When will Leaders of Developing Countries Negotiate South-North Preferential Trade Agreements?

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Introduction

My first-year paper is interested in the political motivations of leaders in developing countries to negotiate a particular type of international treaty with developed countries, the South-North preferential trade agreement. When are they more likely to do so? I hope this study can shed some new lights on exploring how leaders can use trade agreement as a political instrument to consolidate their power at home.

In 1994, South Africa took an opportunity to negotiate a preferential trade agreement with its most important economic partner in history, the European Union (EU). The same year also featured a prominent leadership change: the victory of Nelson Mandela and African National Congress from the first universal suffrage elections ended decades of Apartheid regime. However, the new transitioning democratic regime was measured as one of the most extremely unstable and insecure ones immediately when Mandela started his tenure. Mandela's government wanted to conduct substantial privatization and further economic reforms to restore the collapsing economies due to decades of isolations. However, this new government's initiatives were challenged by the other influential domestic political players that strongly opposed privatization and foreign investment. Mandela immediately approached the EU to start the process of PTA negotiation. After five years of negotiations, the preferential trade agreement with the EU put in force in 2000 helped South Africa to undergo its transitioning economies smoothly. The government was fully prepared to adjust its trade policy by moving away from import substitution industrialization towards a competitive trade liberalization.

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Finally, the reforms have successfully rebuilt the confidence of the foreign investors not only from the EU but also from other countries. South Africa's experience is a successful case for developing countries to pursue its reform-oriented trade strategy in the negotiation of PTAs with the major trade powers. Economic reforms usually provoke controversy and organized opposition domestically, so often times the ability of leaders to implement such liberal economic reforms is limited. A credible and binding international trade agreement with the leading economies has the potential to help facilitate this process. PTAs provide member governments with a mandate to make policy changes, while they supply material benefits and mechanisms to reward and punish members' behaviours.

My research question is: Under what conditions will leaders in the developing countries negotiate the South-North preferential trade agreements with the provisions of economic reforms? After all, not all the leaders in the developing countries who conduct economic reforms would negotiate a PTA with the major trade powers.

This paper is interested in explaining what motivates a leader from the developing countries to negotiate this particular deep and demanding international treaty. This paper also intends to focus only on the leaders from the South and their rationales of initiating a negotiation with the North. The reason is the power imbalances between the contracting parties is particularly stark in the arena of South-North PTAs negotiations. I assume both the South and North voluntarily participate in the negotiation. However, I anticipate developing countries make larger concession to play the rules of the game mainly set by the major players. In other words, when they approach these major powers to negotiate a PTA, they more or less anticipate they have chosen the deep PTAs by design. The PTAs with the leading liberal economies, for instance, E.U., U.S., Japan, Australia, include a wide range of reform provisions in their agreement packages. Most of these deep PTAs generally require structural economic reforms in the partner countries. When developing countries negotiate with these major liberal powers, these developing countries may bargain specific provisions but have little room to change the whole package. In contrast, when developing countries negotiate a PTA with an emerging trade power, China or India, they will not anticipate this type of power partner to demand such liberalizing reforms to a large extent. To understand under what conditions a leader in the developing country will self-select in opting in such a costly treaty motivates this paper. The puzzle is: What motivates leaders to participate in this particularly costly game?

Context and Rationale

Preferential trade agreements (hereafter PTAs) are binding international treaties that help states to foster trade and economic integration among member-states. Current literature on the PTA mainly focuses on the effects of this institution. Scholars examine to what extent the PTAs have achieved their desired economic purposes: lowering tariffs, facilitating trade and increasing the welfare of the states in the long term. In parallel with studying the effects of the PTAs, emerging political economy literature has offered explanations for why states form the PTAs. Notice that the motivations of the leaders in the developing countries to opt into such costly trade treaties are currently understudied. Yet, to understand when and why a leader of developing countries commits to such treaty is important because economic reforms will have immense consequences for the citizens of that country and beyond.

