

## CHAPTER 1

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# Introduction

INTERNATIONAL TRADE AGREEMENTS have played an important and growing role in the global political economy. Among the most important agreements of this sort are preferential trade agreements (PTAs), a set of institutions that are designed to foster economic integration among member-states by improving and stabilizing each member's access to other participants' markets. All PTAs require members to mutually adjust their trade policies, granting each member preferential access to the others' markets. As such, they are one of the most prominent forms of international cooperation. This book addresses why and when countries join these trade agreements and how they design them.

PTAs have proliferated rapidly. Scores of these institutions have formed over the past half-century and almost every country currently participates in at least one. By 2010, according to the World Trade Organization (WTO), roughly four hundred PTAs had been signed, covering more than half of total world trade. The European Union (EU) is the most widely studied PTA, but Europe is not the only region marked by such agreements. The North American Free Trade Agreement (NAFTA) has helped to promote economic integration among the United States, Canada, and Mexico. In South America, Mercosur—an agreement involving Argentina, Brazil, Paraguay, and Uruguay, with four associate members and Venezuela in the process of acceding—plays an important role in integrating the economies of the Southern Cone. African nations have also formed various PTAs, and the South African Development Community (SADC) is currently one of the most important trade accords. It involves fifteen African nations, including South Africa, the continent's economic powerhouse. Asia is the last frontier for PTAs. Since 2000, many Asian countries have formed and joined trade agreements, though countries in this region have been much slower to sign PTAs. In addition, PTAs regulate many types of trade and many aspects of international economic relations. They often affect trade in manufactures, agriculture, and services, as well as foreign investment, labor rights, and environmental practices. Some PTAs regulate more sectors than the WTO (Horn et al. 2010). Indeed, various analysts speculate that if the Doha Round of global trade negotiations convened by the WTO fails, PTAs could become the dominant method of regulating international economic relations (e.g., Baldwin 2011). This book focuses on why and when governments elect to enter trade agreements.

Gaining a fuller understanding of international trade agreements is important because trade is crucial to the global economy and contributes heavily to

many national economies. For the largest 110 countries in the world, overseas trade (i.e., the sum of exports and imports) amounted to 65 percent of total income in 1975, a figure that grew to almost 90 percent in 2005 (World Bank 2011). In 2008, furthermore, world exports amounted to roughly \$20 trillion, accounting for close to a third of global output. International trade has generally grown faster than world output since the 1950s as well (World Trade Organization 2008). PTAs cover well over half of all world trade, a trend that shows no signs of abating. Trade flows have also been tightly linked to global capital flows, as exporters and multinationals develop global production ties linked to their trade. Trade has been an important engine of the world economy, and institutions like PTAs that affect both the volume and direction of trade flows merit attention.

Despite the importance of PTAs to the international trading system, we lack an adequate understanding of why and when governments choose to enter these institutions. Some countries have rushed to join many of these arrangements, whereas others have joined very few of them. Moreover, states have entered them at different points in time. The purpose of this book is to improve our understanding of the political economy of PTA formation. In so doing, this study will also contribute to the larger literature on the sources of international cooperation. We focus on how domestic political factors influence international coordination. While also examining the role of international forces, we argue that certain domestic political factors exert a strong impact on trade cooperation, which previous studies of such agreements have overlooked. We focus attention on a country's regime type and the constraints on its chief executive as central to the demand for and design of PTAs.

Trade and international trade agreements often stimulate domestic interest and opposition. In part this is because trade is a large and critically important element of many countries' economies. As Ronald Rogowski (1989) has pointed out, changes in trade flows can have a profound effect on domestic political coalitions. Others have noted that heightened exposure to international trade can have important effects on individuals' political beliefs, as well as on the political institutions they support (Cameron 1978; Katzenstein 1978; Rodrik 1998; Scheve and Slaughter 2001).

Trade agreements also have political implications. Autocratic governments often eschew trade agreements since they constrain the government's ability to dole out rents (from protectionist trade policies) and because of the domestic fissures they can open (Bueno de Mesquita et al. 2003). Democracies, as we explain further in this book, have a far greater incentive to conclude trade agreements. The Dominican Republic, for example, negotiated no PTAs before it became democratic in 1978; since then it has signed about ten trade agreements. South Korea joined one PTA before it became democratic around 1988; it has subsequently entered more than seven agreements. Taiwan signed no agreements before becoming democratic in 1992, and then signed six of them.

Trade agreements are often sources of political contestation; in some cases they have prompted significant domestic turmoil. In 2003, for instance, South Korea experienced daily protests against its proposed free trade agreement (FTA) with Chile. A few years later, large and sustained protests in South Korea delayed its proposed trade agreement with the United States (Park 2009, 457). In Swaziland, the government was shaken by large protests during 2011 when its revenues from the Southern African Customs Union (SACU) were cut. These revenues accounted for over 60 percent of its government budget (Bearak 2011; Cloete 2011). The domestic benefits of trade agreements may also attract political support. President Clinton's support for NAFTA and President Obama's support for the Korean, Panamanian, and Colombian trade agreements are cases where the domestic political and economic advantages of such accords motivated leaders to press for ratification.

In democracies, struggles over ratification are often epic battles between political parties and their sympathizers. Such a fight erupted in Canada over NAFTA, pitting the Progressive Conservative Party against the Liberals and Left Democrats. In Mexico, the major political parties—the Partido Revolucionario Institucional (PRI), Partido Acción Nacional (PAN), and Partido de la Revolución Democrática (PRD)—argued over whether to enter NAFTA. Costa Rica experienced a pitched battle over the United States-Dominican Republic-Central America Free Trade Agreement (CAFTA) between its supporters in the Partido Liberación Nacional (PLN) and its opponents in the Partido Acción Ciudadana (PAC) (Hocking and McGuire 1999; ACAN-EFE 2006; de la Cruz 2006). In the United States, votes on trade agreements have been among the most hotly contested and narrowly decided. The ratification of CAFTA in 2005 was decided by a single vote in the House of Representatives. And as one commentator summed up the NAFTA experience in the United States, Canada, and Mexico, “what perhaps stands out in all three countries is how hard-fought the free trade [agreement] vote was, how entrenched the industrial and labor opposition was, and how great a political leadership was necessary [to conclude the agreements]” (Doran 1999, xii). As these examples illustrate and as we explain in more detail throughout this book, domestic politics and international trade agreements are often tightly linked.

