instance, according to Hirsch (2005, 3), the *Times of London* defined the RDP as a failure and called for changes in the manifesto.[19] An editorial of Johannesburg's *Financial Mail* was titled "The Road to Hell" (Hirsch, 2005, 3). The Democratic Party (DP), which was a centrist, largely white, small party (now called the Democratic Alliance), blamed the ANC's plans as fiscally irresponsible.[20] Because the financial market looked suspiciously at the ANC, as Hirsch (2005, 68–70) notes, Mandela's government "was forced to be more conservative than it would have been had it been the government in a well-established democracy. This was the main reason that the ANC, before and after the elections, publicly committed itself to economic policies that would not antagonize influential world economic players."

The importance of reassuring the market also explains some of the appointments in Mandela's government. For instance, two key economic positions in the new government were assigned to the technocrats who had been appointed by the apartheid government: Chris Stals, the governor of the South African Reserve Bank (SARB) and Derek Keys, the minister of Finance. Moreover, when the latter minister resigned, Mandela replaced him with Chris Liebenberg, a former chief executive of the Nedcor group, one of South Africa's big four banking houses. As we mentioned in Chapter 4, in presenting the new ministry at the conference press, Mandela admitted that the appointment of such a high-profile banker was necessary since "the boys from the stock exchange and elsewhere seem to be very jittery" (Hirsch, 2005, 67). Furthermore, Mandela reassured the financial market that there had been "no change whatsoever in government policy" (Hirsch, 2005, 67).[21]

All these elements suggest that the credibility of Mandela's government was shaky in the beginning. Indeed, Standard and Poor's risk study in July 1998 placed South Africa second riskiest, after Indonesia, on a list of 10 emerging economies.[22] It is also important for our theory to note that this lack of credibility stems from the fact that a completely new political leadership replaced the old "white" elites. Interviews confirm that credibility was indeed a big problem of Mandela's government. We have already mentioned Ismail's claim that "we were young and inexperienced leaders who spent previous years [the 1980s] hidden in the bush. . . the skepticism from the market was understandable." When interviewed, Hirsch notes that although

> the radical left-wing threat was blunted by the early 1990s, compounded by the end of the Soviet empire, the ANC did not have a clear economic policy or a track record of governing, and because most of its supporters had suffered economically under Apartheid. As such, there was a credibility issue. The ANC addressed this though many public and private engagements with business between 1990 and 1994.

Divisions within the government also raised impediments to reform. The GEAR strategy was particularly difficult to accept for the COSATU and for the SACP, as we have already mentioned. Privatization was a particularly controversial issue. Hirsch (2005, 164) reports that Maria Van Driel, leader of the South African Municipal Workers' Union (SAMWU), "portrayed GEAR as a tool of financial capitalists who promote neo-liberal policies to allow them maximum freedom to make profits. . . . Privatization leads to the fragmentation of the working class, and to inferior conditions for workers."

Moreover, both trade unions and the SACP repeatedly accused the GEAR strategy of an overly tight budget. The continuous criticisms of the GEAR strategy from the SACP led Mandela to issue an ultimatum to his coalition parties in 1998. Specifically, at the SACP meeting, Mandela reaffirmed that the program would not be changed, and that the SACP had to either vote for it or leave the government (Hirsch, 2005, 167). Divisions within the coalition were so serious that in a speech at the COSATU meeting, Mbeki asked: "'When we speak of this strategic alliance, are we speaking of something that continues to exist, or are we dreaming dreams of the past?' Does a Congress movement still exist?"[23]

The experts interviewed seem to have different opinions on the magnitude of these conflicting preferences within the government. Hirsch tends to downplay them. Specifically, he claimed that "all parties of the majority favored reform during the [democratic] transition. The IFP favored a kind of Thatcherite free market reform, the PAC supported a more left-wing anti-imperialist redistributive reform, and the ANC was in the middle, between them." Ismail argued that resistances to economic reforms came from trade unions, which were quite powerful and had links with politicians supporting the government. In particular, Ismail claimed that the European Union asked for more privatization than trade unions were willing to accept during the negotiations of the PTA.

This opposition is not negligible, given the fact that there was a desire to involve every sector of South Africa society within the decision-making process in the negotiation of the PTA with the European Union (Levermore, Gibb, and Cleary, 2000, 1). According to Levermore, Gibb, and Cleary (2000, 1), this desire was driven by "the ongoing process of rehabilitating the disadvantaged people of South Africa." Indeed, Ismail told us that through the National Economic, Development and Labour Council (NEDLAC) all businesses, trade unions, and NGOs must be consulted before every reform. Thus, each of these interest groups was in a position to exert influence on economic policy.

Mandela's Reform Record

In the light of Mandela's difficulties, South Africa's reform record is quite impressive. Mandela partook in the Ready to Govern conference in 1992, which established a broad set of policies for the ANC. The RDP was a further iteration of the Ready to Govern report and the election manifesto of ANC. Moreover, the RDP was the socioeconomic policy framework of Mandela's government. The bulk of the program involves tight macroeconomic policies, redistributive programs, and other economic reforms that encouraged investment that would lead to growth and job creation. Trade liberalization had also a crucial role in the RDP, since it was considered very important for economic growth. The RDP was the product of consultations and negotiations with the ANC, COSATU, SACP, and wider elements of the civil society.

The RDP achieved important goals. For instance, 1.1 million new, inexpensive houses were built between 1994 and 2001; 2.5 million people got access to fresh, potable water by 1998; the portion of rural homes with electricity grew from 12 percent to 42 percent. Moreover, the RDP included major economic reforms, such as a land reform (1999), a healthcare reform (1998), and a public works program that employed 240,000 people. Although critics questioned the scope of these policy changes, there is a consensus that the RDP produced a successful transition from the apartheid to democracy—minimizing conflicts, fears, and selfish interests (Waldmeir, 1998; Hirsch, 2005).

Another important part of Mandela's reform portfolio was the GEAR strategy, a plan to show South African commitment to open market, privatization, and a favorable investment climate. Hirsch (2005, 99) summarizes the main elements of the GEAR strategy: (i) reducing the budget deficit; (ii) prudent fiscal policy, anti-inflation policy, and freeing resources for investment; and (iii) tariff reductions to reduce prices of basic goods, compensating partly for exchange rate depreciation. Moreover, the GEAR strategy aimed to bolster coordination of economic policy and implementation within government and among government, businesses, and trade unions.

A crucial element of the GEAR strategy was the emphasis on private investment to stimulate growth and to alleviate poverty (Weeks, 1999). In particular, establishing "a climate for continued investment confidence" (Weeks, 1999, 799) and "a dramatic shift of investment toward the poorest 40 percent" (Weeks, 1999, 798) were viewed as key tools to achieve fast economic growth and development. It is important to stress that GEAR, which focused on free-market policies, was a very different development strategy compared to the RDP, which focused on state-led reconstruction. For one, unlike RDP, GEAR did not mention the reduction of inequality as a policy goal, but rather it focused on decreasing unemployment (Weeks, 1999, 798). That created tension with the left wing of ANC, which perceived GEAR as undermining and replacing (rather than complementing) the RDP.[24]

Two reforms implemented by Mandela's government are familiar to the reader from our statistical analysis: privatization and regulations to protect investment. Mandela's government privatized the South African Airways and railroads, the telephone company, the post service, electric and gas utilities, and the national parks. The only public companies that remained fully controlled by the government were the Armscor weapons manufacturing consortium and the nationwide television network. In addition to bolstering economic growth, the rationale for these privatizations, which were unusual for a former anti-capitalist party like the ANC, was to improve the living conditions for black residents whose neighborhoods were often without electricity and telephone lines.[25]

Regarding regulations to protect investment, the goal was once again not only dictated by the need to speed up economic growth. As Ismail suggested in the interview with us, FDI was expected to benefit the black majority by creating new job opportunities and by raising salaries. For the black majority, attracting FDI was more important than boosting exports through trade liberalization, since exporters belonged usually to the white population during the 1990s. Finally, a reform on capital mobility was also a priority at that stage. During its first years in office, the government feared outflows of capital due to the risk of nationalization perceived by the market, as our interview with Ismail confirmed.

On balance, the results from the GEAR strategy are mixed. In some areas, such as reduction of fiscal deficit, reduction of government consumption, and reduction of inflation, performance exceeded expectations. Conversely, in terms of job growth, the GEAR strategy turned out to be a disappointment: job growth was less than expected, and the jobs created were often found in the informal sector (Hirsch, 2005, 105).[26]

How Important Was the Preferential Trading Agreement?

At this point, it is useful to recall that there are two main reasons that we believe new leaders want to enter into a negotiation for signing a PTA with the European Union or the United States. First, leaders use PTAs to lock in reforms. As such, we will show that the PTA with the European Union was part of a broad reform strategy, which also involved trade liberalization, and included an enforcement mechanism. Second, leaders might use resources gained by PTAs as side payments to mobilize reform supporters or to compensate losers. In what follows, we provide evidence that the PTA with the European Union helps the South African government to achieve both goals. Importantly, every expert interviewed confirmed that the opposition to the PTA with the European Union was substantively less intense than the opposition to some economic reforms.

The evidence shows that the EU PTA played an important role in enabling South Africa's reforms. After five years and 22 negotiation rounds, the European Union and South Africa signed a PTA at the end of 1999. The long negotiation indicates that there were conflicts among parties. The fear of competition from South African wine producers was a big issue for some EU member countries, causing stall in the negotiation. For instance, only after tough bargaining, Portugal and Spain "agreed to drop their long-standing objections to the use of the terms 'sherry' and 'port' by South African fortified wine producers in their domestic market for a further 12 years" (Irving, 1999, 19–20). The long negotiation shows also that the PTA was very ambitious. Alec Erwin, the South African minister of Trade and Industry, proudly referred to the PTA with the European Union as "the most comprehensive economic agreement the country has ever concluded with any other partner" (Irving, 1999, 19).

There is evidence that South Africa tenaciously tried to seal the deal with the European Union throughout the 1990s. As a sign of its strong interest in the PTA, South Africa decided to bargain bilaterally on the PTA with the European Union, leaving other Southern African countries behind (Lewis, 2001). The reason was that South Africa knew that reaching a deal would have been more difficult if surrounding countries had been included in the talks. Indeed, issues related to the agricultural sector would have been difficult to solve if the region's smaller and poorer countries had participated in the bargaining process. This conjecture seems correct if we look at the difficulties faced by the European Union in signing the Economic Partnership Agreements (EPAs) with the African countries. Thus, economic conditions in South Africa were too severe and the stakes were too high for South Africa to include third parties in the negotiations.

The lock-in rationale is confirmed both by previous research and by our interview with Faizel Ismail. Francois, McQueen, and Wignaraja (2005) list the lock-in argument as one of the main rationales of the EU-–South Africa PTA next to improving market access and attracting FDI. Notably, according to Francois, McQueen, and Wignaraja (2005), not every PTA signed by the European Union with developing countries serves the purpose of locking in reform; for example, EU-Turkey PTA did not. According to our interview with Pillay, "the government used the WTO and the PTA with the EU to tie their hands and to sell reforms to political constituencies that were not happy about economic liberalization."

How can we reconcile the long duration of the negotiation with the incentive to lock in reforms? We can start noting that the negotiations were particularly contentious exactly when they were about market access. In particular, when interviewed, Pillay argued that during the negotiations, the most controversial issues were tariff reductions in fisheries, wine, chemicals, and agricultural products, whereas non-trade issues were relatively unproblematic. This suggests that the mutual interest was actually in economic reform.

Two other studies link the PTA with the European Union to the ongoing effort to reform. Rashad (2007, 9) argued that

> in the eyes of many civil servants, South Africa was an economy in transition; therefore its effort to restructure should be supported by an agreement with the EU. . . . The government saw the FTA as an important vehicle through which they could secure better market access, aid for trade and other forms of support. In this sense we may argue that a key pillar of trade mainstreaming was to fit the FTA into a more ample cooperation agreement.

Similarly, Bilal and Laporte (2004, 14) write that

> [a] noteworthy characteristic of the South African experience is that the trade negotiations with the EU were integrated into a more comprehensive trade policy reform process. More importantly, the new trade regime was perceived as only one element (or rather one instrument) of a broader development strategy. This explicit link between trade negotiations and overall development policy played a determinant role in the coherence of the South African approach, in the coordination mechanisms put in place and in the formulation of its policy objectives.[27]

Finally, in an interview on March 8, 2012, Peter Draper, a senior research fellow at the South African Institute of International Affairs, confirmed that the PTA with the European Union was intended to reassure the international community, to gain credibility vis-à-vis international economic actors, and to reintegrate South Africa's economy into the global market. Draper claims that implementing tight macroeconomic policies, agreeing on the commitments from the Uruguay Round, and entering into a negotiation with the European Union were all part of an overarching strategy. Interestingly, Draper mentions that in the second half of the 1990s, South Africa also signed BITs with several developed countries. The goal of these BITs was to reassure investors, especially after the currency crisis in 1996.

The design of the EU–South Africa PTA is the product of this comprehensive approach. As the minister of Trade and Industry noted, the PTA between the European Union and South Africa is a very inclusive agreement. It is a 361-page document, which includes 109 articles and 10 annexes. Moreover, the EU–South Africa PTA is one of the deepest and broadest agreements among the ones signed by the European Union in the 1990s. For instance, it is deeper than the PTAs between the European Union and Slovenia, the European Union and Latvia, and the European Union and Lithuania.

Moreover, the EU–South Africa PTA is substantially deeper than the PTAs signed by the European Union with MENA countries. The scope of the EU–South Africa is also quite broad. For instance, the agreement includes articles on investment (articles 33 and 52) and services (article 63), which is uncommon for PTAs signed by the European Union in the 1990s. Furthermore, the PTA includes a highly legalized dispute settlement mechanism that can issue binding resolutions and apply sanctions. In sum, if Mandela's strategy was to tie its own hands to make reform and privatization more difficult to reverse, the commitments allowed by the EU PTA can hardly be seen as negligible.

According to a leading negotiator whom we interviewed, Section D on competition policy was particularly important for South Africa. It introduces important improvements and changes in regulations related to the ongoing privatization process. The negotiators claimed that "South Africa learnt extensively by the EU in terms of competition policy." This is not surprising since competition is a sector in which EU PTAs are ahead of all the other countries, as we showed in Chapter 4.

In Chapter 2, we have already mentioned Article 35, which states that restrictions on competition and the abuse of market dominance affecting trade between the European Union and South Africa are not compatible with the PTA. Furthermore, parties have to implement the necessary laws and regulations to comply with the competition provisions within a period of three years from the entry into force of the PTA (Article 36). Finally, public aid favoring certain companies or the production of certain goods, which distorts or threatens to distort competition, is not compatible with the PTA (Article 41).

The same negotiator claimed that IPR provisions were first introduced with the EU PTA. Indeed, South Africa did not have any IPR legislation before the end of 1990s, which is unsurprising given that its economy was isolated and heavily protected during the apartheid regime. Both this negotiator and Hirsch confirmed that stricter IPR rules were largely imposed by the European Union and were not seen favorably by South Africa. Therefore, in relation to IPR reform, South Africa is consistent with the other cases.

Regarding the enforcement of the PTA, there is a much evidence that the EU monitored the implementation of the agreement and its compliance. For instance, in the case of competition, "in at least one case, the EU has vetoed a merger approved by the South African Authorities" (Holmes et al., 2005, 106). Moreover, according to two negotiators, monitoring by the EU is continual. As we mentioned in Chapter 2, Wilhelm Smalberger, a South African trade official who was involved in the implementation of the PTA and was interviewed by the authors on February 13, 2012, claimed that there have never been any complaints from the European Union as a result of violations by South Africa. In sum, the implementation of the PTA appears to have been smooth and without tensions between the two partners.