This article is in line with the argument proposed by Mansfield and Milner (2012): "governments sign PTAs for domestic political reasons" (p. 23). They argue democratic countries are more likely to join a PTA than nondemocratic countries because these governments can send a positive signal of their commitment of liberal trade policies to the median voters (Mansfield & Milner, 2012; Mansfield, Milner, & Rosendorff, 2002). Grossman and Helpman (1995) also focus on the interest groups who benefit from the expanding market promised by the PTAs. The pro-free trade beneficiary groups lobby the incumbent governments to sign such agreement to serve their political objectives. On the other hand, trade policy affects groups in society differently. Some private sectors benefit from the protectionist policy. Over time, they will expand too much, create rents and inefficiencies to distort the economy. Governments make international commitments in the free trade international agreements to tie their hands to avoid making an excessive concession to those sectors in the expectation of protection and subsidies in the future (Staiger & Tabellini, 1999). All of these theoretical frameworks capture the interaction between a government and its domestic audience: median voters, interest groups or private sectors. Leaders generally use the international trade agreements to signal the domestic audience of their welfare-enhancing economic policy for the purpose of retaining office.

To advance the literature on understanding PTA formation, this paper focuses on the strategic behaviours of leaders to negotiate such deep PTAs to consolidate their power vis-à-vis the opposition. In this story, opposition matters. The focus

here has shifted to understand PTA negotiation because there might be leadership change between years of treaty negotiation and signatory. I argue PTA negotiation is a deliberate choice that a leader makes to commit to the binding and stringent policy changes in the treaty package.

Theory

Economic reform as a political strategy

Leaders' fundamental interest is survival. They inherently want powerful and stable leadership. Leaders generally have two general ways to accumulate power: repression and loyalty (Wintrobe, 2000). By repression, it means a leader can restrict individuals' rights to criticize against the government or use severe sanctions to punish the organized opposition to the government, including imprisonment, execution, and torture. By loyalty, it means a leader can accumulate political loyalty of interest groups and elites by means of the distribution of rent. In this framework, political rent is the price a leader pays to buy off the loyalty of the oppositions to exchange for political stability. Certain economic policies that create rent and inefficiencies such as state intervention to protect some economic sectors, subsidies and policy support to State-Owned Enterprises (SOEs) are some examples of policies of loyalty.

Oppositions compete for power. Some have independent power to consider certain types of legislation; some can form political parties to compete in office formally, and some may share covert power bases with interest groups in society. Because a leader's power is not absolute, oppositions may defect and overthrow the incumbent government from time to time. Their ultimate goal is to subvert the rule of the current leader. They can choose to form a coalition with the leader or pose a threat to the current regime. We can conceptualize threat as "the demands on a regime by opposition groups" (Regan & Henderson, 2002, p. 122). The demands can take various forms, such as strikes, protest demonstrations, riots, guerillas and civil war. When the demands are sufficiently strong to destabilize the government, the leader is less likely to accede to the demands. The ruler will perceive it as an open challenge from the oppositions and associate them with defecting from the promised loyalty.

Under normal circumstances, leaders and their subjects have mutual signalling and

commitment problems. For leaders, to reward the loyalty of the opposition, the leader could promise to implement certain policies that the oppositions benefit. One example is the government's subsidies to the SOEs or some public financed projects that create rents for the oppositions. The oppositions, benefiting from such an arrangement, offer support for the regime in return. However, what guarantee does each party have that the other party will live up to their commitment? Leaders could potentially see the risks of increasing power of the oppositions who benefit from collecting political rents, so they could stop appeasing the oppositions by but start torturing them. The oppositions may also promise loyalty to the leader on the surface, but they could take part in an assassination plot as soon as the ruler shows his weaknesses. In sum, the so-called Dictator's Dilemma always exists: "the greater the dictator's power, the more reason he or she has to be afraid" (Wintrobe, 2000, p. 22). Stated differently, a leader never really knows how popular he is and when the promised support stops being delivered. According to Kuran (1991), revolution is unanticipated: a society can come to the brink of a revolution without anyone knowing it, not even those who wish can unleash it. No matter how stable a regime may look, an upheaval may occur any time. The question remains: what prevents the opposition from breaking their promises as often as they wish to overthrow the ruler?