PTAs have not been universally lauded and their economic impacts have been a subject of fierce debate. Some observers fear that these arrangements have adverse economic consequences and have eroded the multilateral system that has guided international economic relations during the post-World War II era. Others argue that such institutions are stepping-stones to greater multilateral openness and stability. This debate has stimulated a large body of literature on the economic and political implications of PTAs.<sup>1</sup> Surprisingly little research, however, has analyzed the factors giving rise to these agreements.

<sup>1</sup>See Freund and Ornelas (2010) for a recent overview of this debate.

Much of the scholarship on PTAs, especially the vast majority conducted by economists, does not adequately explain the origins of preferential agreements. These agreements discriminate against imports from third parties, while economic theory emphasizes that free trade is generally the optimal strategy for each country and that an open, nondiscriminatory multilateral trading system is optimal as well. PTAs contrast with the multilateral trade regime established after World War II—undergirded by the General Agreement on Tariffs and Trade (GATT) and more recently by the WTO—which has promoted open overseas commerce.<sup>2</sup> In the view of many observers, the stability of this regime has reduced the incentives for states to form trade agreements. As such, economic research has furnished few clear answers about why PTAs now abound. In contrast, we emphasize the *political* costs and benefits of PTAs and show how politics has driven their proliferation. Governments may decide to conclude trade agreements in part because they provide domestic political benefits. Leaders trade off the constraining aspect of trade agreements in order to improve their domestic political fortunes.<sup>3</sup>

To explain why leaders would opt to sign a trade accord, which by definition circumscribes their policy-making ability, we focus on the political benefits that leaders can derive from these agreements. Heads of government aim to remain in power and favor policies that help them do so. The calculations of chief executives also involve the domestic political costs of such agreements, which are not limited to the constraints placed on foreign economic policy. Rational leaders calculate both the associated costs and benefits before choosing a policy, as well as the relative merits of alternative policies. Our central hypotheses are that democratic countries are more likely to enter PTAs than nondemocratic regimes and that as the number of groups within a country that can block policy change—so-called “veto players”—rises, the likelihood of that state entering a PTA is reduced.<sup>4</sup> More generally, we argue that domestic politics affects both why and when states have cooperated to form PTAs. We theorize about these two claims in more detail in the next chapter. We also extend the logic of these arguments to develop a number of auxiliary hypotheses about the nature of PTAs that countries sign and the impact of other domestic political factors.

<sup>2</sup> There is a debate on this point. Rose (2004) argues GATT/WTO has had no impact on trade; Gowa and Kim (2005) argue it has increased trade for the developed countries in the agreement; and Goldstein et al. (2007) claim it increased trade for members if they had institutional standing.

<sup>3</sup> We use the terms government, leader, head of government, and chief executive interchangeably. We assume that governments sign trade agreements, not countries per se.

<sup>4</sup> Veto players are those individuals or groups that occupy an institutional position such that they can block any policy change from the status quo. In a simple game, a veto player is one that belongs to all winning coalitions. Veto players are strategic in our setting; that is why they are agents, not veto points (Tsebelis 2002). This concept is addressed at greater length in chapter 2.

In the remainder of this chapter, we begin by defining PTAs, noting the different types and their economic and political effects, and discussing their importance. Afterward we describe some patterns in PTA formation over time and across various geographical regions. Then we summarize our argument about the domestic sources of PTAs. Next we place our study in the context of the larger economic questions it concerns and the theoretical debates on which it touches, and conclude by describing our plan for the rest of the book.

#### WHAT ARE PTAs AND WHY ARE THEY IMPORTANT?

PTAs are not only prolific, they are also important. PTAs are international agreements that aim to promote economic integration among member-states by improving and stabilizing the access that each member has to the other participants' markets. All of these arrangements require members to mutually adjust their trade policies, granting each member preferential access to the others' markets. PTAs can be bilateral or multilateral, but they differ in key respects from the WTO. In the current multilateral system, any market access agreements negotiated by two or more members must be extended to all members of the WTO; this most-favored nation status makes trade nondiscriminatory. Hence, whereas the centerpiece of the multilateral trade regime is the most-favored nation (MFN) treatment accorded to all participants, PTAs are discriminatory since their benefits only accrue to member-states. On the other hand, PTAs may cover many more economic sectors and may regulate many more economic policies than the WTO.

There are five different types of PTAs (Pomfret 1988; Anderson and Blackhurst 1993; Bhagwati 1993; de Melo and Panagariya 1993a; Bhagwati and Panagariya 1996a):

- First, what we refer to as a preferential agreement (PA) grants each participant preferential access to particular segments of the other members' markets. Trade barriers on certain products are lowered by each member and these concessions are not extended to third parties. The initial Association of Southeast Asian Nations (ASEAN) agreement involving Indonesia, Malaysia, Philippines, Singapore, and Thailand in 1977 was such an accord. It was upgraded to an FTA in 1992.
- Second, a free trade area (FTA) is marked by the reduction or elimination of trade barriers on most (if not all) products within the arrangement. Among the most prominent FTAs are NAFTA and both ASEAN (since 1992) and the SADC (since 2000).
- Third, customs unions (CUs) are arrangements in which members eliminate trade barriers on other participants' goods and impose a common external tariff (CET) on imports from third parties.
- Fourth, a common market (CM) is a CU that is augmented by similar product regulations and the free flow of factors of production among members.

6 • Chapter 1

- Fifth, an economic union is a common market whereby members also coordinate fiscal and monetary policies.

As an example, Western European countries have participated in each of the three latter types of PTAs over the past half-century. In 1957, the Treaty of Rome bound the six original members of the European Coal and Steel Community (ECSC) into a customs union. Since then, there has been a progressive broadening of the membership and the issue areas that it covers. After 1985, the EEC became a common market with the conclusion of the Single European Act. The Maastricht Treaty of 1992 led to its evolution from a common market to the EU, an economic union covering many issue areas in addition to trade and including seventeen members in a monetary union.