Is there any evidence of domestic side payments from the PTA with the European Union? As intended under GEAR, FDI played an important role in re-launching South Africa economy. In the early 2000s, FDI inflows from virtually every EU country to South Africa grew substantially, making South Africa one of the European Union's top 10 FDI partners.[28] Although Croatia's case highlights the possibility that FDI mobilizes opposition from vested interest groups, Ismail noted that inflows of FDI were expected to create new job opportunities, especially among the black majority.[29] The combination of democratic transition and the need of resource redistribution, which is peculiar to the post-apartheid era, increases the importance of attracting FDI, as Hirsch also acknowledged.[30]

There is another source of domestic side payments that we must discuss. In their detailed analysis on the impact of the EU–South Africa PTA on trade, Kalaba, Sandrey, and van Seventer (2005, 25) show that trade liberalization has been quite asymmetric. Specifically, the European Union liberalized "at a faster pace (three years compared the 12 for South Africa) and with a broader coverage (95 percent of all imports versus the 86 per cent for South Africa)." The European Union lowered tariffs with South Africa particularly in the textile sector from 20–30 percent to 15–20 percent (Kalaba, Sandrey, and van Seventer, 2005, 26). In clothing, EU tariffs decreased from more than 40 percent to 30 percent (Kalaba, Sandrey, and van Seventer, 2005, 26). In the textile, beverages, and sugar sectors, tariffs of EU imports are more than 3 percent lower than the MFN tariffs

(Kalaba, Sandrey, and van Seventer, 2005, 30). Given the importance of these sectors for South Africa's exports, the tariff reductions represent a further evidence of side payment to ease the reform process implemented by Mandela's government.

Though not as important as FDI, a note on foreign aid is also necessary. Since the South African economy was in turmoil at the beginning of the 1990s, the European Union allocated a large amount of aid during the negotiation period rather than after the signature of the agreement as happened with Chile and Croatia. Ismail confirmed that the European Union allocated generous aid and technical assistance both during the negotiations of the PTA and after its signature. This allocation was aimed to alleviate the short-term cost of economic reform.

Specifically, foreign aid from the European Union in 1998 was more than double in 1998 relative to 1994, moving from US$142,100,000 dollars to US$337,000,000 dollars. Although this amount represents a small percentage of South Africa's GDP, this finding is consistent with our theory. Indeed, if aid is used strategically by major powers to alleviate the costs of compliance and cooperation, the timing of such an allocation is also strategic and is tailored to trade partner needs. Regarding sectoral aid allocation, it is interesting to note that inflows of aid supporting privatization doubled from 1995 to 1996, moving from US$5,965,573 to US$11,300,000. Article 40 in the aforementioned Section D explicitly states that the EU provides technical assistance to facilitate South Africa's compliance with the competition policy provisions.

What were the interests of the European Union in forming a PTA with South Africa? First of all, the European Union aimed to gain direct access to the South African market and indirect access to the South Africa Custom Union (SACU) market as a result of the porous regional borders (Lee, 2010). This access was crucial to secure the European Union's dominant position in the most important African economy against economic competition from the United States and Japan. According to a study by Eurostep (2000), "South Africa will expand duty-free access to its market by 24 percent for EU industrial products and by 47 percent for EU agricultural products." Such a strategy is perfectly in line with the argument that explains the proliferation of PTAs as a function of the competition among countries over foreign markets.

Moreover, the PTA with South Africa provided a model for a post-Lomé arrangement (Commission, 1999). This model was particularly important since the European Union was planning to start negotiating the aforementioned EPAs with African countries. Finally, the EU–South Africa PTA was meant to forge a close political relationship with the main actor in Africa, especially during South Africa's delicate transition to democracy and to the post-apartheid era.

The EU–South Africa PTA seems to confirm our argument that PTAs with the European Union and/or the United States can be strategically used by leaders to lock in reforms that are difficult to implement. However, South Africa is also a unique case due to the shadow of the previous apartheid regime. Thus, there are other confounding factors that have to be accounted for in the analysis.

First, compared to the cases analyzed previously, trade liberalization placed an important role in the EU–South Africa PTA. This is confirmed both by previous research and the experts interviewed. In Hirsch's own words, "our main motivation for the EU agreement was to improve access to the EU market where we expected investment and job creation." Other negotiators seem more cautious in presenting market access as South Africa's main goal. For instance, João de Deus Rogado Salvador Pinheiro, EU commissioner in charge of Relations with African, Caribbean, and Pacific countries in the 1990s, argued that "*the main area of concern for exporters in Southern Africa is therefore not their access to the EU market, which will remain favorable, but their access to the South African or rather SACU market*" (Sudworth and Van Hove, 1998, 10).[31] As already mentioned, Ismail argued that attracting FDI also was a crucial goal for South Africa. Moreover, both Ismail and Smalberger claimed that market access served mainly to level the playing field with competitors. While there is debate whether gaining market access was the main goal or one of the goals, we cannot neglect trade liberalization in the case of the EU–South Africa PTA.

Second, while there is evidence that the EU–South Africa PTA was used as a tool to lock in reform, we also need to acknowledge the role of the WTO. According to Hirsch, the Uruguay Round of the GATT was very important in gaining credibility for South Africa's trade reform agenda. Hirsch claimed that "South Africa developed a genuine and far reaching multilateral trade reform agenda in the early 1990s, and stuck to it through the 1990s and 2000s." Pillay confirmed that the role of the WTO was as important as the role of the PTA with the European Union. In particular, Pillay argues that access to the WTO served to reassure the market that Mandela's government was not doing anything wrong and that it was serious about reforms. This is also why South Africa committed to larger trade liberalization than other developing countries during the Uruguay round, explained Pillay in the interview.

This finding is consistent with our theory that the combined effect of different international institutions can increase the probability that countries successfully carry out large economic reforms. In the case of South

Africa, the seriousness of the economic crisis, the problematic experience of apartheid, and the ongoing democratic transition required multiple international institutions (i.e., IMF, WTO, and EU–South Africa PTA) to enter into a new stage of development.

Although Croatia and South Africa are very different countries, the two cases show similar patterns. In both countries new reform-minded leaders were under pressure to implement policy changes because of an ongoing democratization process. However, both leaders faced an opposition, which was often internal to the coalition government. For Croatia such opposition stemmed from a fragmented government with several parties in power. For South Africa such opposition arose from the presence of a government of national unity, in which the Communist Party was a member. In both cases, the political leaders formed a PTA with the European Union to implement and lock in reforms promised during their electoral campaign and demanded by a large part of the population.

CHAPTER 8

Agreements and Reforms Without Democratization: Chile and Colombia

The previous chapter explored the process of reform and the role of PTAs in two important cases: Croatia and South Africa. Since both countries experienced both democratization and leader change during the period under investigation, Croatia and South Africa were ideal cases for verifying the relevance of the causal mechanisms we posited in our theory. Had we found scarce or no evidence of such causal mechanisms, the cases would have raised serious concerns about the valyidity of our theory. Given that there is clear evidence that PTAs helped political leaders implement important reforms, the cases alleviated this concern.

While this exploration of causal mechanisms is useful, qualitative analysis allows us to test our theory even more systematically. According to our theory, a key reason that developing countries engage in PTA negotiations is the coexistence of reform demand and political obstacles to liberalization. While democratization is a key reason that there is domestic demand for reform, such demand could also exist for other reasons. In this chapter, we examine two important cases in which PTA negotiations ensued following leader change in *established democracies*: Chile and Colombia. We will show that demand for reform was present in these countries even without democratization, which shows that our theory can also account for PTA negotiations outside democratizing countries.

We begin with the case of Chile, with a particular emphasis on Ricardo Lagos's difficulties in implementing economic reforms. Although Chile was an established and relatively liberal democracy during Lagos's era, the stalling of liberalization in the late 1990s, which coincided with poor economic performance, created domestic demand for more ambitious reforms. As the first socialist leader of Chile after Salvador Allende, Lagos and his badly fractionalized government faced considerably difficulties in implementing such reforms. The PTAs with the European Union and the United States allowed Lagos to considerably increase the speed of liberalization, while also enhancing the credibility of the reforms.

We then present the Colombian case, with an emphasis on the country's political instability (reform difficulty) and economic problems (reform demand). Inaugurated in 2002, Alvaro Uribe was the first successful independent presidential candidate in Colombia's history. His electoral pledges focused on improving political security and economic performance, as well as attracting more FDI. However, Uribe lacked a strong support base for reforms within his party, which suffered from a lack of institutionalization and political fragmentation. The PTA with the United States helped Uribe to implement important reforms that leftist constituencies, and even the Colombian Central Bank, opposed.

In both countries, we find that the national leader also used the PTA to reassure the markets. In the case of Chile, investors were uneasy because Lagos was a socialist and some parliamentarians supporting his government held radical leftist views on a range of economic policies. Conversely, in the case of Colombia, markets needed to be reassured because of the ongoing civil war between the military, the guerrilla movement Revolutionary Armed Forces of Colombia–People's Army (FARC), and the drug cartels. Thus, in addition to the direct effect of specific PTA provisions on economic reform, treaties with the European Union and the United States had an important indirect effect on reform in Chile and Colombia. Reassuring the market and attracting foreign investment provided Presidents Lagos in Chile and Uribe in Colombia with new leverage against domestic opposition, allowing the lock in of initially unpopular reforms. The resources used as side payments came both in the form of direct assistance, such as foreign aid, and from the renewed market confidence in these two countries.

As in the previous chapter, we will summarize the most important features of each case in a table. Table 8.1 reports relevant information of the sitting presidents for Chile and Colombia in the time period under discussion.

CHILE: LOCKING IN A SUCCESS STORY

Chile has a reputation of being one of Latin America's economic stalwarts. During Augusto Pinochet's authoritarian rule, Chile had started to liberalize its economy, though in a way that clearly favored the dictator's most loyal supporters (Schamis, 1999). Pressures for democratization

Table 8.1. CHILE AND COLOMBIA: SITTING PRESIDENTS AND THEIR RESPECTIVE PARTIES

Country President	Year of Election	Partisanship	Parties in the Government	% of votes
Chile Ricardo Froilán Lagos Escobar	2000	Left	Christian Democratic Party, Socialist Party, and Radical Party	51.3
Colombia Álvaro Uribe Vélez	2002	Right	Colombia First and Colombian Conservative Party	53

led Pinochet's government to allow political parties in 1987, and by 1990 Pinochet had transferred power to a democratically elected government. Chile's democratic rulers now faced a formidable challenge: how to implement economic reforms to benefit the Chilean people, thus allowing the reform-minded incumbent government to win the next elections.

Without doubt, important reforms had been implemented in the 1990s. Import duties were unilaterally reduced from a uniform tariff of 15 percent to 11 percent during the Aylwin administration (Chumacero et al., 2005, 11). Since 1994, President Eduardo Frei's government expanded the role of the private sector and implemented an aggressive program to give concessions for public infrastructure works to private contractors (Chumacero et al., 2005, 12–13). Moreover, Frei's government implemented an important fiscal reform to reduce public sector debt (Chumacero et al., 2005, 14) and an ambitious labor market reform to extend social rights, linked to the process of democratization (Haagh, 2002).

By the year 2000, Chile had made considerable progress in economic liberalization, but much remained to be done. This section tells the story of how Chile was able to implement and lock in crucial "second generation" reforms that ushered in an era of rapid economic growth, improved the country's international reputation, and gave higher living standards to the Chilean people. We show that Chile's president for the 2000–2006 period, Ricardo Lagos, engaged in PTA negotiations with the European Union and the United States to implemented and lock in a variety of economic reforms that would have been difficult to implement without external assistance. The EU-Chile negotiations began in April 2000, and the treaty was signed in November 2002. The US-Chile negotiations started in November 2000, and the agreement was signed in June 2003. Both treaties entered into force less than a year after signature.[1]

Of the cases studied in this book, Chile is probably the most unqualified success story. We show that the two PTAs with the European Union and the United States were instruments to both lock in previous reforms and to carry out reforms—capital liberalization, for instance—opposed by key interest groups. We find that the decision to form the PTAs was strategically taken by President Lagos, who could only rely on a highly fractionalized parliamentary majority but was under tremendous pressure to improve a sluggish economy. In contrast, we find little evidence that Chile's PTA negotiations were driven by the need to expand market access to the European Union and the United States. As Weintraub (2004, 91) notes, tariffs reductions played a secondary role in Chile's PTAs because the tariffs were not high to begin with. However, we do find that US companies were interested in accessing the service sector in Chile.

We begin by demonstrating that Lagos had good reasons to reform. Next, we explain why reform was difficult for Lagos. Finally, we show that the EU and the US PTAs played an important role in promoting economic reform in Chile. Throughout, we rely on both primary and secondary sources, as well as interviews with five Chilean negotiators. Table 8.2 summarizes the main results of the case study.

Demand for Reform

According to our theory, leaders who prefer economic reform but face difficulties in implementing liberalization engage in PTA negotiations with the European Union and/or the United States. This should be true also for those countries that do not experience democratization: even in the absence of democratization, there are other factors, which we were unable to capture in the statistical analysis, that could create demand for liberalization. Indeed, Chile's democratic transition was already completed at the end of the 1990s.

In the light of these expectations, we begin our analysis by examining the demand for economic reform in Chile. The left's candidate in the 1999 presidential election, Ricardo Lagos, was inaugurated on March 11, 2000. Only a few months later, President Lagos offered an ambitious summary of his goals: "If we all work together, we shall be able to take a better look at our future and be able to think that we shall truly have a better country by 2010, the year of our bicentenary" (Hanzich, 2006, 28). To bolster his pro-market credentials, Lagos, who was the first socialist president after Allende in a country that was still going through a process of democratic consolidation, appointed an MIT-trained economist as the minister

Table 8.2. SUMMARY OF FINDINGS: CHILE

	New Leader	Democratization	Economic Crisis	
Demand for reform	Lagos promised to relaunch the economy and modernize the country	Democratic transition was completed, though Lagos was the first socialist president after Allende	Downturn due to the Asian financial crisis	
	New Leader	Divided Government	Previous Failed Reform	Specific Problems
Difficulty of reform	Business community did not trust some members of the Socialist Party. Lagos was the first president to experience tensions in business-state relations	Weak majority and opposition to reform within Lagos's coalition (30 MPs far on the left)	Electricity reform (1998–1999), labor reform (Frei's era), health reform (Frei's era)	High income inequality
	Reform	Credible Commitment	Side Payment	
The role of PTA	Privatization, FDI protection, capital liberalization, IPRs protection	Very deep PTAs with provisions regulating investment, services, and IPRs. Team of US lawyers periodically visiting Santiago to check the enforcement of the US-Chile PTA	Aid and FDI from both the EU and the US	

of economy and a Harvard-trained, former IMF official as the minister of finance.

Lagos's own pedigree was also that of a free-market economist, though one concerned about social inequality and market inefficiencies. He received a Ph.D. in economics from Duke University and had served as the chancellor at the University of Chile. This helps explain why Lagos was endorsed by many businessmen during the campaign, even though he was the candidate of the left. Eugenio Heiremans, a leading figure of the Chilean national manufacturing association, said that "Lagos is a very intelligent man who realized that the world has changed and that the present economic organization of the world cannot change."[2]

Besides his personal background and convictions, why did Lagos need reform? First and foremost, when Lagos became president, Chile had just emerged from a major recession. The unemployment rate was 12 percent in 1999, and in the same year the economy contracted by more than 2 percent. The economic crisis was the most salient issue for voters, according to a May 1999 poll among Santiago residents.[3] Indeed, 30 percent of all respondents said that "the economic problems derived from the Asian crisis" were their major concern, trumping "delinquency" (27.9 percent) and "the imprisonment of Gen. Pinochet in London" (6.2 percent).[4] This does not come as a surprise, given Chile's history. A small and geographically remote country, Chile has historically been vulnerable to major international shocks, including the Great Depression, the 1970s oil crises, and the 1982 debt crisis (Chumacero and Fuentes, 2002).

Given these economic difficulties, voters were strongly in favor of economic reform. In a 1999 national public opinion poll, the majority of the people interviewed agreed or strongly agreed that the government should leave economic activity to the private sector and agreed that privatization had been beneficial for the country (Davis and Coleman, 2001). In other words, although there was still resistance to reform, Lagos's socialist government had strong incentives to liberalize.