Wintrobe (2000) provides three conditions to prevent actors from reneging on the exchange when no formal contract is written up. One, there is a future interaction between the parties; two, both parties have a reputation for not frequently cheating in the past; and three, the parties receive a premium on the exchange (Wintrobe, 2000, p. 30). I find what is missing here is the punishment mechanism: once one of the two parties reneges, the defector must pay the cost. If the costs of reneging are high, the frequencies of breaking down promises are expected to drop. Severe sanctions raise costs to anti-government actions so that they can deter dissents. Scholars focus on the violent forms of political repression as leader's main response to deter dissent, but I argue a non-violent form of punishment, economic reform, is also effective for governments to reach one of its end – to deter dissent.

In this study, secureness shock occurs when opposition poses threatening demands to challenge the current regime. The attempt to overthrow the ruler comes with severe political instability. Under autocratic regimes, the oppositions may overthrow the leader through a coup. Under semi-democratic regimes, the oppositions may mobilize citizens against the leader to displace him. Note that under mature democratic regimes, "all but

the most extreme form of oppositions" will be channelled into the formal institutions of government, in which dissents of oppositions can hardly dampen the political stability or cause secureness shock. In such democratic regimes, not only secureness shocks rarely happen but also leader turnovers are generally institutionalized and peaceful. Therefore, I limit the scope of this study in only autocratic and semi-democratic developing countries.

In these regimes, for the opposition, the costs of defection are indeed high: once they fail to remove the current leader, they may face severe punishment after the attempt. What strategy a leader adopts after he survives after a secureness shock is the focus of this study. One route that a leader takes is to torture or murder the oppositions. I argue repression is only one of the tactics a leader can use to punish the defectors. A leader who just experiences a secureness shock may not have the capacity to kill all the revolutionary leaders and the conspirators in the organized opposition groups as he wishes. Even if he has the capacity to do so, all the oppositions today will become his potential threats in the future, so it is not feasible to kill all of them.

I argue, another tactic of punishment is economic reform. This strategy withdraws the promised payoffs and limits the rent-seeking opportunities for the opposition today and tomorrow. Economic reforms, i.e., the privatization of state-owned enterprises and fair competition for the government-funded project can effectively cut off the power sources of the oppositions. It is generally safe to assume that much of the opposition somehow benefits from the distribution of rent prior to the secureness shock. Originally, the rents were promised by the leaders to reward loyal groups. Now, economic reforms come at the expense of the interest groups who previously privileged from the political rent. The structural changes of economies also make the oppositions' accumulation of future rents and powers harder. Economic reform as a tool of political survival for leaders can punish the current defectors and deters future cheaters by cutting off their potential sources of wealth and resources. Therefore, a leader, after a secureness shock, conceptualized as an open challenge to the leader, implements economic reforms because he wants to punish the elites who break their promises of offering loyalty to his leadership.

Why negotiating a PTA with major liberal powers?

Suppose a leader perceives economic reform as a tool to punish the oppositions and announces his decision to conduct an economic reform domestically without a PTA negotiation. Earlier on, we have discussed the commitment problem among the leader and opposition is acuter in autocracies and immature democracies. The domestic oppositions are sceptical about the leader's credibility and capacity to implement such a policy. Especially after the secureness shock, a leader needs time to restore the status quo ante yet strong enough to implement the reform unilaterally. Failure to implement economic reform will not only by no means serve as a punishment to the opposition and deter future dissent, but also diminishes the credibility of leaders' future policy changes.

PTAs with major liberal powers mitigates the commitment problem highlighted above. The negotiation of PTA sends a credible signal to the foreign investors that economic reforms will be more likely to be enforced. Recall, PTAs are binding international agreement: governments cannot constantly violate or arbitrarily pull out of the agreements without retaliation. PTAs by design have some coercive mechanisms of influence to make the costs of defection higher than the costs of conformity. In plain words, the expected values of the preferential trade agreements are conditional on the implementation of economic reforms. If leaders fail to implement the provisions, they will pay costs. Therefore, leaders in the developing countries approach to those in the developed countries to negotiate a stringent PTA implies that leaders have anticipated complying the provisions of economic reforms. PTA negotiation sends a credible signal of leaders' commitments to the reforms.