Different types of PTAs are designed to achieve varying degrees of integration, with PAs being the least integrative and economic unions being the most integrative. Initially, we will treat all trade arrangements as a single group since the argument we advance in this book is focused primarily on why states join a PTA rather than on the particular type that they enter. Equally, most of the extant empirical research on PTAs treats them as a group. Afterward, we will briefly address why states choose to enter a particular type of arrangement, an important issue that has received little empirical attention to date. We also analyze aspects of the design of PTAs. Using our theory, we examine whether the choice between PTAs that include formal mechanisms to adjudicate disputes and help enforce agreements and those that do not is affected by domestic political factors. Increasingly, such dispute settlement mechanisms (DSMs) have been embedded in these agreements, and we seek to explore this important aspect of PTA design.<sup>5</sup>

Gaining a fuller understanding of the conditions under which governments join PTAs is likely to contribute to the study of international cooperation, a central topic in the field of international relations. All PTAs involve cooperation by the contracting parties. International cooperation is marked by mutual policy adjustment among nation-states (Keohane 1984, 51–52). Policy adjustment of this sort is intended to achieve a particular set of goals that will benefit the associated countries, although these benefits need not actually be realized or distributed in any particular way for state actions to constitute cooperation (Milner 1997a, 7–8). PTAs meet this definition since they involve reciprocal trade barrier reductions among the contracting parties that are intended to promote foreign commerce and economic integration within the arrangement.

<sup>5</sup> Recent research has focused on other important aspects of PTAs (Bagwell and Mavroidis 2011). Horn et al. (2010), for instance, examine the number and depth of regulatory domains covered in PTAs but not in the WTO. Prusa and Teh (2011) examine escape clause measures (e.g., antidumping, countervailing duties, and safeguards) in PTAs and how they differ from one another and from the WTO.

## ECONOMIC EFFECTS OF PTAS

Social scientists have expressed a lively interest in PTAs for over a century, largely due to a belief that these agreements influence important aspects of international relations. The bulk of research conducted on the effects of PTAs has focused on their economic welfare implications. PTAs have a two-sided quality, liberalizing commerce among members, while discriminating against third parties. As we noted earlier, this quality is what distinguishes PTAs from the multilateral trading system and the WTO, which is based on the principle of reciprocity embodied in the MFN status of member-states. Since such arrangements rarely eliminate external trade barriers, economists consider them inferior to those that liberalize trade worldwide. Just how inferior PTAs are hinges largely on whether they are trade creating or trade diverting: that is, on whether trade barrier reductions within an arrangement will shift the production of traded goods from less efficient producers outside the grouping to more efficient producers within it, or whether such reductions will shift the production of such goods from more efficient suppliers outside the arrangement to less efficient suppliers within it (Viner 1950).

Over the past few decades, economists have tried to determine whether PTAs are trade creating or trade diverting. There is consensus that the preferential arrangements forged during the nineteenth century tended to be trade creating and that those established between World War I and II tended to be trade diverting. However, there is a striking lack of consensus on this score about the PTAs developed since World War II. As an important empirical study on this topic concluded, PTAs “can, depending on the circumstances, be associated with either more or less general liberalization” (Frankel and Wei 1998, 216). Recent research has not made the case any clearer. Some studies, such as John Romalis’s (2007) analysis of NAFTA and Won Chang and Alan Winters’s (2002) assessment of Mercosur, find evidence of trade diversion. Other studies, however, find strong evidence that contemporary PTAs are marked by trade creation (Baier and Bergstrand 2004; Magee 2008; Freund 2011). Furthermore, in the most recent review of the empirical research on PTAs, Caroline Freund and Emanuel Ornelas (2010, 160) conclude that “trade creation, not trade diversion, is the norm.”

Theoretical work on this topic has also failed to arrive at a consensus about whether PTAs promote or undermine welfare. Gene Grossman and Elhanan Helpman (1995, 687), for instance, argue that since a trade agreement requires the assent of various governments, it will most likely occur when “the agreement affords enhanced protection rather than reduced protection to most sectors.” In the same vein, Pravin Krishna (1998) finds that trade-diverting PTAs are easier to form from a domestic political standpoint than trade-creating arrangements. For both Grossman and Helpman (1995) and Krishna (1998), the relative ease of forming preferential arrangements that degrade national

welfare stems from the role played by interest groups. In contrast, other studies conclude that political leaders will only sign such agreements if doing so generates greater domestic political benefits than costs. Ornelas (2005), for example, shows that because PTAs destroy rents for key interest groups, rational politicians will only sign PTAs that generate large enough welfare gains for society as a whole to compensate for the reduced contributions that these groups will provide to the government as a result of the decrease in rents. Martin Richardson (1994) and Kyle Bagwell and Robert Staiger (2001) also observe that FTAs tend to weaken protectionist pressures against nonmembers and thus may be welfare enhancing. Economic theory, then, does not provide clear expectations about the welfare consequences of PTAs.<sup>6</sup>

Taken as a group, economic studies have reinforced Jacob Viner's (1950) conclusion that the welfare implications of trade agreements are ambiguous (Gunter 1989, 16–20; Baldwin and Venables 1995, 1605–13). In addition, recent research suggests that the preference margins gained by most countries in these agreements have been very small, especially for members of the GATT/WTO. That is, the difference between the trade barriers that PTA members offer to their fellow participants relative to nonmembers tends to be quite modest (World Trade Organization 2011). In light of these findings, it is difficult to sustain the argument that states join PTAs for economic reasons alone. Later we will revisit these mixed economic effects as they relate to the domestic political benefits and costs of PTAs.