In addition to economic woes, persistent inequality called for change in economic policy. For instance, 20 percent of the people lived below the official poverty line in 1999 (Olavarria-Gambi, 2003, 103). In this regard, there were high expectations for redistributive policies by the first left-wing government in the post-Pinochet era. To meet these expectations, Lagos implemented, among other things, a $14 million public works program during the first years of his mandate.[5]

Third, Lagos's effort to improve the business environment was at least in part a response to the policies implemented by El Salvador and Mexico, which compete with Chile for FDI. In this respect, Lagos's priority was to reduce the budget deficit, which was 1.5 percent of the GDP in 1999, in an effort to lower interest rates and inflation (Marcel and Tokman, 2002, 47).

Difficulty of Reform

With the benefit of hindsight, Lagos's presidency was exceptionally successful. However, this was not because Lagos never faced any impediments to economic reform. On the contrary, Lagos found himself between the frying pan and fire from day one. In the case of Chile, reform difficulties had four sources: (i) difficult business-state relations from Lagos's standing as the first socialist president of Chile since democratization; (ii) a fractionalized government; (iii) high levels of unemployment; and (iv) the failed record of important past reforms, such as those in the power sector. To explore the causal mechanisms of our theory, we examine each in turn.

Lagos's presidency marked a turning point in Chilean politics, for he was the country's first socialist president since Allende. While Lagos was considered a practical and modern left-wing politician, some of Lagos's party colleagues were regarded with suspicion by the business community. Some members of Lagos's team emphasized redistribution over economic reform, and the Chilean business community saw their ideas as threats. According to Eugenio Heiremans, "people around him [Lagos] are very old-fashioned socialists."[6] As a result of his leftist governing coalition, Lagos was the first president to experience business-state tensions in the post-Pinochet era. As Silva (2002, 340) notes, "Chile's political institutions and the Concertación… contributed to stable, collaborative, and, sometimes, cosy business-state relations in the first two Concertación presidencies." On the contrary, Lagos's presidency saw a "dramatic deterioration in business-state relations" (Silva, 2002, 346).[7]

To explain the business-state tensions, Silva (2002, 346) argues that "the shift in the centre of gravity within the Concertación from the Christian Democrats to the renovated socialist parties—Partido por la Democracia and the Socialist party—was certainly reason for greater vigilance on the part of the private sector" (Silva, 2002, 346). In an odd turn of events, the fact that Lagos could rely on the disciplined support of Concertatión hurt his relationship with the business sector and increased his political vulnerability. Since 2000, sharp tensions in business-state relations could be explained "by the weakness of the Lagos administration due to lingering economic recession and its narrow electoral victory coupled with the strengthening of uncompromising pro-neoliberal forces after the electoral rise of UDI and a shift to hard line leadership in key employer associations."[8]

Lagos's second difficulty was his government's extreme fractionalization. While some of the parliamentarians and ministers who participated in Lagos's ruling coalition supported economic reforms from the beginning, others clearly did not. A group of approximately 30 parliamentarians, whose support was necessary for passing economic reforms given that Chile's parliament had only a total of 120 seats, were far to the left on the country's ideological scale.

Quantitative data can help better understand how problematic the government's fractionalization was during Lagos's presidency. According to the aforementioned government fractionalization indicator, Chile's government fractionalization score was 0.62 during Lagos's era, with 0 indicating no fractionalization and 1 indicating a completely fractionalized government. This score is more than one standard deviation above the mean of this variable in our dataset. Lagos's center-left coalition held 70 seats of a grand total of 120 in the first two years of his presidency. However, his majority shrank to 64–56 when the right-wing opposition party, Alliance of Chile, led by Joaquín José Lavín Infante, won the 2001 elections. Finally, after five congressmen were arrested in a bribery investigation in 2003, Lagos's majority in Parliament shrank to just one vote.

To prevent this heterogeneous and weak majority from paralyzing decision-making, Lagos often relied on technocrats rather than on politicians for the implementation of social and economic reforms. This was an attempt to insulate the government from the pressure of lobbying groups. An interview with one of Lagos's advisors reveals that this is "the exact logic that we wanted to get rid of; the idea that whoever shouts the loudest gets what he wants is a bad idea… no president can govern above parties, but he [Lagos] definitely wanted to maintain autonomy. He didn't want to be reliant on them."[9]

In addition to extreme levels of fractionalization, high unemployment levels meant that Lagos could not afford high short-run adjustment costs from liberalization. Although the economy recovered during the first decade of the 2000s, it was due largely to increased international commodity prices and little job creation. The unemployment rate remained as high as 10 percent until September 2000. The proposed labor reforms that aimed to change collective bargain rights and set new regulations on the ability of employers to replace striking workers were frozen during the first months of Lagos's presidency (Oxhorn, 2001). This decision was to protect employment and to avoid upsetting Chile's powerful central labor union, Central Unitaria de Trabajadores.

The high unemployment rate significantly reduced Lagos's room to maneuver in compensating the losers of economic reform. Lagos had to allocate significant budget resources to the fight against poverty, especially at the beginning of his mandate. For instance, the Lagos administration created Chile Solidario, a program designed by a group of 21 technocrats that aimed to specifically address the challenges and needs of poor families. Moreover, his government authorized annual increases of the monthly minimum wage, raising it from US$200 to US$255 between 2001 and 2005. This is particularly important in light of our argument that PTAs create new resources that leaders can use to create political support for reforms.

Finally, Chile's record of economic reform during the 1990s was mixed at best, which meant that there was considerable skepticism about Chile's ability to continue liberalization. For instance, the previous Chilean president, Eduardo Frei, had largely failed to carry out labor and health reforms, mainly due the economic turmoil that hit Chile after the Asian financial crisis (Silva, 2002). Moreover, a planned reform of the electricity sector following the electricity crisis in 1998–1999 turned out to be less effective than originally hoped due to political resistance to liberalization and the government's electoral concerns (Murillo and Le Foulon, 2006). As the Chilean senator William Thayer, formerly President Frei's minister of labor, said about the reform record in the post-Pinochet era: "The government had to do an extremely difficult thing. That is, to give the impression that much was reformed, but in reality reform little" (Haagh, 2002, 99).

Lagos's Economic Reforms

Although Lagos faced tremendous difficulties in the implementation of reform, his liberalization record was quite impressive in retrospect. Most important, there is plenty of evidence that Lagos's government pushed forward privatization, investment protection, and capital liberalization.

To begin with, Lagos continued the privatization of water utilities started during Frei's tenure. In particular, Lagos's government sold the operation rights of seven public companies to private actors for 30 years (Bitrán and Valenzuela, 2003). Moreover, Lagos privatized the waterworks company Essbio at the beginning of his mandate, in September 2000.[10]

This second privatization was quite controversial. It provoked strong opposition in Region VIII, where Essbio was based, and was criticized by "two prominent Concertation senators" (Edwards, 2000, 3).[11] Lagos justified this reform by claiming that privatizing the water system was particularly beneficial for the rural areas that suffered the most from water shortages, though he acknowledged that the government needed to subsidize the poor areas that could not afford to pay for the water from private companies.[12]

Moreover, Lagos privatized Chile's oil company Enap, arguing that "private capital would allow Enap to expand its operations into the rest of Latin America."[13] Similarly, Lagos opened up CODELCO, Chile's large, state-owned copper mining industry, to private pension funds, though the state maintained control of the industry. This partial privatization created tensions among some parliamentarians who were supporting Lagos's government at the time.[14] Here, Lagos's goal was to make Chile's economically most important sector more competitive in the international market.

Capital account and service liberalization were also top priorities for Lagos (Egan, 2000). To encourage investment, Lagos dismantled Chile's capital controls. This move boosted liquidity on the Santiago stock exchange, though not as much as the government had expected. Moreover, other measures to rekindle investor interest, such as the removal of the 15 percent capital gains tax levied on foreigners, languished in the Congress (Egan, 2000). Regarding services liberalization, Lagos's government offered tax breaks and other incentives to foreigners, especially in strategic sectors, such as energy and high technology. This decision was, at least in part, a response to similar policies implemented by competing countries, such as Mexico, and was meant to bolster inflows of FDI into Chile.

Of the economic policies directly relevant to our argument, we find little evidence of Lagos's interest in IPR reform. As confirmed by Kathleen Uribe and Ana Novik, two leading Chilean negotiators, IPR provisions were largely imposed by the United States during the Chile-US PTA negotiations.[15] To be sure, Lagos did agree on the need to improve protection for intellectual property. One of the negotiators, Rodrigo Contreras, interviewed by the authors on February 10, 2012, claimed that the Lagos government recognized the importance of complying with the regulations set by developed countries. In his words, Lagos was aware of the importance of "sharing the same model." However, implementing such a policy has always been a difficult issue in developing countries. As some experts maintain, the main problem was that Chile lacked the institutional capacity to effectively protect IPRs at that time.[16] Indeed, an independent institution to administer IPRs was created only after the formation of the PTAs with the European Union and the United States.[17]

What Role for Preferential Trading Agreements?

Recalling our theoretical framework, we expect PTAs to serve two purposes in the presence of simultaneous demand for reform and barriers to implementation. First, PTAs increase the credibility of commitments by tying the hands of the government. Second, they provide a surplus of resources—larger inflows of FDI, for instance—that can be used as side payments to compensate losers or mobilize winners.

We begin by analyzing the credible commitments that the two PTAs produced. Both the EU-Chile and the US-Chile PTA are long treaties with over 700 pages. Both PTAs include so-called WTO-plus provisions, that is, commitments that go well beyond the WTO rules. For example, they regulate a large number of non-trade sectors such as investment and IPR protection. The US-Chile PTA includes 24 chapters, which also deal with the environment, labor, and transparency of trade relations. Finally, both PTAs include a dispute settlement mechanism that allows the complaining party to select the forum to be used for solving the dispute and drafting the final report, that is, either the WTO or the PTA. Moreover, if the final report of the arbitration panel is not implemented, benefits under the agreement may be suspended.

In an interview in Princeton, New Jersey, in December 2011, Kathleen Uribe, who negotiated both the PTA with the European Union and the PTA with the United States, claimed that the formation of the PTAs with these two major economies were perceived by the Chilean political elites as an important step in their effort to modernize the country. Uribe said that PTAs with the European Union and the United States were nothing like the other PTAs that Chile signed with Latin American countries, or even Canada. "A sign of these high expectations for the PTAs with the EU and the US," she argued, "is that *El Diario Financiero*, which is the main economic newspaper in Chile, had at least an article every day on the prospective and benefits of negotiating these PTAs during the 1990s." The Chilean public seems to have agreed. The public opinion poll Latino Barometro included a question about the importance of trade between the European Union and the United States and each country in Latin America. Second only to Colombians, Chileans placed the highest importance on trade relations with the European Union and the United States.[18]

Uribe also maintained that "[t]he formation of PTAs with the EU and the US was used by the Chilean government as a lock-in instrument. There is little doubt about that."[19] This view was also shared by two other top negotiators. They both claimed in interviews by the authors that there was the conviction that PTAs with the European Union and the United States would have made it impossible to renege and reverse these policies in the future. According to Ana Novik, opposition to trade liberalization and pro-market policies was, and still is, fairly limited in Chile. As such, forming PTAs with the European Union and the United States was not too problematic.[20] As another leading negotiator said, it was an effective way to obtain a seal of approval from the market after all the reforms carried out in the two previous decades.[21]

If there was a broad consensus on retaining trade openness and the virtues of a market economy, why was it even necessary to lock in the previously implemented reforms? Using the EU and US PTAs as a lock-in strategy was certainly related to the fact that Chile's political system is characterized by strong presidentialism. If a future president were in favor of reversing reforms in the future, she would have the constitutional power of doing so (Chumacero et al., 2005). The thick international network of economic cooperation developed by Chile in the past two decades was intended to make such reversals infeasible, which would enhance Chile's credibility.

Another top Chilean official, to whom we promised anonymity at the time of the interview on July 7, 2010, revealed the presence of some conflicts among different interest groups. Moreover, he claimed that PTAs with the United States and the European Union were used as instruments to persuade reluctant domestic constituencies to accept further liberalization. As an example, this top official proposed that the liberalization in the banking and insurance sectors would have been impossible to achieve without the agreements with the European Union and the United States.

According to Uribe, whenever PTAs created political tensions, the government's strategy was to channel all the attention of the public opinion and the criticisms to the minister of Finance, Nicolás Eyzaguirre Guzmán. Eyzaguirre's role was particularly important in the last and more controversial rounds of the agreements. By focusing the attention on the minister of Finance, the broader government remained fairly isolated from the political tensions produced by these negotiations. That said, we need to acknowledge that negotiations were conducted by, and in consensus with, other ministers, including Minister of Foreign Affairs Soledad Alvear *in primis*, and that the role of the president was crucial in the hierarchical Chilean political system.

Uribe added that "reforms would have been implemented in any case, also without trade agreements. PTAs with the EU and the US were the occasion to make it happening in that particular moment, well ahead other direct competitors among developing countries." The emphasis on the timing is shared by the others negotiators that we interviewed. Having qualitative evidence on the timing is crucial for testing our hypotheses during

PTA formation and following ratification. The values of the explanatory variables of the theory, especially leader change, fluctuate over time and generate precise predictions about the timing of PTA effects on reform. Furthermore, the rolling regression analysis provides convincing evidence of the causal relation between PTAs and reforms only to the extent that the latter occur during the negotiation or soon after the signature of these agreements.[22]

Let us now consider specific sectors included in these two PTAs and likely to produce important policy changes. Regarding investment, both PTAs include important provisions that substantially improve the standing of foreign investors. Most favored nation (MFN) status and national treatment are included, and neither party can require that the senior management of an enterprise of that party be of a particular nationality. In addition, each party must permit all transfers relating to a covered sector of investment to be made freely and without delay. Expropriation can occur only for a public purpose and must be non-discriminatory upon payment of prompt, adequate compensation in accordance with the due process of law. Finally, investment disputes may be submitted to arbitration.

As to the liberalization of the service sector, which we argued earlier to have been a crucial component of Lagos's economic agenda, the US-Chile PTA produced important changes. In particular, Roy, Marchetti, and Lim (2007) argued that "the commitments undertaken by Chile in its PTA with the US go further than the others in key sectors such as professional services; telecommunications, by allowing access to its local market; and financial services, by allowing more services to be supplied on a cross-border basis, and by allowing US insurance companies to establish as branches."

In the case of Chile's services liberalization, there was clearly opposition to reform. Although services liberalization was part of Lagos's economic agenda, the PTA provisions to liberalize services were controversial among the parliamentary majority supporting Lagos's government. This can be seen in the phasing in of liberalization. For instance, the treaty allowed liberalization of the insurance sector and of the investment funds one year after entry into force of the agreement (Roy, Marchetti, and Lim, 2007, 192). Finally, we do acknowledge that the inclusion of provisions to liberalize services was also in line with the services sector lobbies in the United States (Bergsten, 2002; Weintraub, 2004). However, that fits with our argument about the strategic use of PTAs with major powers to carry out controversial reform.

Both the EU-Chile and the US-Chile PTA require parties to agree and ratify a large number of IPR treaties and conventions, such as the Patent Cooperation Treaty and the Trademark Law Treaty. Moreover, specific provisions of the Berne Convention are cited for the protection of copyrights and related rights. National treatment and transparency are required in both PTAs as a means to specifically improve enforcement. In particular, laws and regulations pertaining to the enforcement of intellectual property rights must be published and made publicly available. Each party is directed to publicize information on its efforts to provided effective enforcement. The chapter fosters also cooperation in defending IPRs. Specifically, each party must provide criminal procedures and penalties at least to cases of willful trademark counterfeiting or copyright or related rights piracy on a commercial scale. Although the inclusion of such provisions was controversial, a negotiator told us that the government was aware that improving IPRs protection could contribute to increase the inflow of FDI, especially in the pharmaceutical sector."[23]

Is there any evidence that the European Union and the United States had the ability to enforce Chile's reform commitments? In the aforementioned interview, Uribe described some other factors that shed light on the enforcement of the EU and US PTAs. First of all, she claimed that the Chilean government was very concerned about the provisions to be included in the treaty, given that a failure to fulfill an agreement with the two major economic powers would carry high political and economic costs. For instance, the inclusion of provisions on more stringent environmental standards was very controversial in Chile since exporters perceived them as protectionist tools.