PTAs negotiation also sends a signal to the opposition that the current leader has won support from the international community, especially from the major powers. Because both the leader and the opposition are assumed to be office-seeking, so they all hold a value from holding power or seeking power. The opposition cannot perfectly observe the power of a leader holds and how much he has recovered from a secureness shock. While a leader's announcement of economic reforms probably induces backfiring by the oppositions, the successful negotiation of a treaty sends a strong signal to indicate the power of the current leader. This can reduce the possibility of the opposition's further attempts to overthrow the leader in the short run. In short, leader's strategic choice of negotiating the PTAs with the provision on economic reforms provides a

credible and enforceable mechanism to implement such policy.

Now let us turn to explain why PTAs can help leaders to implement economic reforms. The PTAs are expected to increase trade volumes and the flow of foreign direct investment, and hence increase tax revenues. As a result, the leader has more resources at their disposal, furthering their hold on power to recover from the secureness shock. The promising trade benefits also expect to increase national income. Leaders can claim credit for the improvement in welfare, so the citizens' loyalty to the leadership will be higher. The oppositions, who mainly lose from the liberalized economic reforms, can be pacified by the values of the PTAs. With the PTAs in place, the oppositions benefit from the increasing welfare of the trade as a citizen and operate in a more efficient economic institution to accumulate wealth as a business operator. They can rebuild their power bases by building up substantial connections with foreign traders, or even gain political support from the foreign governments in the evolving relations of business. Oppositions, depending on where their power sources base, may be affected by the trade liberalization unevenly.

Oppositions whose power bases are in the exporting sectors with comparative advantages can reap the most benefits from the opening market. They are the potential winners from the PTAs, whose benefits offset or outweigh their loss in the pre-reform period. In contrast, those in the previously protective sector are forced to compete with foreign producers, are hit with a double-whammy: structural economic adjustment process and net losses in trade.

The main argument in the previous section is economic reform punishes disloyal oppositions who deviate from the promises of offering support to the leader. However, economic reforms may inevitably hurt the elites who are in fact the government supporters. Recall, political rent is a tool that a leader uses to gain loyalty. Economic reforms will stimulate dissent and decrease loyalty, so the leader has to re-buy loyalty from the oppositions after both parties recover from the secureness shock. After reestablishing their pro-government credentials, a leader can use the increased revenue from trade as a side payment to compensate the loyal oppositions, so they can restart their rent-seeking cycles to accumulate wealth and power. Alternatively, leaders carefully crafted the economic reforms to increase rents for the potential winners of the trade liberalization to coalesce a coalition (Schamis, 1999). A leader can use economic reform to not only target the disloyal oppositions responsible for the secureness shock, but also

reestablish a coalition with loyal oppositions to consolidate his power.

Summary

The puzzle to explain is what motivates a leader in the developing country to negotiate one of the most costly and stringent trade agreements with the developed country. One of the most important features of these PTAs is the provision of economic reforms, whose implementation will ignite domestic opposition. My argument, in brief, is the following: a leader strategically negotiates PTA when he is insecure. I argue after a leader is hit by a secureness shock, he can choose economic reforms to punish the disloyal oppositions responsible for the outbreak. Leaders are more likely to implement economic reform when the PTAs negotiation is in place. The PTAs with major economic powers send positive signals to mitigate commitment problem that a leader has, and offers material benefits to facilitate the reforms. This argument has a main empirical implication that can be used to test its validity in the next section. My prediction is: The presence of secureness shocks in a regime is associated with higher probabilities of its leader's PTA negotiation.

Research Design

I design a quasi-experiment in my observational data. My design compares the likelihoods of leaders with secureness shocks and those without to negotiate the South-North PTAs. The hypothesized treatment in this study is *secureness shock.* You may ask, how should I conceptualize it? I defined two types of secureness shock. Before getting into a shock, here I use two indices to measure the secureness of a leader:

1) a leader's secureness when he starts his tenure at time 0 and,

2) the secureness of the regime when the leader holds office at time *t*.