## POLITICAL AND SECURITY EFFECTS OF PTAs

In addition to their economic impact, PTAs may affect political-military relations among countries. Over a century ago, for example, Wilfred Pareto argued that “customs unions and other systems of closer commercial relations [could serve] as means to the improvement of political relations and the maintenance of peace” (quoted in Machlup 1977, 143). At the conclusion of World War I,

<sup>6</sup>In addition to creating or diverting trade, PTAs can affect the welfare of states by influencing their terms of trade and their capacity to realize economies of scale. Forming a PTA typically improves members' terms of trade vis-à-vis the rest of the world, since the arrangement almost always wields more market power than any constituent country. At the same time, however, attempts by a PTA to exploit its market power may backfire if other such arrangements exist, since the blocs may become enmeshed in a trade war that harms everyone (Krugman 1991, 16). A trade agreement can also influence the welfare of members by allowing firms located in member-states to realize economies of scale due to their preferential access to a larger market (Cooper and Massell 1965a and 1965b; Johnson 1965; Bhagwati 1968). This motivation contributed to the spate of PTAs established by less developed countries throughout the 1960s, although few such arrangements were successful from an economic standpoint. More recent studies addressing the welfare effects of PTAs have examined whether the proliferation of these arrangements will accelerate or inhibit multilateral trade liberalization, an issue that Bhagwati (1993 and 2008) refers to as “the dynamic time-path question” and that Baldwin (2008) refers to as part of “big think regionalism.”

John Maynard Keynes (1919, 249) echoed this view, speculating that “[a] Free Trade Union, comprising the whole of Central, Eastern, and South-Eastern Europe, Siberia, Turkey, and (I should hope) the United Kingdom, Egypt and India, might do as much for the peace and prosperity of the world as the League of Nations itself.” Since World War II, scholars have continued to advance the argument that PTAs dampen hostilities between participants, and policy makers have established various preferential groupings in an effort to stimulate peace as well as prosperity (Nye 1971; Fernández and Portes 1998; Schiff and Winters 1998).

A number of empirical studies have concluded that PTAs do in fact inhibit political-military hostilities (Nye 1971; Mansfield et al. 1999; Mansfield and Pevehouse 2000; Bearce 2003). Despite the ambiguous welfare implications of PTAs, most states enter them expecting to derive at least some economic benefits. Sometimes these expected benefits are realized; sometimes they are not. Regardless, conflict between member-states can scuttle these anticipated benefits by damaging economic relations between participants and the arrangement itself. States may avoid conflict then if they fear its effects on their economic gains from greater openness. PTAs also inhibit antagonism by establishing a forum for bargaining and negotiation among members, thereby facilitating the resolution of interstate tensions prior to the outbreak of open hostilities (Nye 1971, 109). Furthermore, trade agreements facilitate the construction of focal points that forestall conflicts by shaping states’ expectations about what constitutes acceptable behavior and by identifying deviations from such behavior (Garrett and Weingast 1993).

Finally, recent research also suggests that PTAs can be useful in fostering cooperation in other issue areas. Nuno Limão (2005), for example, demonstrates that trade agreements can be used to improve environmental policy coordination. Emilie Hafner-Burton (2009) concludes that PTAs often promote human rights enforcement. And Tim Büthe and Helen Milner (2008) and Badi Baltagi et al. (2008) show that PTAs can induce greater foreign investment in developing and transition countries, perhaps accelerating their economic development. Such arrangements, then, affect a variety of outcomes in world politics.

International relations would be altered if these agreements did not exist. Trade and investment among nations might be depressed and flow in different directions; patterns of conflict might change; and policy covering areas like human rights, intellectual property, and the environment might look very different in the absence of trade agreements. Trade agreements are important components of the global political economy and they have been for some time.

## PTAs IN HISTORICAL PERSPECTIVE

We focus on explaining PTA formation since World War II. The vast bulk of contemporary research on PTAs centers on this time period and we lack the

data necessary to systematically address the determinants of trade agreements in earlier eras. However, it is important to recognize that PTAs are not just recent phenomena. Countries have formed them at various points over the past two centuries (Mansfield and Milner 1999). To place the post–World War II proliferation of these arrangements into historical perspective, we now turn to a brief description of these episodes.

The initial phase occurred during the second half of the nineteenth century and was largely a European phenomenon (Pollard 1974; Kindleberger 1975; Lazer 1999).<sup>7</sup> Throughout this era, intra-European trade both rose dramatically and constituted a vast portion of global commerce (Pollard 1974, 42–52 and 62–66). Besides the well-known German Zollverein, the Austrian states established a customs union in 1850, as did Switzerland in 1848, Denmark in 1853, and Italy in the 1860s (Pahre 2008, 318–19). In addition, various groups of nation-states forged customs unions, including Sweden and Norway and Moldavia and Wallachia (Pollard 1974, 118; Irwin 1993, 92).

The development of a broad network of bilateral commercial agreements also marked this era. Precipitated by the Anglo-French commercial treaty of 1860, they were linked by unconditional MFN clauses and created the bedrock of the international economic system until the late nineteenth-century depression (Kenwood and Lougheed 1971; Pollard 1974; Irwin 1993; Lazer 1999; Pahre 2008). Furthermore, the desire by states outside this commercial network to gain greater access to the markets of participants stimulated its rapid spread. As of the first decade of the twentieth century, Great Britain had concluded bilateral agreements with forty-six states, Germany had done so with thirty countries, and France with more than twenty states (Irwin 1993, 97). These arrangements contributed heavily to the unprecedented growth of European integration and to the relatively open international commercial system that characterized the latter half of the nineteenth century, underpinning what Douglas Irwin (1993, 97) refers to as an era of “progressive bilateralism.”<sup>8</sup>

<sup>7</sup> For a somewhat different characterization, see Pahre (2008), who argues that there were various episodes of preferential trade agreements during the nineteenth century. Note that PTAs were not confined solely to Europe during this era. Prior to 1880, for example, India, China, and Great Britain comprised a “tightly-knit trading bloc.” Afterward, Japan’s economic development and its increasing political power led to marked changes in intra-Asian trade patterns. Kenwood and Lougheed (1971, 94–95) report that “Asia replaced Europe and the United States as the main source of Japanese imports, supplying almost one-half of these needs by 1913. By that date Asia had also become Japan’s leading regional export market.”