The issue of enforcement is particularly interesting in this case, since scholars of international relations and political economy often downplay the level of compliance in international agreements. Uribe argued that "there was the fear that once these provisions are in, there is no way of escaping their enforcement."[24] Moreover, she told us that a team of US lawyers has been going regularly to Santiago to monitor the fulfillment of the agreement. Another negotiator told us that there are yearly meetings held between Chilean negotiators and EU and US negotiators to assess the enforcement and implementation of the provisions included in the treaties. According to this negotiator, 95 percent of the commitments included into the PTAs with the European Union and the United States have been promptly and fully implemented by Chile.[25]

The high degree of legalization of the EU-Chile and US-Chile PTAs provides evidence for the importance of credible commitment in Chile's case. We also find evidence for the second part of our argument: the PTAs created resources and opportunities for politically influential domestic constituencies. Already in Chapter 2, we showed that Chile received a large inflow of foreign aid in the five years that followed the signature of the EU PTA. Specifically, EU foreign aid increased from US$47,870,000 to

US$82,840,000. Similarly, foreign aid from the United States also increased in the five years following the signature of the PTA, though to a somewhat lesser extent. The increase of EU and US foreign aid was particularly pronounced in sectors that are directly relevant to PTA provisions, such as banking, industry, privatization, and trade policy. On the contrary, no aid was allocated by the European Union or the United States in sectors such as fishery and tourism, which are important for the Chilean economy but not covered by the PTAs. These patterns suggest that the European Union and the United States used foreign aid strategically, so as to reduce adjustment costs in key sectors of the Chilean economy (Baccini and Urpelainen, 2012).

The EU and US PTAs also created resources for domestic constituencies through increased FDI. For instance, FDI from Germany to Chile doubled from 2004 to 2005. Similarly, FDI from the United States to Chile increased by $1 billion from 2004 to 2007.[26] As a consequence of the more favorable business environment created by the EU and US PTAs, Chile also experienced an increase of FDI from the rest of the world. According to OECD data, FDI to Chile almost doubled from 2002 to 2007.[27] Between 2002 and 2007, FDI to Chile grew faster than FDI to Brazil, even though Brazil is a much bigger economy that had maintained similar growth rates during the past 10 years. This suggests that Chile's FDI growth was not exclusively driven by Latin America's improved growth rates during this period.

To complete the argument, it is important to consider the interests of the European Union and the United States in forming a PTA with Chile. Chile is a small economy compared to the European Union and the United States, but it is also growing rapidly. Previous research finds that the European Union and the United States were particularly interested in the Chilean services sector (Weintraub, 2004). More generally, although the emphasis of the EU-Chile PTA and the US-Chile PTA was on non-trade issues, we do not want to completely ignore the role tariff reductions for Chile. When interviewed, Ana Novik confirmed that in signing the PTA, Chile was also interested in expanded market access, especially to the United States.[28]

On a final note, there is also a systemic reason that the European Union and the United States simultaneously began negotiating a PTA with Chile. Previous studies suggest that exporters mobilize in response to discrimination abroad and push their governments to conclude trade agreements to protect their foreign market access (Dür, 2007; Baccini and Dür, 2012). This is exactly the sequence of events in the case of the EU-Chile PTA and the US-Chile PTA.

To summarize, Chile's case shows how demand for reform can, due to poor economic performance and a troubled history of liberalization, induce developing countries to engage in PTA negotiations even in the absence of democratization. President Lagos's ability to implement reforms was undermined by a lack of trust in his government among the business community, a fractionalized and highly heterogeneous ruling coalition, and the shadow of failed reforms in the 1990s.

COLOMBIA: LIBERALIZATION IN THE SHADOW OF INTERNAL CONFLICT

Until recently, Colombia's future did not seem all that bright. Troubled by a vicious internal conflict and socioeconomic problems related to the production of cocaine, neither Colombia's internal security nor economic growth prospects appeared very favorable. But during President Alvaro Uribe's tenure, Colombia experienced many positive changes, with decreased violence and improved economic performance.

In this section, we examine if and how Colombia's PTA negotiations with the United States made a difference in Colombia's political-economic development. Colombia differs from our other cases in that it had been, at least formally, a democracy for half a century. Colombia's case thus allows us to investigate whether mechanisms other than democratization create demand for economic reform. That is, the Colombian case allows us to answer the following question: Can our general theory, which emphasizes reform demand and difficulty, also shed light on political dynamics in PTA negotiations in established democracies, such as Colombia?

If we found evidence that the combination of reform demand and difficulty drove Colombia's interest in PTA negotiations with the United States, this would be consistent with our theory, because in the statistical analysis democratization was used as an indicator for the more general phenomenon of domestic demand for liberalization. At least initially, this conjecture seems quite plausible: Colombia's economic troubles in the beginning of Uribe's tenure were serious. Similarly, the ongoing civil war meant that Colombia's established democracy remained fragile, if not on the verge of collapse.

Initiated by Colombia, the PTA negotiations with the United States started in May 2004, about two years after Uribe's inauguration. As Schott (2004, 363) explains:

> bilateral fast-track authority, as emended by the Trade Tariff Act of 1984, required that US trading partners take the initiative… for developing countries, taking the initiative is particularly important to demonstrate political

commitment to pursue the requisite reforms in domestic and trade policies that would be required by a free trade pact.

The PTA was signed in November 2006 and, after a lengthy delay in the US Congress, was ratified in October 2011.

To foreshadow, we find strong evidence that the PTA with the United States locked in economic reforms implemented by Uribe's government and its predecessors governments in the 1990s. Moreover, we find evidence that the PTA with the United States led to stricter regulations for FDI and IPR protection. Although the financial system was already liberalized in the 1990s, the PTA with the United States further improved Colombia's capital openness. As in Chile, the US PTA also included several provisions to liberalize the service sector.

To bolster the domestic side payments argument, we show that the United States provided financial aid and technical assistance to Colombia, both during the negotiations and following the signature of the PTA. The USAID development program MIDAS, to be described in greater detail later, was central in this regard. Moreover, we show that as a consequence of the US PTA, Colombia is emerging as a magnet for attracting FDI not only from the United States, but also from the rest of the world. Finally, we find little evidence for the claim that gaining access to the US market would have been Colombia's main goal in signing the PTA with the United States. Indeed, Colombia already faced low tariffs in exporting to the US market.[29] Table 8.3 summarizes the main findings of this case study.

Demand for Reform

Having left Colombia's Liberal Party (Partido Liberal Colombiano), Uribe ran as an independent on the "Colombia First" (Primero Colombia) ticket in the presidential elections of May 26, 2002. Securing over 53 percent of the vote, he was the first presidential candidate to obtain a one-round majority victory since Colombia introduced a two round run-off system in 1991. Uribe's campaign slogan, "Firm Hand, Big Heart," summarized his priorities: citizens' security and social concerns. In the course of his political career, Uribe was viewed as both a social reformer and a law-and-order politician. Already during his term as senator, Uribe was one of the primary proponents of national health legislation. As governor of Antioquia, the second largest province in Colombia, he emphasized education, providing subsidies to encourage school attendance (Congressional Research Service, 2002, 2). He also achieved "successes in carrying out public works projects and new social spending."[30]

Table 8.3. SUMMARY OF FINDINGS: COLOMBIA

	New Leader	Democratization	Economic Crisis	
Demand for reform	Uribe won the elections with a programs that emphasized citizens' security and social reform	Democratic transition was completed, though political stability was undermined by FARC guerrillas during the 1990s	Sluggish economy during the 1990s. Lack of political and economic security scared foreign investors.	
	Leader Change	Divided Government	Previous Reform	Specific Problems
Difficulty of reform	First independent candidate to become president; lack of support in Uribe's own party	High government fractionalization and lack of support from an institutionalized party (Uribe was an independent), financial liberalization opposed by the Central Bank	Few attempts of reforming during the 1990s	FARC guerrilla and powerful drug cartels
	Reform	Credible Commitment	Side Payment	
Role of PTA	Privatization, FDI protection, capital liberalization	Deepest PTA signed by the US, with provisions regulating investment, services, and IPRs	Aid (MIDAS program) from the US, FDI from the US and third countries	

Uribe's 100-point program presented a broad social, political, and economic agenda. Three main points stand out. First, Uribe promised to increase Colombia's military budget, doubling the size of the army to 100,000 men, and creating a million-strong civilian militia to support the Colombian military. Although Colombia was formally a consolidated democracy, it was undermined by political instability in the 1990s due to drug cartels and the FARC guerrillas. Second, he promised pro-market policies. Specifically, Uribe, who was a businessman himself, assured "a clear and correct macroeconomic policy, public order and a stable business environment designed to make Colombia attractive to foreign and domestic investors alike."[31] Third, he proposed a series of governance reforms to reduce the size of the state and bureaucracy, as well as to fight corruption. For instance, he promised to eliminate one of Colombia's two legislative chambers to cut government spending. In sum, Uribe's campaign was that of a hard-liner and a reformer.

In addition to his personal views, Uribe's emphasis on reform had a political logic behind it. First and foremost, violence and political instability had become so high as to become a serious obstacle to economic development and growth. When Uribe came to power in 2002, assassinations of politicians and businessmen were endemic. Guerrillas and paramilitaries controlled important parts of Colombia's territory, spreading insecurity across the country.[32] For instance, on August 7, the day that Uribe formally became president of Colombia, several bombs caused 19 deaths and injured at least 60 people in Bogotá. Soon after his inauguration, Uribe declared a state of emergency and asked powers to strengthen Colombia's military and police forces.[33]

A negotiator, whom we interviewed on February 3, 2012, claimed that the security trouble was directly related to economic issues. Due to a lack of investment security, Colombia lagged behind other neighboring countries, such as Chile and Mexico, in attracting FDI during the 1990s. For instance, inward FDI flows to Colombia amounted to US$2.4 million in 2000, whereas Chile and Mexico attracted, respectively, US$4.9 million and US$18.1 million in the same year.[34] Juan Carlos Echeverry, a top official in Colombia's finance ministry in the 1990s, effectively described Colombia's situation before Uribe's presidency: "I was here ten years ago when the economy was in crisis and every day's news was worse than the day before."[35]

The economic crisis is the second element that increased the demand for reform, as we saw in the other case studies. The Colombian economy was sluggish and the level of unemployment reached a worrisome level in the late 1990s. Since Uribe campaigned heavily for political and economic reform to fight corruption and "politicking," voters held high expectations that he would fulfill his electoral pledges. Pressure to promote growth, stability, and social equity also came from abroad. As reported by Cepeda Ulloa (2003, 7), "On January 15, 2003, the IMF approved a standby agreement worth US$ 2.1 billion intended to bolster Colombia's economic program until 2004. IMF Director Horst Köhler acknowledged that Colombia had embarked upon a strong reform program."

Difficulty of Reform

In the case of Colombia, reform difficulties have four sources: (i) lack of an institutionalized party supporting Uribe; (ii) a heterogeneous coalition government; (iii) opposition from the Central Bank in relation to capital liberalization; and (iv) opposition against foreign investment. We examine each in turn.

As discussed above, Uribe was the first independent candidate to win the presidency in Colombia's history. This created two problems. On the one hand, Uribe could not rely on a highly institutionalized party (Holmes, de Piñeres, and Amin, 2012). Indeed, Uribe did not have a congressional list, and his majority was formed by the combined allegiances of congressmen from more than 60 political groups (Dargent and Vergara, 2011). Interestingly, the lack of a loyal and institutionalized party is specific to Uribe's presidency and in sharp contrast with Uribe's predecessors. Indeed, the Colombian party system has usually been characterized by high institutionalization with two main parties, Liberals and Conservatives, that have been in power in rotational shifts since the 1950s (Holmes, de Piñeres, and Amin, 2012; Sanchez, 2008).

On the other hand, Uribe could only rely on a fractionalized congressional majority. Despite President Uribe's high approval ratings, getting bills passed by the Congress was never an easy task for him. The Uribe coalition in Congress encompassed a variety of parties with rather heterogeneous interests. Even after the landslide victory in 2006, Uribe was supported by an alliance of five national parties, which often held conflicting political preferences (Dargent and Vergara, 2011).[36] According to the aforementioned government fractionalization indicator, Colombia scored 0.58 in 2003, clearly above the mean value for other Latin American countries.

Things became complicated for Uribe as soon as the honeymoon period was over. For instance, Uribe's health reform was issued by decree and without congressional approval, with a politically controversial declaration of "social emergency." This unilateral use of executive power caused widespread public opposition that focused on the lack of consultation with stakeholders, restrictions on prescribed treatments, and penalties against doctors who failed to adhere to the new program. Conflicts between the government and key interest groups lasted for several years. In April 2010, Colombia's Constitutional Court ruled that Uribe's declaration of a "social emergency" was unconstitutional, meaning that the president's proposed health reforms lacked a legal foundation. This example shows that despite Uribe's popularity, veto players were able to constrain Uribe's reforms (Lopez, 2009).

Another example of Uribe's difficulties as a reformer is highlighted by the referendum held in 2003. By asking people to decide directly on key policy changes, the referendum was intended to overcome the deadlock in the Congress, where Uribe's allies had constant trouble maintaining unity. The referendum was a package with 15 constitutional reforms on various issues such as measures to combat terrorism, policies to fight corruption, and new fiscal policies to constrain public spending. For any measure to win approval, 25 percent of registered voters had to cast a ballot on it. The result of the referendum was a major defeat for Uribe. Eleven of the 15 reforms failed to meet the 25 percent threshold. And yet, Uribe's popularity was above 70 percent at the time of the referendum and *all* 15 reforms received the support of a majority of voters, though only four reached the turnout threshold. Colombia is, therefore, a striking example of how difficult is to overcome resistances to reform by only relying on domestic strategies.

According to a Colombian negotiator, whom we interviewed on March 2 2012, the leftist El Polo Democratico Alternativo (PDA) was the most important political party that vehemently opposed Uribe's liberalization agenda.[37] In particular, the party was against trade liberalization in the agricultural sector and regulations to protect IPRs. This party was a serious challenger until the 2006 presidential election, in which Uribe won a landslide victory, with 62 percent of the vote versus 22 percent of the vote won by the leader of the PDA, Carlos Gaviria. In commenting on the results of 2006 election, Daniel Nino, head analyst at Bancolombia SA, emphasized the importance of Uribe's victory in terms of his reform effort.[38] In particular, Nino claimed that "Uribe's landslide victory gives him huge political capital to put through the reforms.... Colombians back the economic reforms and the free-trade pact, which the leading opposition parties attacked."[39]

Perhaps surprisingly, opposition to financial liberalization came from the Central Bank of Colombia. Skepticism toward liberalization was mainly a product of the serious problems experienced by Colombia during the financial crisis in late 1990s. In particular, José Darío Uribe, appointed as governor of the Central Bank by President Uribe in 2005, was a supporter of prudential rules to stop capital inflows that cause financial instability.[40] Notably, financial stability was the main reason that the chairman of central bank was not supportive of capital mobility.

Finally, there was also opposition to establishing more favorable conditions for foreign investors, particularly in the energy sector, where foreign oil companies would pay lower royalties and would be released of the requirement to enter into partnership with the state. Opponents were concerned that only foreign companies would exploit the increasingly favorable investment climate and would benefit from the economic boom produced by Uribe's reform. They were also concerned that most of the profits would have left Colombia, with little benefit to the people. An example of these tensions was a protest in Bogotá in October 2004. As the *Colombia Journal* reported, "more than one million Colombians marched through the streets of cities throughout the country to protest President Alvaro Uribe's economic policies."[41]

Reform and the Preferential Trading Agreement

To evaluate the consequences of PTA negotiations for economic reform, we begin by listing Uribe's policies that were potentially related to the trade talks. Privatization was an important part of Uribe's neoliberal reforms during his tenure. For instance, he budgeted the privatization of more than 280 state-owned enterprises, including the oil company Ecopetrol.[42] Moreover, improving the legislation for promoting and protecting FDI was also a priority for Uribe's government. In this regard, Uribe implemented several important changes. For instance, "in order to protect investors from adverse changes in national legislation, Colombia has provided legal stability contracts (LSCs) since 2005" (Kalin, 2009, 18). Since 2005, the Colombian investment promotion agency, Proexport, has also implemented various reforms to facilitate the inflow of foreign capital and streamline administrative procedures (Kalin, 2009, 16–17).