In non-democratic regimes, the secureness of leaders at time 0 is coded as authoritarian leaders' affiliation with their previous leaders. An authoritarian leader is coded as secure at time 0 when he is politically affiliated and from the same ruling coalition with his previous leader. An authoritarian leader is insecure at time 0 when a leader is in the opposition party of the previous leader, or he is unaffiliated with the preceding

government. In other cases, if he is in a military regime or a regime with no authority where by assumption there are higher risks of coups d'etat and popular uprisings, he is also defined as insecure when he starts his tenure at time 0. However, note that in democracies, a leader's relation to his past is irrelevant; hence, a leader is automatically assumed as a secure leader at time 0.

The secureness of the regime over time t measures the vulnerability of the regime to collapse in any given year. I use political effectiveness score in the state fragility index to measure the political secureness of a regime to capture the dimensions of political opposition, citizen's confidence in the political process, political violence of a regime etc. The index ranges from 0 to 3, 0 means the most secure, and 3 means insecure. I recoded all the regimes with score 0 and 1 as secure otherwise insecure starting at time 1, if the political effectiveness score remains unchanged during one's tenure. I coded a change of worsening scores (for example, from 0 to 1) as a period of the regime experiencing an insecure shock over time t.

Here I develop two types of secureness shocks:

Type 1: a leader who is secure at time 0 becomes insecure immediately onward at time 1. Substantively, it means a leader starts his tenure in an unstable and contested environment in which the leader is highly constrained by the opposition.

Type 2: a leader experiences a secureness shock during his tenure at time t. The political crisis captured in such a secureness shock can be a result of threats from the fractionalized ruling coalition, popular uprisings, or even the actual use of force.

The *unit of analysis* is a leader. The dataset covers 286 leaders in 62 developing countries in the period 1995 to 2015. Note that at least one of the leaders in these developing countries negotiated one PTA with the provision of competition policy with a developed country at some point during this period. It excludes leaders in the liberal democracies (V-Dem's Electoral Democracy Index above 0.75) where the rule of law and constraints on the executives are respected most of the time. In a regime as such, leadership change is routine and institutionalized. Therefore, there are lower risks for leaders losing power and hence lower incentives for leaders to use binding trade agreements for political survival. Furthermore, it removes leaders whose tenure is less than one year, in such case they have no time to pursue any substantial policy changes given the short amount of time in office.

The *dependent variable* is a binary one. If a leader in the developing country has ever negotiated a South-North PTA with the provisions of economic reforms during his tenure, then this event happened, coded as 1, otherwise 0. Notice that a leader may negotiate a couple of PTAs at different points of his tenure, however, the event will be only counted once, which is the first PTA he negotiated. In this dataset, a majority of the PTAs have been put into force, while some of them were still in the negotiation process.

The *independent variable* is the hypothesized treatment of secureness shock. If a leader experienced either or both types of secureness shock, he is considered treated.

I completely aware that the treatment assignment is not random in an observational study, so I used a matching design on balancing the following observed *covariates* so that the treatment and control group are comparable. The covariates in this study are qualities of democratic or autocratic authority measured by V-Dem's Electoral Democracy Index, GDP per capita measured by World Bank, human rights conditions measured by Political Terror Scale, and the length of uninterrupted regime duration up to a leader starts his tenure. The covariates by definition are variables measured prior to treatment assignment and unaffected by the hypothesized treatment. Therefore, I only concern about all of these indices of the covariates for each leader in the same year when he starts his tenure at time 1.

I also include two confounding variables in my model. The first one is leader's tenure. A leader's tenure is a confounder because the longer a leader holds office, the probability of engaging in the PTA negotiation may be higher, and the risks of being exposed to the secureness shock is be higher. The second one is GDP decline. In a period when a country experiences poor economic performance, a leader in the developing country perceive the potential economic benefits of the PTA with the South can help with the economic recovery. Also, this regime may be more likely to experience an insecure shock when the economy declines. Therefore, a country's economic growth is an important confounder for both the explanatory and outcome variables.

My *hypothesis* is: The more insecure a leader is, the more likely a leader negotiates a PTA as a tool to secure his power in office and overcome domestic opposition. Leaders who experience a secureness shock are expected to have higher probabilities of negotiating a PTA than those do not.