<sup>8</sup> Some recent research contests this view of the trade agreements in the nineteenth century. Acominotti and Flandreau (2008, 175), for example, maintain that “the empirical evidence reported here suggests that nineteenth-century bilateralism did not give any boost to international trade whose expansion actually started losing momentum after 1860. Thus, the evidence leans toward the age-old wisdom emphasized long ago by the classics, that if the goal is liberalization, then treaties are pointless.” Their research supports our view that economic benefits do not seem to be the major factor driving countries to sign trade agreements.

Domestic politics played a role in the formation of many of these PTAs (Nye 1991; Irwin 1993; Pahre 2008). Trade policy was intensely political during this era and frequently aroused intense domestic debate. Autocratic leaders often used protectionism to seal domestic alliances that solidified their continued rule. The “marriage of iron and rye” in Germany is one of the most famous instances of this tack (Schonhardt-Bailey 1998). The 1860 Anglo-French Treaty of Commerce, which many believe “served as the catalyst for virtually all the major trade treaties in 19<sup>th</sup> century Europe,” was also a hotly contested political affair in both countries, but especially in France where Napoleon III and the legislature disagreed on the course of trade policy (Nye 1991, 474; Lampe 2009). Robert Pahre (2008) also shows that domestic political institutions affected nineteenth-century trade relations. He finds that more democratic states in Europe were particularly likely to cooperate on trade and sign trade treaties (Pahre 2008, 228). Moreover, he concludes that the ratification of trade treaties depended heavily on domestic institutions and divided government (Pahre 2008, ch. 9). In sum, then, domestic politics played a key role in many of the trade agreements formed during the nineteenth century.

World War I disrupted the growth of trade agreements. But soon after the war’s conclusion, numerous PTAs were signed, most of which had a decidedly more discriminatory cast than earlier ones. The agreements formed between World War I and II tended to be highly preferential. Some were created to consolidate the empires of major powers, including the customs union France created with members of its empire in 1928 and the Commonwealth system of preferences established by Great Britain in 1932 (Pollard 1974, 145). Most, however, were formed among sovereign states. For example, Hungary, Romania, Yugoslavia, and Bulgaria each negotiated tariff preferences on their agricultural trade with various European countries. The Rome Agreement of 1934 led to the establishment of a PTA involving Italy, Austria, and Hungary. Belgium, Denmark, Finland, Luxembourg, the Netherlands, Norway, and Sweden concluded a series of economic agreements throughout the 1930s. Germany also initiated various bilateral trade blocs during this era. Outside of Europe, the United States forged almost two dozen bilateral commercial agreements during the mid-1930s, many of which involved Latin American countries.<sup>9</sup>

Longstanding and unresolved debates exist about whether these PTAs deepened the economic depression of the interwar period and contributed to political tensions culminating in World War II (Condliffe 1940, esp. ch. 8–9; Kindleberger 1973; Hirschman 1980 [1945]; Oye 1992). Contrasting this era with that prior to World War I, Irwin (1993, 91) presents the conventional view:

<sup>9</sup>On the commercial arrangements discussed in this paragraph, see Condliffe (1940, ch. 8–9), Hirschman (1980 [1945]), Kenwood and Loughheed (1971, 211–19), and Pollard (1974, 147–49). While our focus is on trade agreements, this era was also marked by the existence of at least five currency regions. For an analysis of the political economy of currency regions, see Cohen (1997).

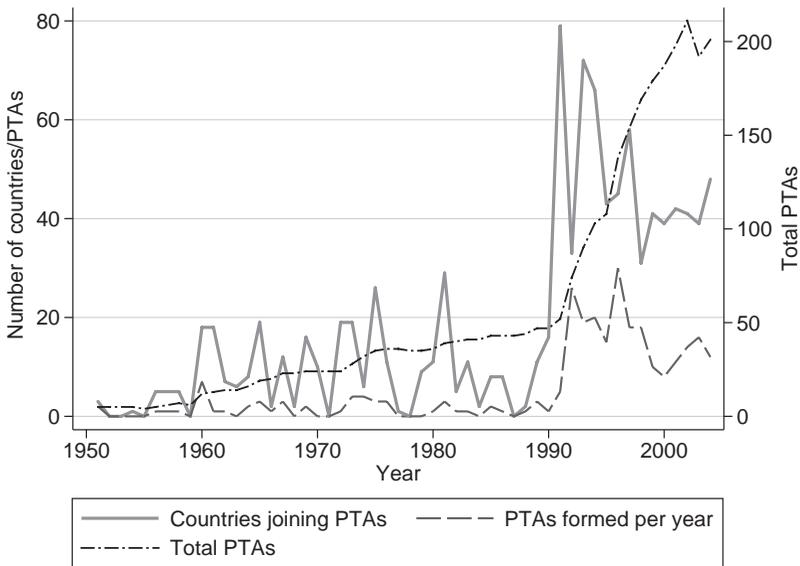
In the 19<sup>th</sup> century, a network of treaties containing the most favoured nation (MFN) clause spurred major tariff reductions in Europe and around the world[, ushering] in a harmonious period of multilateral free trade that compares favorably with . . . the recent GATT era. In the interwar period, by contrast, discriminatory trade blocs and protectionist bilateral agreements contributed to the severe contraction of world trade that accompanied the Great Depression.<sup>10</sup>

The latter group of PTAs is often associated with the pursuit of beggar-neighbor policies, protectionism, depression, and political conflict. Kerry Chase (2005, ch. 4) provides an interesting account of how domestic politics in the major imperial powers of the time helped build these exclusive trading blocs. These two historical episodes thus suggest that PTAs can have very different consequences; they underline the view that the economic gains from PTAs may be positive, negative, or nonexistent, and hence not determinative of the demand for such arrangements.

Since World War II, states have continued to negotiate trade agreements, despite the existence of a multilateral economic framework. To help illustrate the contemporary growth of PTAs, figure 1.1 shows the frequency with which countries have joined these agreements since 1950, as well as the total number of PTAs in the world; figure 1.2 illustrates the number of countries in each region entering a PTA during this era.