Capital liberalization was, compared to the previous reforms, a more controversial one. Similarly to many other developing countries, Colombia initiated aggressive financial liberalization at the end of the 1990s. As a result of the weakness of financial regulations, Colombia was severely hit by the Asian financial crisis between 1998 and 2001. Colombia's solvency and asset quality worsened significantly during this period. According to Arbeláez, Flórez, and Salazar (2006, 6), "since 2002 the system has improved considerably, although financial deepening is still below the levels registered before the crisis."

How could the PTA with the United States help Uribe in his effort to reform? Let us begin with investment. According to a negotiator interviewed by the authors, attracting FDI from the United States was more important than increasing trade flows with the United States. She argued that Uribe's emphasis on security also involved better protection of investors to improve the business environment in Colombia. For instance, the government passed several regulations to reduce the high level of corruption that kept investors away and, ultimately, damaged Colombia's economy. The importance of the US PTA for Colombia's quest for more FDI is also stressed by Schott (2006, 7).

Further, the PTA improved the surveillance and inspection capacity of the Instituto Nacional de Vigilancia de Medicamentos y Alimentos (Invima), which is responsible for monitoring public health in Colombia. For instance, all the pieces of legislation passed by the Congress to comply with the US PTA are now published on a website. In general, the negotiator we interviewed claimed that the US PTA enabled changes in several policies and regulations that improved Colombia's status as a market economy. Arbeláez, Flórez, and Salazar (2006, 50) confirms the importance of the PTA with the US for FDI. Specifically, they argue that by setting stricter rules on FDI protection, the PTA placed Colombia in a stronger position to attract FDI.

As Arbeláez, Flórez, and Salazar (2006, 4) argue, "the U.S. FTA has the direct impact of fostering the domestic reform in the financial sector, particularly in the area of collective investment schemes and insurance." Regarding insurance, the PTA with the United States prompted fundamental changes by increasing competition in the sector. In particular, the US PTA introduced the possibility for Colombian customers of acquiring insurance policies from American companies. Moreover, four years after the PTA entered into force, American insurance companies are allowed to sell their policies in the Colombian market without any restrictions and without facing any discrimination (Arbeláez, Flórez, and Salazar, 2006, 44).

Moreover, there is strong evidence that the US PTA stimulated a debate on the need to reform the financial system in Colombia. For instance, at the beginning of the negotiations Uribe's government hired two financial institutions, Fedesarrollo and Anif, to draft a technical report that covered all the financial sectors and assessed the impact of the PTA with the United States. The report concluded that

> Colombia's FTA negotiation with the United States offered significant great opportunities, such as enhanced access to foreign capital, reducing the cost of capital and offering a chance to improve know-how. Nonetheless, the FTA also implied important challenges, for which it was advised that the government makes modifications in the internal regulatory framework in order to put domestic financial entities in a better competitive position in the FTA context. (Arbeláez, Flórez, and Salazar, 2006, 44)

A final point on financial liberalization concerns the role of the WTO. According to Arbeláez, Flórez, and Salazar (2006, 18), Colombia first tried to use the multilateral framework for improving its financial openness. In particular, Colombia presented an initial offer on liberalization in financial services that was in line with the Doha Round commitments agreed in 2001. However, since the Doha Round was going nowhere, Colombia decided to use a bilateral strategy and to commit to greater financial liberalization in the PTA with the United States. This example highlights the reasons that, following the Doha negotiation gridlock, some developing countries shifted to bilateralism in an effort to implement regulations beyond the WTO commitments, especially in non-trade sectors. We have referred to these provisions as "WTO-plus."

Regarding IPRs, we first need to acknowledge that Colombia already had improved its IPR protection in the Andean Pact in 1993 and 1994. However, the United States was still concerned over deficiencies in licensing, patent regulations, and copyright protection. The issue was a controversial one during negotiations. Arbeláez, Flórez, and Salazar (2006, 20) note that "although the financial sector played an important role in the reform process in the 90s, in the context of a FTA with the United States it would be other economic sectors that would occupy a larger part of the discussions such as intellectual property rights." In any case, IPR protection was part of Uribe's effort to improve investment security. The most important policy changes were: (i) protection for copyrighted works in a digital economy; (ii) tough penalties for piracy and counterfeiting; (iii) robust patent and test data protection; and (iv) state-of-the-art protection for US trademarks. Protection of US trademarks is a particularly sensitive issue and shows Colombia's effort to improve the level of transparency in its economic system. In relation to trademarks, "the Agreement... requires the establishment of an online system for registration and maintenance of trademarks, as well as a searchable database. Finally, the Agreement requires transparent procedures for the registration of trademarks and geographical indications."[43]

While non-trade issues were very important in the US-Colombia PTA, conventional trade issues such as market access were secondary. In explaining the formation of the US-Colombia PTA, Arbeláez, Flórez, and Salazar (2006) focus specifically on non-trade issues and the need to improve Colombia's economy, with little attention to tariffs. Moreover, a negotiator interviewed by the authors confirmed that from a trade perspective, the importance of the PTA with the United States was marginal. This is understandable, for Colombia's products had already enjoyed a privileged access to the US market under the Andean Trade Preference Act since 1992.

We now explore the credible policy commitments that the US-Colombia PTA enabled. The agreement is one of the deepest among PTAs, according to the Dür et al. (2014) data set. Only seven agreements out of 560 scored higher in depth than the US-Colombia PTA. For instance, it includes state-of-the-art regulations on IPRs. The services chapter, which includes the MFN provisions and the NT provisions, specifically regulated the liberalization of the financial sector in line with what was discussed earlier. The investment chapter is also strictly regulated with provisions on the MFN clause, the NT principle, and free movement of capital and business. Finally, the Dispute Settlement Mechanism (DSM) not only allows the creation of a standing body with delegated powers, but also allows retaliation in the same sector, cross-retaliation, and monetary sanctions in case of defection.

The lock-in argument is confirmed by a negotiator interviewed by the authors. She said that rather than forcing Colombia to implement reforms, the PTA with the United States served the purpose of locking in economic reforms implemented in the previous years. These pro-market reforms are crucial for explaining the remarkable performance of the Colombian economy during Uribe's era. Protecting them from putative future leftist presidents à la Chavez was considered a priority by the Uribe government.

Schott (2006, 8) offers a nice summary from the US perspective of the importance of the PTA for overcoming domestic opposition to reforms in Colombia. He argues that "many of the reforms… required by the FTA obligations may well parallel changes in domestic economic policies that were sought by the government but were blocked or diluted because there has been insufficient political support to gain legislative approval. In other words, the trade and investment incentives built into the FTA could provide the catalyst to move ahead on the domestic reform agenda."

As to domestic side payments, consider first foreign aid. Aid allocation from the United States almost doubled from 2004 to 2006, moving from US$376 million to US$720 million. A negotiator interviewed by the authors confirmed that the United States was generous in providing both financial resources and technical support. In particular, the five-year (2006–2010) program MIDAS, which stands for Mas Inversion Para El Desarrollo Alternative Sostenible, was the instrument for allocating large amounts of US aid to Colombia.

The MIDAS program contributed to the development of the country's productive and competitive capacities, and its achievements are quite impressive. The program created 171,000 new jobs, generated 62 percent of employment in the country's rural areas, implemented 470 projects in 596 municipalities, created or strengthened 18,107 businesses, and provided support for more than 25 economic sectors, such as retail, technical services, and food and beverage.[44]

Notably, MIDAS was intended to assist the government of Colombia in the implementation of critical economic policy and institutional improvement in the areas of fiscal reform, financial sector development, investment regime, and trade and market access. These reforms enhanced the competitiveness of the Colombian economy. Moreover, the program specifically targeted small and medium-sized enterprises, which faced high levels of competition from US companies, and might have otherwise opposed reform.[45]

The role of FDI was also important. In 2004, one-fifth of Colombia's FDI came from the United States.[46] In the year of the PTA's signing, FDI from the United States increased by 16 percent and that from the rest of the world by 23 percent.[47] One explanation is that the seal of approval from a major economic power signals a market-friendly environment, where foreign investors are free to enter and can do business safely. However, the PTA between Colombia and the United States also elucidates another mechanism through which FDI from the rest of the world might increase as a result of a PTA. As Diego Laje puts it:

> 'Colombia's free trade agreement with the U.S. creates opportunities for Chinese businesses getting squeezed out of the North American market by the ongoing trade disputes between the world's two largest economies. For China, this is the opportunity to get goods relabeled as Colombian and enter the U.S. with zero tariffs. And as businessmen think about the new possibilities, many are rushing to rewrite business plans. The Chinese have their eyes on Colombia because it is the bridge they need to reach the U.S.,' José Antonio Mutis, Colombian Consul General in Hong Kong, told CNN.

In the same article, Andrés Peña, a former Mexican consul to Hong Kong, said that PTAs are generally a "magnet to attract foreign investment, like many that came to Mexico to re-export."[48]

What were the interests of the United States in forming a PTA with Colombia? Schott (2006, 8–11) summarizes the main American objectives in negotiating the PTA with Colombia. First, the United States aimed to reduce tariff and non-tariff barriers on trade in services. Second, the United States requested acceleration of the full implementation of the agreement on the TRIPS. Indeed, IPR protection was an important issue for US companies. Third, the United States aimed to improve transparency, especially in Colombia's public administration, and anti-corruption policies. Fourth, the United States wanted to promote greater protection of labor and environmental standards. Furthermore, there were also security issues that explain why the United States decided to form a PTA with Colombia. The PTA with Colombia was an instrument to foster political stability and stop the cultivation and trade of illegal drugs (Schott, 2006, 4). Finally, a PTA with Colombia was "part of the incremental process of building a hemisphere-wide free trade regime that has been slowed by numerous setbacks in recent years" (Schott, 2006, 10).

Similar to Chile, the case of Colombia shows the importance of PTAs with the European Union or the United States in implementing economic reform. Faced with economic difficulty and political opposition to necessary reforms, Uribe used the US PTA negotiations to overhaul many key economic policies and to enhance the credibility of earlier reforms that a future leftist government could have jeopardized without the treaty commitment.

Combining insights from the two cases, what is particularly interesting in these two cases is that both Chile and Colombia were economically successful developing countries that already had implemented important reforms in the 1990s. Still, our analysis demonstrated that new leaders faced opposition in changing specific policies, such as openness of the financial and services sectors. Both Lagos and Uribe entered the negotiations with the European Union and the United States to lock in previously implemented reforms and to gain domestic support for controversial policy changes.

CHAPTER 9

Conclusion

International institutions are ubiquitous. Most forms of interaction between sovereign states are now governed by sets of rules and standards codified in formal treaties (Goldstein et al., 2000; Koremenos, Lipson, and Snidal, 2001). One of the most important classes of international institutions is composed of economic agreements that regulate commerce across and within their members (Mansfield and Milner, 1999, 2012). Some economic agreements do little more than codify existing arrangements, but others contain demanding and politically controversial reform provisions that, if properly implemented, fundamentally change the implementing country's trajectory of economic development. For better or worse, such economic agreements are now an integral part of the landscape of global governance.

This book has focused on the causes and consequences of such agreements. It is not surprising that national leaders engage in negotiations on relatively unambitious economic agreements. Often, reputational benefits and concerns about transaction costs mean that it is optimal to codify existing practices in the formal language of international law. In contrast, the practice of forming deeply disruptive international institutions raises several questions to students of international law and political economy. Why would leaders sacrifice their policy autonomy? Why would they not implement major policy changes on their own, without heeding to the demands of foreign powers? If national leaders are as jealous of their sovereignty as the conventional wisdom in international relations has it (Bradley and Kelley, 2008; Moravcsik, 2000), codifying excessively demanding economic reforms in international institutions is a major puzzle that demands explanation.

To solve this puzzle, we have argued that, under the right conditions, certain types of international institutions can allow leaders to pursue their preferred liberal economic reforms—in particular, microeconomic liberalization—in spite of (i) stiff political opposition and (ii) the resulting lack of credible commitment to the coherent implementation of these reforms over time. Our basic premise was that when a national leader prefers to reform the economy, either to redistribute wealth from political opponents to supporters or to create economic growth, her efforts are often stifled by people and interest groups who expect to lose. Even on a good day, economic reforms are a nasty business. It is virtually certain that the beneficiaries of previous state intervention will attempt to mobilize to prevent economic reforms that would deprive them of their prior privileges. Thus, economic reforms suffer from a dual problem: a lack of credibility and the difficulty of implementation due to domestic political opposition. To gain empirical leverage on these issues, we have made the case that democratization increases domestic political demand for reform, while new leaders are in a particularly difficult position with respect to implementation due to their unconsolidated, uncertain position in power. Democratization empowers new mass constituencies, and these mass constituencies would benefit from the dismantling of policies that previously benefited the authoritarian ruler's cronies. However, if the democratic transition is overseen by a new government, as is often, but not always, the case, the new government's ability to implement liberalization is at risk.

In these circumstances, the leader wants economic reform, but the cost of liberalizing by exclusively domestic means is high. International institutions come to the rescue by offering the leader an opportunity to pursue these reforms at a lower domestic political cost. On the one hand, international institutions enhance the credibility of a commitment to economic reform. If the leader were to violate a commitment codified in international law, she would subject herself to adverse reputational consequences and possibly even sanctions. Given the expectation of these high costs, third parties, such as foreign investors and domestic detractors of reform, would understand that the leader's commitment is difficult to undermine. Therefore, foreign investors would respond to new relative prices by investing, and detractors of reform would not mobilize to oppose the leader's reform. Credibility enhances the benefits of economic reform and indirectly incapacitates the domestic opponents of reform.

On the other hand, the international institutionalization of economic reform can also directly reduce domestic political opposition. Suppose the international institution contains not only a commitment to economic reform, but also other provisions that benefit influential domestic constituencies. Even if these domestic constituencies were uninterested or even mildly hostile to economic reform in isolation, they might support economic reforms that allow the implementation of lucrative provisions contained in the international institution. For example, suppose a trade treaty prescribes economic reforms but also reduces tariffs. Exporters who would benefit from those tariff reductions would also support the economic reforms, as long as these economic reforms were credibly linked to the tariff reductions. This domestic policy package helps the leader build political support for economic reform.

Not all international institutions can promote economic reform through these two causal channels. The first requirement for a working international strategy is that the international institution actually contain legally binding provisions prescribing economic reform. Without such provisions, the international institution cannot unleash the power of international economic law to change the domestic political economy of liberalization.

Given this requirement, our first empirical approach was to examine the institutional design of international institutions. For concreteness, we focused on PTAs. Among all international institutions, these agreements are uniquely suitable for removing political obstacles to liberalization in developing countries. In addition to being directly relevant to economic policy, they are more flexible than comparable multilateral institutions, such as the WTO. The proliferation of PTAs since the end of the Cold War, during the "new wave of regionalism" (Mansfield and Milner, 1999), has been one of the big stories in international political economy. Understanding the implications of these agreements for economic reform promises high theoretical and empirical payoffs, as well as some guidance for improved foreign policy.

We found that an important subset of PTAs, namely those formed by the European Union and the United States, meet the criteria for promoting economic reform. They contain a variety of stringent provisions for economic reform across a variety of issue areas, such as intellectual property rights and competition law. In contrast, PTAs formed by many other countries, such as China, are not comparable in their depth of economic reform commitments. Therefore, our theory should apply to EU and US PTAs in particular. Japanese PTAs fall somewhere between the two extremes.

The second requirement for effective international institutionalization to promote economic reform concerns the foreign partner's identity. An international institution cannot promote economic reform unless the commitments enshrined in it are enforceable and are linked to other provisions that promise resources to influential domestic constituencies. For both reasons, it is ideal to negotiate international institutions with major economic powers that are firmly committed to economic liberalization. The European Union and the United States are the leading economic powers of the world, and promotion of economic reform is an integral element of their economic foreign policy. They are willing to help developing countries implement economic reforms that open markets and create investment opportunities for European and American corporations. This combination of willingness and ability creates a window of opportunity for leaders of developing countries who want to implement economic reforms but could not easily do so in the absence of international institutions.