Data Summary

The dataset originally covers 406 leaders in the developing countries across regime types between 1995 to 2015. It excludes leaders in the liberal democracies (V-Dem's Electoral Democracy Index above 0.75) where a more demanding notion of democracy that the rule of law and constraints on the executives are respected. The rationale of PTA as a result of power consolidation, as argued, does not apply to stable and consolidated democracies. This dataset also excludes 7 cases where the PTA negotiation (*event*) happened before the insecure shock (*treatment*). Furthermore, it removes leaders whose tenure is less than one year, in such case they have no time to pursue any substantial policy changes given the short amount of time in office. Currently, the dataset covers 293 leaders in 61 developing countries.
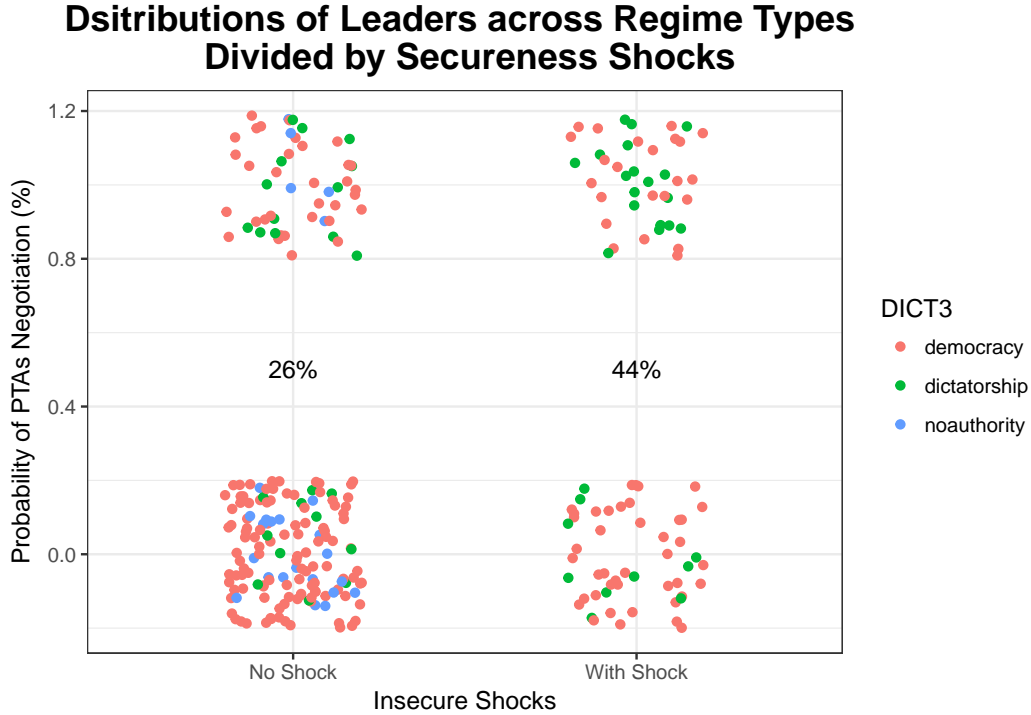

	All Regime Types	Democracies	Nondemocrac
Percentages of leaders being treated (%)	32.52	31.10	36
Percentages of those treated negotiated a PTA (%)	44.09	35.38	64

Table 0.1: Percentages of Leaders being Treated and those Trated Having an Event

There are 93 events out of 286 total observations. Across regime types, 32.52% of the leaders have experienced secureness shocks. Among leaders across regimes, 44.09%

of those who have experienced a secureness shock have chosen to negotiate a PTA with a developed countryy at some point in their tenure. 26.42% of those who have not experienced an insecure shock have negotiated a South-North PTA. Now, let us look at the relative frequency distribution divided by regime types. In non-democracies, 64.29% of leaders have experienced an insecure shock, while 31.1% in democracies have experienced one at some point during the time of their tenures. Among leaders in non-democracie regimes, `percent_leader0_event_auto`% of those who have experienced a secureness shock negotiated a South-North PTA. In contrast, only 31.1% of those who have experienced a secureness shock in democracies negotiated one.