Clearly, the incidence of PTA formation and the frequency with which states have entered such arrangements has waxed and waned. Few were established during the 1950s, then a surge in trade agreements occurred in the 1960s and the first part of the 1970s, after which the incidence of PTA creation leveled off. But there was an explosive rise in these agreements and the number of states joining them during the 1990s; and by the end of the twentieth century, more than 50 percent of all world commerce was conducted within these agreements (Serra et al. 1997, 8, figure 2; Freund and Ornelas 2010, 140). The rush to form such arrangements continued during the first decade of the twenty-first century. Indeed, PTAs have become so pervasive that Mongolia is currently the only WTO member that does not belong to at least one, and the average WTO member now has agreements with more than twelve countries (World Trade Organization 2011, 56, figure B.1b). As figure 1.2 shows, there is also substantial variation across geographical regions in the extent to which states participate in PTAs. In Western Europe, Africa, and Latin America, countries have entered PTAs with considerable regularity. In East Asia and the Middle East, by contrast, these agreements have been much less pervasive, although—led by China—East Asian countries have demonstrated an increasing interest in

<sup>10</sup> He notes, however, that these generalizations are somewhat inaccurate, as do Eichengreen and Frankel (1995). But both studies confirm a difference between the effects of PTAs in the nineteenth century, the interwar period, and the present; and both view PTAs in the interwar period as most malign.

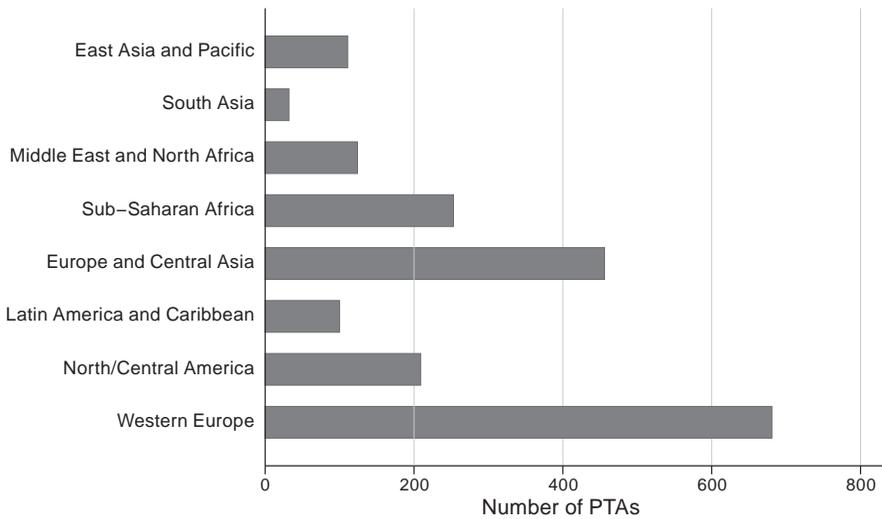


**Figure 1.1: The Distribution of PTAs over Time, 1951–2004**

entering these institutions over the past decade (Pomfret 2007). In later chapters, we will address the regional variations in PTAs.

Our brief historical overview indicates that PTAs have been enduring features of the international political economy and that domestic politics has been an important element in their formation. A substantial amount of research has been conducted on the economic and political effects of PTAs. Very little work, by contrast, has been conducted on the sources of these agreements.<sup>11</sup> Furthermore, most of the work conducted on this topic has focused on either the economic or the international factors shaping PTAs. In contrast, this book offers one of the first analyses of the domestic political determinants of PTA formation.

<sup>11</sup> It is important to distinguish our focus on PTAs from a focus on economic regionalism. Regionalism is generally defined as heightened economic integration among geographically proximate countries or, relatedly, a process whereby economic flows grow more rapidly among a given group of states (in the same geographical region) than between these and other states (Mansfield and Solingen 2010). Heightened integration within a region, however, need not stem from the economic policy cooperation among countries on which our study is focused (Fishlow and Haggard 1992; Yarbrough and Yarbrough 1997, 160 fn. 1). Furthermore, regionalism implies that the states involved are located in the same region. Many PTAs (for example, the United States's arrangements with Israel and Jordan, or South Korea's arrangements with Chile and New Zealand) are not regional in any conventional sense of the term. Regionalism and PTAs are different phenomena, and our focus is on the latter.



**Figure 1.2: Total Number of PTAs per Geographical Region, 1951–2004**

#### THE EFFECTS OF DOMESTIC POLITICS ON PTAs: THE ARGUMENT IN BRIEF

Our central argument is that trade agreements are often motivated by domestic political conditions. We seek to explain why leaders choose to enter these agreements. Such agreements are costly for political leaders since they constrain a chief executive's ability to set policy. Hence, for a leader to rationally choose to enter a PTA, he or she must calculate that membership will provide benefits that outweigh these costs. In contrast to most of the literature on PTAs, which emphasizes their economic benefits and costs, we argue that a country's domestic politics has an important influence on whether and when it elects to sign a trade agreement. It also affects the design of the agreement itself.

In chapter 2, we develop a rationalist theory to explain why governments negotiate PTAs. We argue that political leaders focus on how trade agreements can reassure the public and domestic groups about their decision making, but that they also worry about the domestic costs involved in ratifying agreements. Balancing these two forces is central to a decision maker's calculations regarding whether to sign a PTA. In particular, a country's regime type and its institutional veto players—that is, those groups that can block policy change—are crucial in this regard. Both factors have been analyzed in recent work on trade policy, but very little research has been conducted on whether regime type and veto

players influence the formation of PTAs.<sup>12</sup> Regime type and veto players are two distinct elements of a country's domestic political institutions. Regime type is linked to the degree of political—especially, electoral—competition, while veto players affect the checks and balances on the executive branch. We maintain that democratic countries are more likely to join a preferential arrangement than nondemocratic states. Equally, as the number of veto players increases, the likelihood of joining a PTA declines. From this general argument about the factors influencing why and when political leaders choose to enter PTAs, we also derive a variety of auxiliary hypotheses that help to further probe the underlying logic of our claims.