In addition to examining PTA design, we analyzed the formation and consequences of EU and US PTAs. Building on the literature on democratization (Haggard and Kaufman, 1995; Przeworski, 1991) and political survival (Bueno de Mesquita et al., 2003), we argued that a leader's demand for economic reform should be positively associated with recent democratization, while the extent of domestic political opposition should be particularly acute for new leaders. Given this, we hypothesized that the interactive effect of recent democratization and leader change on the probability of PTA negotiations between a developing country and the European Union or the United States should be positive. We conducted extensive statistical analyses and found support for this claim. We were also able to reject plausible alternative explanations.

An important feature of the European Union and United States as PTA partners is their openness to negotiations with many developing countries, perhaps excluding the least developed ones. Since EU and US PTAs can be negotiated on a bilateral basis, they offer a particularly flexible international strategy for promoting liberalization. While some multilateral institutions, such as the WTO, offer another international support mechanism for liberalization, their multilateralism makes them somewhat cumbersome for leaders in need of liberalization at a specific time. Others, such as the IMF, implement programs that also allow reform, but these programs generally focus on macreconomic stabilization, instead of the "second generation" microeconomic reforms emphasized in this book. Given this, there is clearly a market for EU and US PTAs as instruments of liberalization.

Building on this insight, we also analyzed the consequences of EU and US PTA negotiations and signature for developing counties. Based on our design analysis, we focused on four economic reforms: intellectual property rights, privatization, liberalization of foreign direct investment, and capital account openness. Of these, the first three are microeconomic and the last pertains to the macroeconomy. We devised a method to identify major economic reforms in developing countries and examined whether these reforms could have plausibly been induced by EU and US PTA formation.

First, we found that, with the partial exception of capital account openness, developing countries that form a PTA with the European Union and the United States at some point implement major economic reforms during and immediately following the conclusion of PTA negotiations. This shows that even countries inclined toward economic reform rarely do so in the absence of EU and US PTA negotiations. Second, we compared the group of negotiating countries to a statistically selected group of countries that have not negotiated a PTA with the EU or the US. We found that these countries rarely implement economic reforms, even though they are in many ways similar to the negotiating countries. This also supports our finding concerning the reform effects of EU and US PTAs. We also examined two important multilateral organizations, the WTO and the IMF, and conducted several statistical tests of the causal mechanisms of the argument. Case studies of Chile, Colombia, Croatia, and South Africa offered qualitative evidence for the argument.

This book contributes both to the study of the role of domestic politics and international relations and to the study of the international dimensions of economic reform. In the following section, we summarize the implications of our findings for the role of domestic politics in international relations. Next, we discuss the meaning of our study for the study of economic reform, and especially the international dimension thereof.

UNDERSTANDING DOMESTIC POLITICS AND INTERNATIONAL INSTITUTIONS

National leaders' decisions to seek membership in international institutions are motivated by political considerations. The findings reported in this book shed light on why international institutions can help leaders achieve their goals in domestic politics. In addition to the benefits of credible commitment, international institutions provide leaders with opportunities to reshape the balance of interests in domestic politics. Putnam (1988) recognized that national leaders can use international institutions to promote their domestic goals, but neither he, nor much of the subsequent literature (Büthe and Milner, 2008; Mansfield and Pevehouse, 2006; Moravcsik, 1997), has offered specific hypotheses on (i) when and how leaders have incentives to engage in international negotiations for domestic purposes and (ii) what kinds of foreign partners are particularly helpful in this regard.

The book also shows that international institutions are effective in promoting these goals. Not only do leaders join international institutions for domestic political reasons, but this strategy is often effective. In the case of economic reform, a PTA with a major power can be a powerful tool. Our evidence shows that EU and US PTAs, by virtue of creating reciprocal market access and containing legally binding commitments to liberalization, have profoundly altered the political economy of important liberal microeconomic reforms, from privatization to FDI liberalization, by enhancing the leader's credible commitment to these reforms, and by distributing benefits to influential domestic constituencies.

These findings contribute to the academic debate on the role of international institutions in domestic politics. Although the realist theory of said institutions as mere "window dressing"(Mearsheimer, 1994–1995) has not found much support in recent empirical scholarship (Baccini and Urpelainen, 2012; Büthe and Milner, 2008; Mukherjee and Singer, 2010; Simmons, 2009), there remains the question of how international institutions shape domestic political outcomes. While Abbott and Snidal (2010) have recently downplayed the possibility that international institutions can facilitate the enforcement of commitment, we have shown that an important subset of properly designed institutions formed between major powers and developing countries can support deep economic reforms. This result underscores the need to examine the diversity of the global institutional landscape and account for not only the design but also the membership composition of international institutions and organizations.

An important contribution of the book is to show how these two questions—why join international institutions, and to what effect—can, and must, be analyzed as jointly determined. If leaders join international institutions to promote their domestic political goals, then one would expect international institutions to affect outcomes. While many previous studies have analyzed the determinants of PTA formation, (Baccini and Dür, 2012; Baier and Bergstrand, 2004; Mansfield and Milner, 2012), these studies usually forgo the next step of investigating the consequences of PTA formation. This omission means that there is no link between *intention* and *outcome*, and this in turn means that the relevance of international institutions to the domestic political economy remains subject to doubt. For example, had we found that international institutions are not effective, or had we found that they are effective but leaders do not use them, something would have been amiss. This dual strategy of empirical investigation allows us to scrutinize rational theories of international institutions as domestic political instruments in great detail.

Instead, what we found was that leaders engage in PTA negotiations with the European Union and the United States to promote liberalization, and that these PTA negotiations have observable effects on liberalization. The results contradict skepticism concerning the effectiveness of international institutions. From realists to neoliberal institutions, previous studies have often questioned the possibility that international institutions can constrain and influence state behavior (Abbott and Snidal, 2010; Keohane, 1978; Mearsheimer, 1994–1995). We have shown that while this criticism may be true of most international institutions, it does not apply to all of them. If the structural conditions are suited for enforcement because one of the parties is a major power, international institutions can enhance the credibility of promises and thus cause significant departures in state behavior. This goes back to Krasner's (1982) idea of regimes as "intervening variables" that can modify but not override structural factors such as state power.

Of particular import is the fact that PTAs with the European Union and the United States are simultaneously flexible *and* legally binding. As we have documented above, the European Union and the United States have shown considerable interest in promoting liberalization in developing countries. The interest of the European Union and the United States means that leaders in many developing countries, with the notable exception of the least developed countries, have a door open for liberalization should they see a need for promoting reform. Although scholars of international cooperation have argued that states generally shun institutions with high "sovereignty costs" (Bradley and Kelley, 2008; Moravcsik, 2000), this need not be the case if the agreements have been designed to solve specific domestic problems that the leader cannot implement due to domestic political opposition. The institution negotiated by the leader *enhances* her ability to implement domestic policies, and thus strengthens the government of the country. This is a far cry from the conventional view that states sacrifice sovereignty to deal with negative externalities. When leaders use international institutions to achieve their domestic goals and to overcome opposition, the clash between sovereignty and commitment disappears.

The lack of conflict between sovereignty and commitment shows that the effects of international institutions on domestic politics are contingent on their mandate and the context in which they operate. The IMF, for example, conditions crisis lending on policy reforms that leaders themselves might not implement without the reward of an emergency loan (Caraway et al., 2012; Steinwand and Stone, 2008; Stone, 2008). Exactly the opposite seems to be the case for the EU and US PTAs analyzed here. This variety suggests that speaking of conditionality in international institutions as a general condition is not helpful. In the IMF case, conditionality is often, though not always (Vreeland, 2003), imposed on leaders; in the PTA case, it is a strategy that leaders use to pursue their own goals. The difference in the context changes the logic of the negotiations and the expected effects of the international institution on political and economic outcomes.

The compatibility of flexibility and credible commitment is particularly interesting in light of the commonly perceived trade-off between flexibility and credibility in institutional design (Koremenos, 2001; Pelc, 2011). While legally binding obligations do play an important role in promoting liberalization, our findings draw attention to another side of the equation: in addition to the design of flexibility, international agreements vary greatly in the extent to which their formation is flexible. Some multilateral institutions, such as the WTO, are fairly difficult to negotiate and renegotiate due to their large membership. They are not particularly suitable for pursuing specific domestic reforms. Bilateral institutions, which require the consent of only two sovereign states, are much easier to negotiate and tailor to both parties' needs.

For scholars of democratization and international organizations, the finding on EU and US PTAs is also important. While scholars of international relations initially thought that democratizing states join intergovernmental organizations in an effort to credibly commit to policy reform (Mansfield and Pevehouse, 2006; Pevehouse, 2005), more recently this association has been shown not to hold. Poast and Urpelainen (2013) show that democratizing states do not join existing organizations, but instead form their own. Since this strategy does not appear ideal for credible commitment, our result on EU and US PTAs explains how governments of democratizing states pursue their preferred reforms. Instead of trying to meet the possibly demanding accession conditions of multilateral organizations, they negotiate bilateral or plurilateral agreements with major powers who have a direct economic interest in reform.

Another important dimension of international institutions that our analysis illuminates is the role of institutional design. Previous scholarship (Abbott and Snidal, 1998; Koremenos, Lipson, and Snidal, 2001) has maintained that states design international institutions to solve international cooperation problems, and our evidence also provides much support for the basic tenets of rational design. International institutions promote the goals that they are intended to promote, and their institutional design reflects this fact. At the same time, the findings put a crucial stricture on this finding. Governments design international institutions not only in view of international cooperation problems, but also in view of domestic political impediments to policy change. This means that the motivation for international institutionalization need not be international.

While we confirm the basic notion of rational design, we also emphasize the importance of state characteristics and context. An international institution of a given design is only helpful to the extent that it is backed by a state capable of implementing those institutional designs. In our case, forming a PTA with a poor country is unhelpful, no matter how stringent the institutional design. Therefore, scholars of institutional design should pay closer attention to interaction between structural and institutional factors. From the perspective of liberalization, the optimal design must exhibit a good fit to the structural characteristics of the two partners. In our case, it is only because of the major powers' willingness and ability to enforce liberalization commitments, while also generating domestic side payments, that the elaborate institutional designs found in the EU and US PTAs are effectively enforced. If pairs of smaller countries tried to mimic the same strategy, they would probably fail because they do not have the structural power to effectively use the institutional designs incorporated into their PTAs. This shows that the idea of rationally designed institutions is compatible with theories of international relations that emphasize history and context (Jupille, Mattli, and Snidal, 2013; March and Olsen, 1998). Governments negotiate international institutions in specific contexts to solve often idiosyncratic problems, but they do so in a rational fashion that allows systematic theory development and hypothesis testing.

These observations also emphasize the importance of accounting for empirical variation in the design of seemingly similar international institutions, such as PTAs. Previous scholarship has offered several explanations for PTA formation, ranging from economic interest (Baier and Bergstrand, 2004) to trade competition (Baccini and Dür, 2012) and governments' need to signal commitment to liberalization to their voters (Mansfield and Milner, 2012; Mansfield, Milner, and Rosendorff, 2002). However, these studies do not recognize the essential difference between EU and US PTAs versus most other PTAs. Our study has shown that the deep economic commitments contained in EU and US PTAs allow them to exert influence on domestic economic policy far beyond simple trade liberalization, while we find no similar evidence for less ambitious PTAs. This difference suggests that future research should not approach PTAs as a homogeneous group of agreements, but instead should recognize their heterogeneity and develop theories that explicitly explain and account for it.

For the design of potential EU and US PTAs in the future, and perhaps also for the design of Japan's PTAs, our findings offer useful insights. For one thing, the considerable variation across developing countries' political and economic situations means that major powers should allow flexibility in their PTA designs, so as to encourage leaders in developing countries with specific needs to engage in negotiations. Since our findings show that different developing countries' propensities to, and reasons for, engaging in PTA negotiations vary over time, it is important for the European Union and the United States to leave open the door for negotiations on trade treaties that promote a variety of microeconomic reforms. By maximizing developing countries' opportunities to engage in PTA negotiations, the European Union and the United States can promote their global economic interests through liberalization.

INTERNATIONAL DIMENSIONS OF ECONOMIC REFORM

Another set of important contributions of our book pertains to understanding economic reform. Throughout this book, we have adopted the premise that economic reforms are difficult to implement. In both autocracies and democracies, economic reforms provoke political opposition. Since political opposition is often enough to topple the country's leader, economic reform is a difficult decision that may easily backfire.

Crisis is often seen as the primary cause of economic reform (Haggard and Kaufman, 1995; Pop-Eleches, 2009; Weyland, 2002). Given the difficulty of economic reform and people's aversion to large losses, leaders are expected to only pursue economic reform if they have no other choice. Accordingly, economic reforms would be difficult to pursue outside unusually difficult economic conditions. Regrettably, then, change would require a crisis. Without a crisis, developing countries would not be able to overcome the high political impediments to liberalization. To the extent that liberal policies strengthen the economies of developing countries, these countries would be doomed to fluctuate between crisis and reform.

Even scholars who allow for international influences often emphasize crises. According to Pop-Eleches (2009), for example, the IMF has had contingent effects on economic reform in times of economic crises. Vreeland (2003) also finds that countries engage in negotiations with the IMF on conditional loans more often during economic crises. Again, though both scholars offer a relatively nuanced argument that contains and emphasizes other factors, one cannot but wonder whether these findings have any significance beyond the special case of economic crisis.

Our findings suggest that there is, at least in the case of microeconomic liberalization, a desirable alternative to crisis: developing countries can promote reform by forming PTAs with the European Union and the United States. These PTAs allow credible commitment and generate domestic political support for liberalization, and so they may allow interested leaders to pursue liberalization even during normal times. These strategies allow developing countries to implement their preferred reforms *before* the failure of economic governance or exogenous shocks prompt a deep crisis.

In other words, we have found that when it comes to economic reform, international institutions influence outcomes well beyond the narrow domain of crisis politics. Leaders often wish to pursue economic reforms regardless of crisis, and they can create the necessary political support for economic reform through international institutionalization. In the case of economic reform through PTA formation, a crisis is not a necessary condition for economic reform. Countries whose economy generally performs well, such as Chile, also implement economic reforms. PTAs seem to play a major role as ways for countries to implement economic reforms in the absence of economic crises. To the degree that these economic reforms can boost national economic performance, they serve as a useful defensive strategy against economic crises.

This finding goes against the pessimistic conventional view that reform depends on desperate economic conditions (Drazen and Grilli, 1993; Drazen and Easterly, 2001; Haggard and Kaufman, 1995; Pop-Eleches, 2009; Przeworski, 1991). While crises may promote liberalization, we find that trade treaties offer a less painful alternative, at least for "second generation" reforms. Leaders can engage in treaty negotiations with major powers to push through their preferred domestic policies. If these policies increase the probability of avoiding serious economic crises, then trade treaties can help leaders avoid recession. This, again, underscores the major effects of international institutions on domestic politics and the economy.

For students of the political economy of economic reform, our findings offer an important lesson: it is essential to account for international institutions in the study of feasibility of reform, and in accounting for international institutions it is important to look beyond the usual suspects, such as Bretton Woods institutions. PTAs are a flexible and effective strategy for national leaders to implement economic reforms, be it for distributive purposes or to generate economic growth. Failure to account for these previously unrecognized international strategies may result in unduly pessimistic estimates of the feasibility of economic reform in a given country at a given time.

The importance of these findings is particularly pronounced at present times. Many developing countries have now secured the status of a liberal market economy, but the challenge of "second generation" reform remains. During the global financial crisis that began in the US housing markets in 2008, economic governance has also become increasingly complex. While the European Union and the United States have largely focused on their own economies, it is important to remember that a genuine global economy exists, and that international economic policy is an important means to generate global economic growth. In the economic climate created by the global financial crisis, liberalization has increasingly been under attack. EU and US PTAs allow developing countries, should they so wish, to consolidate their liberal policies and thus create confidence in international and domestic investor markets. Our findings suggest that PTA formation may be one way of achieving this goal.