OLS model

Estimated Propensity Scores before Matching
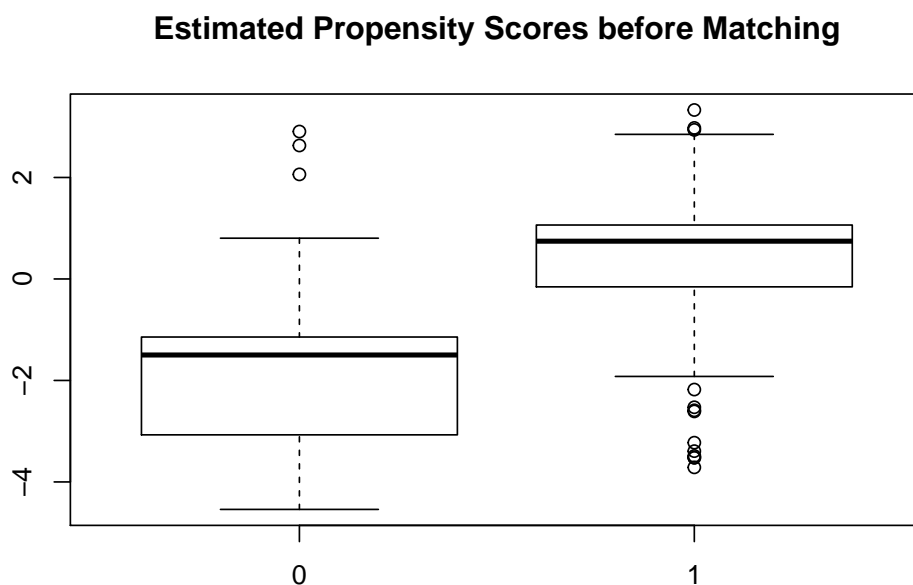
Before matching, we can see the estimated propensity scores, the fitted probabilities of being treated given five covariates, are substantially different. This suggests those leaders who have experienced a secureness shock are different from those who have not in terms of regime type, human rights conditions, regime duration, GDP per capita. After full matching, the two groups are balanced.

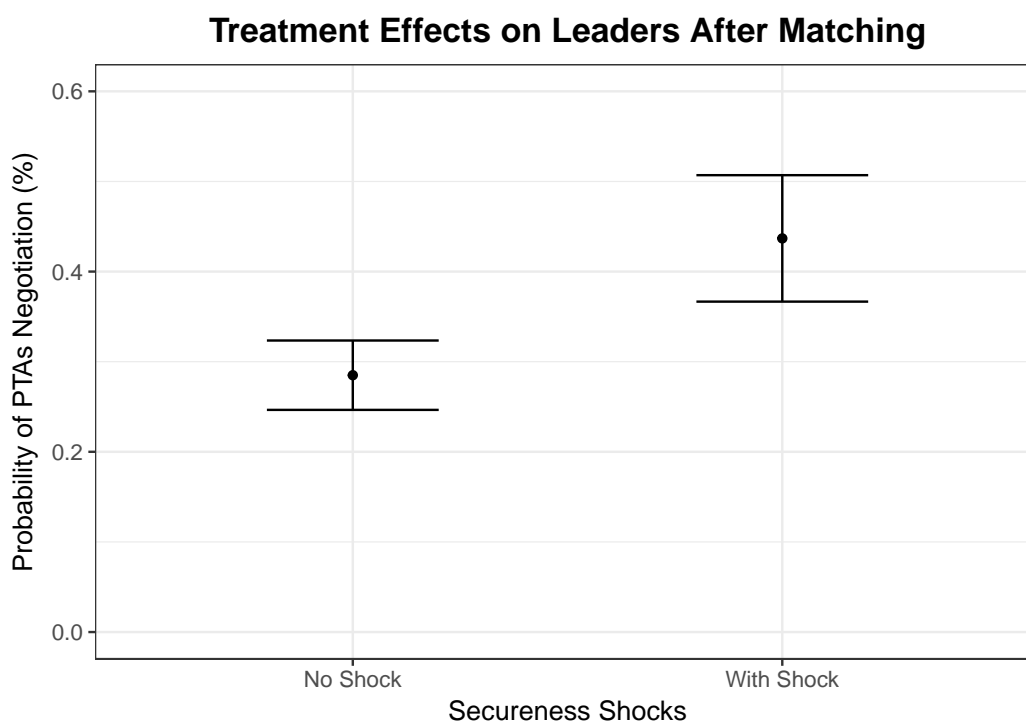*Event = Secureness shock + Mean Tenure + GDP decline + Error*