### *Regime Type*

Our first argument is that democracies have greater reason to enter PTAs than other countries. The notion of democracy that we employ here is Schumpeterian (Schumpeter 1976 [1942]) and therefore stresses domestic political institutions. The existence of competitive elections in which leaders can be replaced is the sine qua non for democracy, according to this widely used definition. It focuses attention on the features of regimes that make elections possible, free, and fair. Many regimes have elections, but not all such contests are competitive ones where incumbents face the prospect of being removed from office. Autocracies, for example, frequently hold elections, but they are much less likely to lead to leadership turnover than democratic elections. Instead, autocrats must maintain the allegiance of small, select groups within the country, often including the military, labor unions, key members of the ruling party, or owners of the means of production. The greater political competition for office in democracies, we argue, motivates leaders to sign international trade agreements.

Leaders in various types of polities are caught between the pressures of special interest groups and the preferences of voters. Some special interests press for policies—such as protectionist trade policies—that adversely affect the economy. Heads of government may want to satisfy these interest groups in exchange for benefits like campaign contributions. But giving in to all interest group demands would have very harmful economic consequences and could imperil their hold on office. Leaders, however, face a domestic political problem. They have a hard time convincing the public that they will not accede to special interest demands. When elections take place in times of adverse economic circumstances, voters may blame incumbents for economic problems and turn them out of office. As such, chief executives need to find ways to reassure the public and other domestic groups that they are not overly compliant with respect to the demands of protectionist groups. Heads of government

<sup>12</sup> For an exception that addresses the effects of regime type on trade agreements in the nineteenth century, see Pahre (2008).

would prefer to remain in office and do less for special interest groups if they could convince voters of their actual behavior.

PTAs provide such a reassurance mechanism. They allow leaders to commit to a lower level of protectionism than chief executives might otherwise desire, and to signal voters that leaders will not allow trade policy to be determined solely by special interests. Voters, if reassured that leaders are generally abiding by the terms of the international agreement, thus have reason to believe heads of government who claim that their policies did not cause tough economic times. In turn, these leaders are more likely to remain in office since voters will choose to reelect them even during economic downturns. The more political competition that exists, the more leaders have to worry about being ejected from office and the greater the costs generated by their inability to reassure the public. Hence, we argue that democratic governments, which encounter greater political competition in general, should be more likely to sign trade agreements since they face larger costs from not doing so.

For autocracies, the calculations differ. Interest group pressures for protectionism in autocracies vest leaders of these countries with an incentive to resist entering PTAs that reduce the rents they can provide to supporters. Equally, leaders do not face as great a cost since electoral competition is less likely to determine their fate. Consequently, autocrats have less incentive to enter into trade agreements than their democratic counterparts. This argument, which we develop in chapter 2, provides the microfoundations for understanding leaders' (differential) domestic motivations for negotiating trade agreements.

### *Veto Players*

A rational leader deciding to enter a trade agreement focuses not only on the benefits of doing so but also on the associated costs. A central domestic political cost of signing a PTA involves the ratification process. Our second argument is that the number of players that can block policy change because of their institutional position affects the transaction costs that governments bear when ratifying a PTA. These costs are greater in countries marked by a large number of veto players, thereby reducing the incentives of leaders to negotiate and ratify PTAs. Political institutions can then provide both inducements and obstacles to international cooperation.

Veto players have the ability to block policy change; their assent is necessary to alter existing policies (Tsebelis 1995 and 2002, 2). We focus on veto players, rather than veto points, since we assume that these groups are active, strategic participants in the policy process, especially the ratification of international agreements. They calculate their interests and, because of their institutional positions, can block policies that they oppose. Conceptually, regime type and veto players are distinct and we treat them as such. Veto players exist in all types of regimes. Even

in nondemocratic countries, domestic politics is rarely a pure hierarchy with a unitary decision maker and no constraints on leaders (Bueno de Mesquita et al. 2003; Gandhi 2008; Weeks 2008). Domestic groups with varying preferences that have veto power often compete for influence over policy, and even dictators depend on them in making policy and retaining office. Democratic regimes are more likely to have veto players than nondemocratic regimes, although the number of such players varies considerably even among democracies

In most countries, the executive sets the agenda in foreign affairs and has the power to initiate foreign economic policy. However, veto players must ratify policy choices made by the executive, such as joining a trade agreement. Formally, the head of government in a democracy—prime minister, president, chancellor, or premier—is often required by the national constitution to obtain the approval of the legislature for international agreements, including PTAs. He or she will therefore need to anticipate the legislature's (or any other veto player's) reaction to the proposed arrangement and ensure it is domestically acceptable.

Ratification can also be less formal. In dictatorships, shifts in foreign economic policy often require the support of groups like the military or local leaders; implicitly these groups have ratified a trade agreement when they have the ability to veto it and choose not to. Informal ratification also occurs in democracies. If a leader needs to change a domestic law, norm, or practice in order to implement a PTA, even if no formal vote on the arrangement itself is required, a legislative vote on any necessary domestic change becomes a vote on the agreement.

Because of this ratification constraint, veto players affect the formation of PTAs. As the number of veto players increases, so does the likelihood that at least one such player will have a constituency that is adversely affected by the PTA and therefore will block its ratification. To ratify an agreement when many veto players exist is costly for political leaders. They either have to modify the agreement to fit the preferences of the veto groups or to bribe the veto groups into accepting the agreement. These means of securing ratification pose transaction costs for leaders. And the greater these transaction costs, the less likely leaders are to enter into trade agreements and the more difficult it will be to secure ratification.

### *Domestic Politics and Trade Agreements: Auxiliary Hypotheses*

The claims that we outlined in the previous section about regime type and veto players are developed in greater detail in chapter 2, where we also develop seven novel hypotheses that follow from our argument and that allow us to probe some of the causal mechanisms underlying this argument. These hypotheses explore in more detail the logic of the main claims and some puzzles that arise from them.