PROMOTING ECONOMIC REFORM AT HOME AND ABROAD

In addition to guiding social science research, this book has implications for policy formation both in developing and industrialized countries. To begin with, the central findings of the book suggest that leaders in developing countries can use PTAs with the European Union and the United States to promote economic reform. While dozens of developing countries have formed EU and US PTAs to date, most countries in the world have not done so. This includes several very important economies, such as Brazil, Argentina, and Indonesia. For various reasons, these and many other developing countries have not, at least as yet, successfully concluded or even initiated PTA negotiations with the Euopean Union and the United States. Our findings suggest that leaders in these countries can promote economic reform, if they so wish.

However, this strategy may not work for all developing countries. For the strategy to work, it is important that the European Union and the United States are sufficiently interested in promoting economic reform in the partner country. Given this, leaders in the poorest and weakest African economies may not be able to rely on EU and US PTAs for economic reform. Their ability to exploit international institutionalization to promote economic reform is severely limited by the fact that neither the European Union nor the United States are very interested in cooperating with them on economic reform.

For the European Union and the United States, this book brings welcome news: their PTAs are working. We have found that these PTAs were designed in view of promoting economic reform, and our empirical findings also suggest that they have been reasonably successful in doing so. For the future, these strong PTAs mean that the European Union and the United States can continue to rely on PTAs as a way to promote liberal economic reform abroad. Their PTAs are an ideal combination of formation flexibility and design rigidity, so they allow leaders to engage in PTA negotiations when such negotiations are the most beneficial, while also promoting credible commitment and creating domestic support for reform.

The importance of this strategy is difficult to overestimate these days. Waves of democratization have swept the strategically important areas of Middle East and North Africa. Our findings suggest that the European Union and the United States can use trade agreements to promote economic reform in these areas. If liberal economic reform can in turn help leaders of these countries increase economic growth in their economies, then EU and US PTAs may produce large strategic benefits over time.

Though our argument has emphasized the economic interests of the European Union (EU) and the United States, it is notable that these major powers could also use PTAs to promote their geo-strategic interests. In this regard, our case study of Colombia is particularly notable: in addition to promoting its investment interests, the United States used the PTA to support an important ally in the war on drugs. Similarly, the European Union and the United States could deepen their trade and general economic cooperation with potential partners in the Middle East. For example, Tunisia's recent democratization and geographic location make it a promising economic partner for the European Union and the United States. If the European Union and United States can deepen trade cooperation with Tunisia to promote liberalization, and thus improve Tunisia's long-term economic prospects, then their foreign policy could support broader democratization trends in North Africa and, hopefully, in the Middle East. In this regard, the US decision to launch bilateral trade and investment talks already in October 2011 is welcome news: as the US Trade Representative for Europe and the Middle East put it, "the United States strongly supports Tunisia's transition to democracy and to an open economic system governed by the rule of law… enhancing U.S. trade and investment integration with Tunisia to increase economic growth and jobs is an important part of the support we can give to this process."[1]

To maximize the political and economic benefits of their PTAs, the European Union and the United States should reach out to potential partners. Our findings suggest that leaders in developing countries show interest in PTAs when their ability to implement reforms is curtailed. This contingency is not necessarily easy to predict, so the European Union and the United States should leave the door open for interested developing countries. In contrast, we find little support for the effectiveness of coercive imposition of economic reform through PTA formation. Leaders need not engage in PTA negotiations unless they so desire. Therefore, even major economic powers such as the European Union and the United States must base their strategy of PTA expansion on voluntary participation by developing countries. Given the intricacies of the timing of leader interest in PTA negotiations, this requires a flexible "open door" policy.

Third, our results have implications for the WTO. In recent years, the proliferation of PTAs has provoked intense controversy concerning their implications for the multilateral trade regime (Bhagwati, 2008). Contravening the basic assumptions of this debate, we have found that some of the most important PTAs exert their most important influence outside trade liberalization. Given this, it is not at all clear that a trade-off exists between regionalism and global multilateralism. If the most important PTAs mostly promote economic reform outside trade liberalization, possible trade diversion effects may ultimately be secondary to broader economic reform effects. If so, the importance of the debate on the consequences of PTA proliferation for the multilateral trade regime may be overstated. The real question should be whether the economic reforms that PTAs between major powers and developing countries promote are desirable or not.

Finally, our findings could shed light on the consequences of China's increasing importance as a trading partner for many developing countries. According to our design data, China has not, unlike the European Union and the United States, chosen to negotiate PTAs with liberalizing potential. In the future, China's increasing prominence may present challenges to the European Union and the United States. Their PTAs are no longer "the only game in town," and so they may have to compete with China for influence. This could prevent leaders in developing countries from exploiting EU and US PTAs for economic reforms.

In sum, PTAs hold considerable promise as an instrument of political-economic statecraft in the future. Liberal major powers, notably the European Union and the United States, can use PTAs to offer leaders in developing countries opportunities to liberalize their economies, especially with regard to microeconomic incentives. This book has shown that EU and US PTAs have already had this effect in many key countries, from Croatia and South Africa to Chile and Colombia, and we see no reason that this trend would not continue. In tumultuous economic times, PTAs and other similar economic instruments can play an important role in economic governance and restarting growth in important developing countries.

NOTES

CHAPTER 1

1. "First generation reforms" generally refer to macroeconomic stabilization in a crisis, while "second generation reforms" are structural changes that enhance the stability and productivity of the economy in the long run after the initial stabilization goals have been achieved (Naìm, 1994).
2. For differences between the politics of the two types of reforms in Latin America in general, see Pastor and Wise (1999).
3. Throughout this book, "reform" refers to microeconomic reform unless otherwise noted. When we discuss macroeconomic policy change, we say so explicitly.
4. For the concept of multilateralism, see Kahler (1992).
5. Some leaders, such as Brazil's Lula, have managed to reform by purely domestic means.
6. In some cases, such as NAFTA, it seems clear that trade increased due to liberalization. Statistical evidence suggests, however, that the trade effect is far from uniformly positive (Baccini et al., 2011).
7. Baldwin (1993) proposes a "domino theory of regionalism," whereby countries form PTAs as a defensive move against PTAs formed by others: a group of countries forms a PTA if the net benefits of trade liberalization within this group exceed the costs, such as domestic political opposition. Baccini and Dür (2012) provide empirical evidence for this theory: if country *A*'s economic competitor *B* forms a PTA with a third party *C*, then *A* can be expected to form a PTA with *C* as well. Manger (2009) emphasizes that the home countries of foreign investors also have strong incentives to form such PTAs as a defensive move against third parties who have formed PTAs due to investment discrimination.

CHAPTER 2

1. In the empirical analysis, the timing aspect is captured by the event of leader change under democratization.
2. However, measuring service liberalization in the aggregate can be difficult. This is why the quantitative analysis of this book focuses on other sectors. In the case studies, we also consider service liberalization more broadly.
3. Fernandez and Rodrik (1991) show formally that even if liberalization is expected to generate net benefits, it may fail to secure majority support if the distribution of benefits is subject to uncertainty. While recognizing the merits of this argument, we maintain that democratization increases demand for liberalization relative to the previous autocratic rule.

4. This is not necessarily true of certain macroeconomic reforms, such as anti-inflationary policies, given their general equilibrium effects on the economy.
5. *Maghrebia* on January 23, 2008.
6. From the reverse perspective, Urpelainen (2012) shows that markets can also help leaders engage in international cooperation and form international institutions.
7. "House Rejects U.S. $300 Million World Bank Loan." *This Day* on December 10, 2009.
8. Often, scholars of international relations let "issue linkage" refer to international negotiation strategies (Davis, 2004; Sebenius, 1983). For an analysis of domestic issue linkage, such as linking trade cooperation and microeconomic liberalization, see Rector (2001).
9. In contrast, the IMF has failed to enforce such policies for major borrowers, such as Russia. Stone (2002) shows that this credibility problem stems from the fact that the cost to IMF of punishing Russia is too high. This counterexample suggests that an international institution's ability to promote credible commitment is contingent. In our empirical application, the power asymmetry between the European Union or the United States and a developing country means that the developing country's credible commitment to economic reform prescribed in the treaty is, at the very least, plausible.
10. To be sure, King and Roberts (2012) note that the effect of PTA formation on FDI is not statistically significant in the Büthe and Milner (2008) analysis when quadratic trends are included by country.
11. International institutions may also have negative consequences. For example, McLaren (1997) shows that small countries may become dependent on large countries if the former's domestic companies implement costly adjustments in expectation of trade negotiations. These negative effects may explain why many developing countries have historically worried about economic dependence (Grieco, 1982). However, they do not negate our argument: even if international institutions may create dependence, leaders with a strong interest in domestic liberalization are often willing to incur this cost.
12. Emphasis removed.
13. Specifically, we estimate that countries forming a PTA with the EU and the US receive more than twice the amount of aid in the following five years than they did on average before forming a PTA.
14. See https://sites.google.com/site/leonardobaccini/book-manuscript.
15. Given our focus on microeconomic reforms, the major power's lack of interest in "terms of trade" with small partner countries is not directly relevant. And even in the case of liberalization, a relatively small partner country can be influential within a sector. For example, Chile is a small economy that nonetheless commands market power in international trade in minerals.
16. See http://www.ustr.gov/trade-topics/intellectual-property. Accessed on August 31, 2011.
17. Interview by the authors on February 12, 2012.
18. See http://ec.europa.eu/enlargement/index_en.htm. Accessed on August 31, 2011.
19. "The Western Balkan Countries on the Road to the European Union." See http://ec.europa.eu/enlargement/index_en.htm. Accessed on September 18, 2011.

CHAPTER 3

1. In the empirical analysis, we will also account for the role of other international institutions, such as the IMF and the World Bank. In the case studies, we examine causes other than democratization of increased domestic demand for reform.

2. Within the group of democracies, one may also distinguish between presidential and parliamentary democracies. For theoretical and empirical analysis of the differences between presidential and parliamentary democracies, see Cheibub (2007).
3. Another problem that governments in democratizing countries face is the possibility of deposition through a coup that results in authoritarian reversals. We recognize the importance of this problem, but we do not emphasize it for three reasons. First, during the time period of our empirical analysis, from 1990 to 2007, losing elections has been a far more common threat to a leader's political survival under democratization than coups. Second, the countries that are under threat of a coup are mostly fragile states in Africa. Their ability to negotiate an EU or US PTA is severely limited because the two major powers do not have a clear commercial interest in these countries. Finally, it seems somewhat implausible that a PTA could prevent the violent overthrow of a leader.
4. However, it is plausible that democratization focuses political attention on redistribution instead of liberalization. In some contexts, such as post-apartheid South Africa, we find evidence that both redistribution and liberalization became salient upon democratization (Hirsch, 2005).
5. In a global analysis, measuring the heterogeneity of preferences in ruling coalitions across regime types, over time, and between political cultures would be difficulty. Similarly, measuring the degree of domestic opposition is not practically feasible. In contrast, leader change is a direct and readily observable measure for reform difficulty.
6. *Cape Times* on July 6, 1994.
7. The data for leader survival and tenure are from the Archigos dataset (Goemans, Gleditsch, and Chiozza, 2009) for the years 1990–2007, the time span of our empirical analysis.
8. Democratization is defined as a shift from autocracy to democracy using the binary variable in Cheibub, Gandhi, and Vreeland (2010).
9. This is not to say that other supply constraints do not exist. Our general theory does not focus on any specific factor, but rather emphasizes the more abstract notion of impediments to domestic reform strategies. Leaders may find it difficult to implement economic reforms if their governments are polarized, for example (Frye, 2002). They may also face difficulties because powerful interests, such as the military, oppose reform. For testing our general argument, all that matters is that new leaders face, all else being equal, more difficulties in the implementation of domestic reform.
10. While our focus here is on PTAs as instruments of economic reform, already at the onset we are compelled to note that we do *not* claim that this is the exclusive, or even primary, reason that countries form PTAs. Instead, we claim that PTAs with major powers are suitable for promoting economic reforms well beyond trade liberalization. Our primary interest is not in developing a theoretical model that maximizes the number of PTAs we can explain. As discussed in the introduction to this book, much research already addresses this question (Baier and Bergstrand, 2004; Mansfield and Milner, 2012).
11. The current system of preferential access to European markets for countries from countries from Africa, the Caribbean, and the Pacific is governed by the 2000 Cotonou Agreement. While South Africa is a contracting party, it does not obtain full preferential treatment.

12. This argument may not apply to the least developed countries. Indeed, our empirical analysis shows that EU and US PTA negotiations mostly feature middle-income countries.
13. The US-Colombia PTA was signed in 2006 and has been ratified by Colombia in 2007. "The agreement entered into force in May 2012 after the US Congress ratified it."
14. "Press: Bosnia-EU Relations Put on Hold." April 26, 2011. Available at http://archive.today/9l3w. Accessed on May 27, 2014.
15. In other words, we do not summarize other explanations for PTA negotiations that do *not* specifically predict EU and US PTA negotiations. For example, Mansfield and Milner (2012) argue that democratic governments form PTAs to signal their liberal economic policies to voters. However, they do not argue that the combination of democratization and leader change would prompt negotiations, let alone with the EU and the US in particular.
16. We thank Kevin Young for alerting us to this possibility.
17. Interview with an anonymous Colombian trade negotiator, February 2012.

CHAPTER 4

1. Examples of Cold War PTAs formed by the EU and the US include the EU-Turkey (1963) Association Agreement and the US-Israel (1985) Free Trade Agreement. Both agreements are driven by geopolitical interests, and neither imposes specific reform criteria.
2. Only a sub-sample of all the PTAs signed are notified to the WTO (583 as of January 31, 2014). PTAs notified by the WTO have two common features: (1) PTAs member have to be WTO member; (2) PTAs have to be reciprocal trade agreements.
3. Unfortunately, we were not able to find official data on the onset of negotiations for Chinese PTAs. This is because the Chinese government does not publicize the official starting date for negotiations.
4. For this figure, multilateral PTAs such as CAFTA-DR are disaggregated.
5. Interviews by the authors on March 5, 2012.
6. Interviews by the authors in January 2012.
7. Interview by the authors on February 6, 2012.
8. Interview by the authors on February 26, 2012.
9. Technically, the figure shows the "kernel densities" for the different numbers of IPR provisions that the PTAs in the sample contain. As the relative frequency of a given IPR scope value increases in a data set, its kernel density also increases.

CHAPTER 5

1. For a current listing, see http://data.worldbank.org/about/country-classifications/country-and-lending-groups. Accessed on January 18, 2012.
2. The data set is unbalanced since some countries, such as those from the former Soviet Union, enter the data set only a few years after the year 1990. Moreover, dyads are dropped as they engage in PTA negotiations with the EU or the US.
3. Technically, some of the models we use are based on the survival approach: we predict the time that a developing country "survives" without forming a PTA with a given major power. From a substantive perspective, this technical distinction is unimportant. See Box-Steffensmeier and Jones (2004) for various approaches to event history modeling in the social sciences.
4. The full details of the coding are available in a supplementary Appendix to be published online upon the publication of this book.