Table 0.2: Ordinary Linear Squared Regression Model (After Full Matching): Results

	Dependent variable:
	Preferential Trade Agreement Negotation Rate
Constant	0.049
	(0.154)
Secreness shock	0.152*
	(0.090)
Mean Tenure	−0.026
	(0.068)
GDP Decline	0.036***
	(0.006)
Observations	228
R^2	0.318
Adjusted R^2	0.180
Residual Std. Error	0.426
F Statistic	2.316***

Note:	*p<0.1; **p<0.05; ***p<0.01
	Automatic reporting p-values, need to be replaced with Fishers' Null

Treatment Effects on Leaders After Matching

Holding leaders' mean tenure constant, after matching on five observed covariates, when there is no GDP decline, those leaders who have experienced secureness shocks on

average have 15.1799% higher probability to negotiate a PTA than those without such "treatment". You can see there are no overlaps between the two confidence intervals, which suggest that the treatment effect is statistically significant.

So far, my hypothesis is empirically supported. When leaders experience political crisis, they are more likely to negotiate a South-North preferential trade agreement with the provision of economic reforms.

Statistical Inferences: Permutation test

P-value tells us how likely I can get the observed treatment effect from my experiment under the no treatment effect null hypothesis. Here, in this study, the hypothetical experiment is that countries are "randomly assigned" to experience an insecure shock (*treatment group*) or not experience one (*control group*). The worrisome is the Fisher's sharp null hypothesis: there is a possibility of no effect for all the units in this hypothetical experiment. Instead, I just observe the differences in means by chance. My null hypothesis is there is no treatment effect between the treated and control groups for each unit.

P−value distribution with Permutation in 100−times simulation

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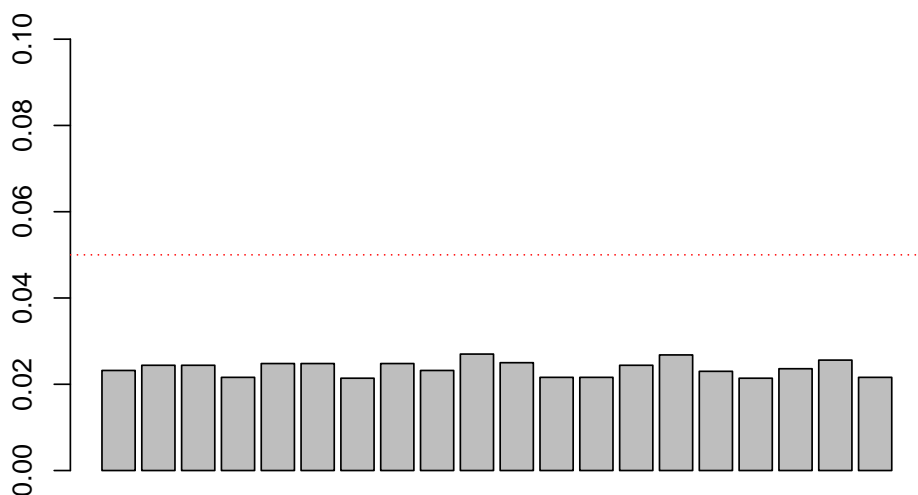
The p-value here is the probability that value as extreme or more extreme will be observed under the null hypothesis. This probability gives me the information that I may not have much evidence to against the null effect hypothesis, which is the difference between the observed treatment effect and the effect under the null hypothesis is not due to chance. In this test, we observe we have 2.4% (less than 1 in 50 replications of the no effect experiment) to produce the values as large as or greater than the differences-in-means (treatment effect 15.1799%). That suggests by using the computer power as if I were to replicate the experiments for 10000 times, the probabilities of observing effects while in fact there is no relationship between the variables are less than 0.05 in both settings.