5. To scrutinize the consequences of our assumption, we also conducted additional statistical tests under the assumption that the negotiations had actually began a year earlier. Our results remained robust, suggesting that any small measurement error from our coding of the negotiations would not compromise our results.
6. We prefer the binary indicator from Cheibub, Gandhi, and Vreeland (2010) both for conceptual clarity and because measuring democracy as a continuous concept is difficult.
7. Manger and Shadlen (2011) argues that North-South PTAs are also a tool for developing countries to lock in preferential market access granted by the Generalized System of Preferences (GSP) and related schemes. Ideally, we would like to include a variable that takes into account whether a country is member of the GSP. However, all the countries in our data set are part of the GSP, so such a variable would have no variation. Moreover, other asymmetric agreements usually cover all the countries in a specific region. For instance, the African Growth and Opportunity Act (AGOA) covers all the Sub-Saharan African countries. Thus, region fixed effects should take into account the presence of such asymmetric agreements.
8. For this table, to expand coverage we allow for any three definitions of democratization (Cheibub, Gandhi, and Vreeland 2010; Polity IV; and Freedom House) and a leader change within three years of PTA negotiations. The purpose of this expansion is to capture as many cases as possible for illustrative purposes. Notably, the statistical analyses above show that our hypotheses are valid for the more stringent definition as well.
9. Of the two, Mexico's record of democratization in 1990 is certainly weaker than that of many other cases in our sample. However, it is not a stretch to argue that Mexico was undergoing a period of political change toward democratization.
10. In addition to clustering standard errors by region, we estimate probit regressions with region-year fixed effects and survival models where the number of treaties in a region (Mansfield, 1998) is included as a contemporaneous, instead of lagged, control variable.
11. For these South-South PTAs, we were unable to find systematic and reliable information on the date of negotiations. Given that negotiations are generally short, we use the year of formation as a proxy. The results are similar if we lag the year of formation by one or two or three years. The data come from Baccini and Dür (2012).
12. There is a theoretical reason to doubt this argument: for domestic political reasons, the EU and the US might want to avoid associating themselves with dictators who have recently implemented a coup.
13. Here, we use a figure instead of a table because it allows us to more readily present the inconsistent pattern of autocratization effects that we expected than a conventional regression output table would.
14. Robert Zoellick, September 2004, available at http://www.ustr.gov/about-us/press-office/ speeches/archives/2004/september/transcript-us-bahrain-free-trade-agreement-si. Accessed on May 22, 2012.
15. The data come from http://www.isaf.nato.int/troop-numbers-and-contributions/index.php. Accessed on May 21, 2012.
16. The data come from http://www.globalsecurity.org/military/ops/iraq_orbat_coalition.htm. Accessed on May 21, 2012.
17. The data are from http://www.un.org/sc/members.asp. Accessed on May 21, 2012.

18. For an overview, see http://ec.europa.eu/trade/creatingopportunities/bilateral-relations/regions/mercosur/. Accessed on February 20, 2012. After difficult negotiations, the negotiations were in suspended in 2004. Six years later, in May 2010, and following informal discussions in Buenos Aires and Brussels, the European Commission chose to relaunch the negotiations.
19. "Bolivia Seeks to Negotiate Free Trade Treaty with U.S." *Notisur*, May 20, 2005.
20. From "Thaksin's Loss, US's Gain", by Shawn W. Crispin, published on *Asia Times Online* on February 9, 2006. Article available at http://www.atimes.com/atimes/Southeast_Asia/IB09Ae03.html.

CHAPTER 6

1. The data are available at http://www.wipo.int/members/en. Accessed in March 2011.
2. See http://rru.worldbank.org/Privatization. Accessed on March 21, 2012.
3. See http://www.prsgroup.com/ICRG_Methodology.aspx. Accessed on March 21, 2012.
4. In experimental terminology, PTA would be the "treatment," and differences between treated and untreated subjects emerge because the PTA is not randomly assigned on subjects. In this sense, the observational data we used can be thought of as a broken experiment.
5. It is not necessary to match on a history of economic reforms because our statistical technique can account for past levels and trends of liberalization.
6. Technically, the problem is a correlation between the dependent variable and the error term.
7. Blackwell et al. (2009, 531) note that "the L_1 value is not valuable on its own, but rather as a point of comparison between matching solutions." However, there does remain imbalance between the two sub-samples. This, again, testifies to the importance of subsequent qualitative analysis.
8. For an application of rolling regressions to time series analysis, see Yaffee (2007).
9. Technically the R^2 value and/or the root mean square error (RMSE) of the prediction model increases so much from time $t - 1$ to t that such a change would be highly unlikely without a change in the underlying data generation process. In other words, the change in the R^2 or the RMSE is statistically significant.
10. The qualitative case study of South Africa provided in the next chapter gives a detailed account of one of these cases.
11. For a thorough discussion on the difference-in-differences estimation, see Angrist and Pischke (2009).
12. By dropping Eastern European countries, we also avoid confounding the WTO effect on reform with the EU accession effect on reform.
13. For an analysis on IMF conditionality, see Dreher and Vaubel (2004).
14. See http://www.keionline.org/ustr/special301. Accessed on April 20, 2013.
15. See http://www.state.gov/s/l/c3439.htm. Accessed on April 20, 2013.
16. See http://ec.europa.eu/trade/creating-opportunities/trade-topics/intellectual-property/enforcement. Accessed on April 20, 2013.
17. See http://ec.europa.eu/trade/tackling-unfair-trade/trade-barriers/investigations/. Accessed on April 26, 2013.
18. See http://trade.ec.europa.eu/doclib/html/130596.htm. Accessed on April 26, 2013.
19. EU-Egypt is a partial exception, with some fluctuation in Egypt's capital account openness over time. However, this fluctuation is difficult to distinguish from white noise in the data.

20. The data are from the World Development Indicators. See http://data.worldbank.org/indicator. Accessed on March 2012.
21. See http://www.aiddata.org. Accessed on March 2012.
22. "The Western Balkan Countries on the Road to the European Union." *European Commission*. Available at http://ec.europa.eu/enlargement. Accessed on February 23, 2012.
23. "Regions: Euromed." *European Commission*. Available at http://ec.europa.eu/trade/creating-opportunities/bilateral-relations. Accessed on February 23, 2012.
24. "Trade Capacity Building." *United States Trade Representative*. Available at http://www.ustr.gov/ trade-topics/trade-development. Accessed on February 23, 2012.

CHAPTER 7

1. Carlotta Gall, "A Feeble Croatia Is Battling Its Ex-Leaders," *New York Times*, September 3, 2000. Available at http://www.nytimes.com/2000/09/03/world/a-feeble-croatia-is-battling-its-ex-leaders.html?pagewanted=all&src=pm.
2. Interview conducted by the authors on January 23, 2012.
3. Interview conducted by the authors on January 23, 2012.
4. The document of the EU commission is available at http://ec.europa.eu/enlargement/pdf/ key_documents/2007/nov/croatia_progress_reports_en.pdf. Accessed on March 26, 2012.
5. Interview conducted by the authors on January 18, 2012.
6. Interview by the authors on January 23, 2012.
7. Interview by the authors on January 18, 2012.
8. Interview by the authors on January 23, 2012.
9. SAA is the acronym for Stabilization and Association Agreement, which is the official name of the agreement between Croatia and the EU. For consistency with the other cases, we use the acronym PTA also for Croatia.
10. Interview by the authors on January 18, 2012.
11. We note that such an increase of FDI was also driven by diaspora dynamics, that is, investment coming from Croatians living abroad. We thank Julia Gray for bringing that to our attention.
12. The data are from EU Commission Trade Statistics. Available at http://ec.europa.eu/enlargement/candidate-countries/croatia/eu_croatia_relations_en.htm. Accessed on March 26, 2012.
13. "Croatia Moves Closer to Joining the EU." February 2, 2012. Available at http://blogs.fco.gov. uk/davidlidington/2012/02/02/croatia-moves-closer-to-joining-the-eu/. Accessed on March 26, 2012.
14. Nelson Mandela's 100 Day Speech to Parliament on August 18, 1994, in Cape Town. Document available at http://www.africa.upenn.edu/Govern_Political/Mandel_100.html. Accessed on March 25, 2012.
15. Interviewed by the authors on February 6, 2012.
16. We thank Joachim Wehner for pointing that out to us.
17. Interviewed by the authors on February 27, 2012. Ms Pillay's views do not necessarily represent the views of the Department of Trade and Industry.
18. Interviewed by the authors on February 13, 2012.
19. The original source is *Cape Times* on January 26, 1994.
20. From *The Argus* on April 12, 1994; cited in Hirsch (2005, 3).
21. Original source is *Cape Times* on July 6, 1994.
22. Data available at http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245213114875. Accessed on February 20, 2012.

23. Johannesburg on June 22, 1998.
24. We thank Joachim Wehner for raising this point with us.
25. “Dissolving South Africa Inc. Privatization: Mandela Government Prepares to Auction Off Unwieldy State Companies.” *Baltimore Sun* on March 17, 1999. Available at http://articles.baltimoresun.com/ 1997-03-17/ news/1997076020_1_south-africa-afrikaners-apartheid. Accessed on March 27, 2012.
26. For a thorough evaluation of GEAR, see Streak (2004).
27. Emphasis of entire paragraph in the original text removed by the authors.
28. See http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Foreign_ direct_ investment_statistics. Accessed on March 14, 2012.
29. Interview by the authors on February 6, 2012
30. Interview by the authors on February 13, 2012.
31. Emphasis in the original.

CHAPTER 8

1. Chile was designated as the first in line to enter into NAFTA by the Canadian, Mexican, and US presidents at the Summit for the Americas in Miami in 1994. However, Chile’s accession to NAFTA went nowhere because of the expiration of the fast track approval in the US Congress, the Mexican peso crisis, and the 1994 presidential transition from Patricio Aylwin to Eduardo Alfredo Juan Bernardo Frei Ruiz-Tagle. Informal negotiations between Chile and the US spanned three Chilean administrations (Aylwin, Frei, and Lagos).
2. “Chile Embraces a Socialist Revival.” *Chicago Tribune*, June 29, 1999.
3. Reported in Murillo and Le Foulon (2006, 6).
4. Reported in Murillo and Le Foulon (2006, 6).
5. Ricardo Lagos’s Second State of the Nation Address on May 21, 2001, in Valparaíso, Chile. Available at http://timelinesdb.com/showsubj.php?subj=52.
6. “Chile Embraces a Socialist Revival.” *Chicago Tribune*, June 29, 1999.
7. Concertación is shorthand for the Concertación de Partidos por la Democracia (Concert of Parties for Democracy). It is a coalition of Chilean center-left to right-wing political parties and it was founded in 1988. With the exception of the current president, Sebastián Piñera, every presidential candidate supported by the Concertación won every election in the post-Pinochet democratic era.
8. Independent Democratic Union (Unión Democrata Independiente, UDI) is a Chilean right-wing, conservative political party, founded in 1983.
9. Interview quoted in Pribble and Huber (2010, 29).
10. “Lagos: Credibility at Stake in Essbio Privatization.” *Business News Americas*, June 28, 2000. Available at http://www.bnamericas.com/news/privatization/Lagos:_ Credibility_at_Stake_in_ Essbio_Privatization. Accessed on March 14, 2012.
11. The VIII Biobío Region is one of the 15 administrative divisions in Chile. The region includes four provinces: Arauco, Biobío, Concepció´on, and Ñuble. The capital of the Region is Concepción.
12. Commanding Heights: Ricardo Lagos. *Public Broadcasting Service*, January 19, 2002. Available at http://www.pbs.org/wgbh/commandingheights/shared/mini textlo/int_ricardolagos. html. Accessed on March 26, 2012.
13. “Lagos Considers Enap Privatization.” *Business News Americas*, April 26, 1999. Available at http://www.bnamericas.com/news/oilandgas/Lagos_Considers_ Enap_Privatization. Accessed on March 14, 2012.

14. “Chile’s Left Covets the Fruits of Economic Success.” *Wall Street Journal*, September 8, 2000.
15. Interview with Kathleen Uribe, February 13, 2013. Interview with Ana Novik, January 23, 2012.
16. “Intellectual Property under Scrutiny.” *Business Chile Magazine*, January 5, 2000. Available at http://www.businesschile.cl/en/news/reportaje-principal/intellectual-property-under-scrutiny. Accessed on March 14, 2012.
17. Interview with Kathleen Uribe, December 8, 2011.
18. Latino Barometro (1995–2009), available at http://www.latinobarometro.org/latino/ latinobarometro.jsp. Accessed on February 20, 2012.
19. Interview conducted by the authors on December 8, 2011.
20. Interview conducted on January 23, 2012.
21. This negotiator was interviewed by the authors on February 10, 2012, and required anonymity.
22. This is not to say that Chile or other PTA-negotiating countries did not implement other reforms earlier and later. The theory predicts effects in sectors specifically included in the PTA, and the empirical analysis focuses on these sectors only.
23. Interviewed by the authors in February 10, 2012.
24. Interviewed by the authors on December 8, 2011.
25. Interviewed by the authors on February 10, 2012.
26. Based on UNCTAD data available at http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx?sRF_ActivePath=P,5,27&sRF_Expanded=,P,5,27. Accessed on February 20, 2012.
27. Data available at http://stats.oecd.org/Index.aspx?DataSetCode=FDI_FLOW_PARTNER. Accessed on December 10, 2011.
28. Interview conducted on January 23, 2012.
29. Colombia benefited—together with Bolivia, Ecuador, and Peru—from the Andean Trade Promotion and Drug Eradication Act, which exempted 6,300 products from tariffs. The agreement replaced the Andean Trade Preference Act, which was in place from 1991 until early 2001. In February 2011, the US Senate renewed the Andean Trade Promotion and Drug Eradication Act for Ecuadorian products only. Information about the Andean Trade Promotion and Drug Eradication Act can be found at http://georgewbush-whitehouse.archives.gov/news/releases/2002/10/20021031-9.html.
30. “Colombia Elects a Hard-liner on Fighting Rebels.” *Washington Post*, May 27, 2002.
31. “Colombia Presidential Hopeful Focuses on Security, Stability.” *Financial Times*, April 4, 2002.
32. “Colombia’s Uribe: A Tough Leadership Style in a Once-Dangerous Part of the World.” Janine Zacharia for *Stanford Graduate School of Business Headlines*. Available at http://www.gsb.stanford.edu/news/ headlines/uribe-colombia-2012.html. Accessed on March 15, 2012.
33. From “Álvaro Uribe Vélez” by Brian F. Crisp (primary contributor). Document available at http://www.britannica.com/EBchecked/topic/862399/Alvaro-Uribe-Velez.
34. Based on UNCTAD data, available at http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx?sRF_ActivePath=P,5,27&sRF_Expanded=,P,5,27. Accessed on March 4, 2012.
35. “Inflows, Outperforming.” *Economist*, April 14, 2011.
36. “Reforming Labor Law: Lessons from Colombia,” prepared by Booz Allen Hamilton in cooperation with USAID for the World Bank’s 2007 Doing Business

Reformers' Club Conference. Document available at http://www.bizclir.com/cs/best_practices.

37. El Polo Democratico Alternativo is a leftist party that was created by the merger of Polo Democrático Independiente and Alternativa Democrática in 2005.
38. Bancolombia S.A. is the biggest commercial bank in Colombia and one of the biggest in Latin America.
39. "Uribe, With Win in Colombia, to Extend War, Cut Taxes (Update 1)." *Bloomberg* on May 29, 2006. Available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aoTyAaLoTe_c. Accessed on March 15, 2012.
40. "Inflows, Outperforming." *Economist* on April 14, 2011.
41. "Colombians Protest Economic Policies." *Colombia Journal*, October 18, 2004. Available at http://colombiajournal.org/colombians-protest-economic-policies.htm. Accessed on March 26, 2012.
42. Ecopetrol was only partially liberalized, since the state aimed to maintain a partial control of the strategic energy sector (Estache and Trujillo, 2008, 145).
43. Information from the Office of the United States Representative, US-Colombia Trade Agreement, "Intellectual Property Rights in the U.S.-Colombia Trade Promotion Agreement," available at http://www.ustr.gov/uscolombiatpa/ipr. Accessed on March 5, 2012.
44. The data come from Tetra Tech, "Highlight of the Month: Colombia MIDAS," available at http://www. tetratechintdev.com/index.php?option=com_k2&view=item&id=423%3Ahighlight-of-the-month-colombia-midas&Itemid=59&lang=us. Accessed on July 4, 2013.
45. See USAID TCBoost, available at http://tcboostproject.com/_resources/resource/Colombia% 20More%20Investment%20for%20Sustainable%20Alternative%20Development.pdf.
46. Data are from http://unctadstat.unctad.org/.
47. Data are from http://unctadstat.unctad.org/.
48. "Colombia-U.S. trade agreement helps China?" *CNN Espan˜ol*, October 18, 2011. Available at http://business.blogs.cnn.com/2011/10/18/colombia-u-s-trade-agreement-helps-china/. Accessed on March 8, 2012. We acknowledge that re-exporting to China or any other country might be problematic because of the presence of rules of origin included in both NAFTA and the US-Colombia PTA. We thank a referee for raising this important caveat.

CHAPTER 9

1. See "United States and Tunisia Re-Launch Bilateral Trade and Investment Talks in Support of Tunisia's Democratic Transition." Available at http://www.ustr.gov/about-us/press-office/press-releases/2011/october/united-states-and-tunisia-re-launch-bilateral-trad. Accessed on February 2, 2012.

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