First, our argument implies that a government should realize an increase in political support as a result of signing a PTA. More specifically, since PTAs help leaders overcome domestic political problems, leaders who sign them should have a longer tenure in office than those who do not sign such agreements. Second, partisanship should affect the likelihood of a government signing and ratifying a PTA. Left-wing governments should be more likely to join a trade agreement because they have a greater need to reassure the public that they will not engage in excessive protectionism than centrist or right-wing governments. Third, underlying our argument about the propensity of democracies to sign PTAs is that democratic leaders need an external mechanism to convince voters that they have not mismanaged the economy. Entering a PTA to create such a mechanism, however, is likely to be much more effective in countries that depend heavily on foreign commerce. Hence, we examine whether democracies that are heavily trade dependent are more likely to enter PTAs than other democratic regimes. Fourth, whereas we expect that nondemocratic regimes will sign fewer PTAs than democracies, the former regimes nonetheless do join various trade arrangements. Nondemocratic regimes exhibit considerable variation in the extent of domestic political competition and we expect that more competitive nondemocracies are more likely to accede to PTAs than less competitive regimes.

Fifth, we mentioned earlier that different types of preferential arrangements are designed to achieve different degrees of economic integration among members, with PAs being the least and economic unions being the most integrative. It follows from our argument that democracies should seek PTAs that aim to achieve deeper integration. Further, leaders can choose to include institutional features in PTAs to enforce trade integration. Chief among these are DSMs, which furnish member-states with the means to legally settle disputes over the agreement. Leaders who have a greater need to reassure the public about their economic activities have greater reason to include a DSM in trade agreements; as such, democratic countries are more likely to enter PTAs that include DSMs than autocratic ones.

Sixth, the institutional design of a PTA is likely to be affected by the number of veto players in a country, as well as its regime type. More integrative arrangements have more pronounced distributional consequences. Equally, the inclusion of a DSM bolsters a trade arrangement's enforcement capacity. As the number of veto players rises, there is a growing likelihood that at least one such player will be adversely affected by greater integration and enforcement within the arrangement, reducing the likelihood that a country marked by a large number of veto players will enter a highly integrative arrangement or one with a DSM. Seventh, veto players not only affect whether a country enters a PTA, they also influence the length of time that it takes to ratify such an arrangement. In countries where the number of veto players increases between the signing and the ratification of a PTA, the length of time needed to ratify the arrangement should grow.

Using a variety of new datasets, in chapter 5, we elaborate on and examine empirically these auxiliary hypotheses. Our analysis of these novel hypotheses should help to build confidence in our main claims about the important role of domestic politics in international trade cooperation.

Our focus on domestic political considerations in the calculations of governments stands in stark contrast to most existing work on the formation of trade agreements, in general, and PTAs, in particular. For the most part, such work has taken one of three tacks. First, some economic studies have argued that states enter trade agreements in order to generate welfare gains. Clearly, states sometimes form PTAs for economic reasons. However, we argue that they do so for political reasons as well and that economic analyses of trade agreements often ignore these political factors. Second, some studies emphasize that international political factors stimulate PTA formation. We do not dispute this claim and we analyze many of these factors in the empirical portions of the book. However, studies cast at the international (or systemic) level of analysis usually give short shrift to domestic politics. We argue that domestic factors are also important for the purpose of explaining PTAs. Indeed, unlike almost all previous empirical analyses of PTA formation, we combine a systemic investigation of PTAs in chapter 3 with a country-level focus in chapters 4 and 5. Furthermore, in order to conduct these tests, we have compiled the most comprehensive dataset on reciprocal trade agreements formed since World War II. Third, various studies of PTAs have focused on the effects of domestic politics, but almost all of them have stressed the role played by interest groups. We agree that such groups may be influential; however, these studies generally ignore the role played by political leaders within domestic institutions. We view the interaction between these institutions and domestic trade policy preferences as important.

## THE BROADER THEORETICAL CONTEXT

Our analysis of the domestic sources of PTA formation bears on a host of important theoretical issues in the fields of international relations and political economy. For example, it contributes to certain avenues of research on the political economy of trade policy. Much of the contemporary research on trade policy relies on an open economy politics (OEP) approach. As David Lake (2009, 221) points out, one of the two main questions that OEP deals with is “how, when, and why do countries choose to open themselves to transborder flows of goods and services, capital, and people? In other words, what are the political determinants of what we now call globalization?” The issue at the core of our study centers on this question. Why do countries decide to open their economies internationally, even if this opening is only partial? Historically and politically, such decisions to open up are rare and thus are worthy of attention.

OEP models tend to involve three logical steps in addressing this question (Lake 2009, 225). They begin at the microlevel, seeking to identify the policy preferences of the individuals, sectors, or factors of production within a country. Taking economic models as their baseline, they usually assume that these agents are most concerned with maximizing income and that an underlying economic model provides information linking policy choice to income distribution and hence setting forth their policy preferences. The second step outlines how domestic political institutions serve as the means by which all of these preferences are aggregated and how the government makes its policy choice at the end of the day. The third step introduces bargaining among states and the role of international institutions in setting the outcome at the global level. For OEP models, then, “interests, institutions, and international bargaining explain the choice of policies by countries and the outcomes experienced by the world economy. . . . OEP proceeds towards an explanation in a linear, unidirectional fashion” (Lake 2009, 230). The argument in this book falls within this paradigm but also pushes it in new directions.

There are three primary differences between OEP models and our approach. First, our focus is less on the derivation of domestic preferences than is typical in OEP models. Instead, we emphasize how political institutions shape leaders’ calculations about foreign economic policy. Second, we focus less on international bargaining than on the role of international trade institutions in affecting domestic politics. Our aim is to address how political leaders view the role of trade agreements in terms of their domestic political situation. Third, we argue that leaders sign trade agreements because they yield domestic political benefits. PTAs can reshape the domestic political landscape. As Lake (2009, 237–38) asserts,

if international institutions really matter, they will alter the interests and possibly institutions within states as well. This feedback from the international political economy to the domestic arena is now almost entirely ignored in OEP, but need not be. Indeed, in a way fully consistent with the core assumptions of the paradigm, international institutions may actually create an important endogenous dynamic with important effects on politics.

We show that such a dynamic movement between domestic and international institutions is likely in the case of PTAs. They can help political leaders in their domestic political struggles and thus affect domestic politics, while also being a product of domestic political institutions. Thus, this book is located within the tradition of the OEP models but links international institutions much more closely to domestic politics.

Our study presents a rationalist model of international cooperation. It locates the decision to join a PTA in leaders’ political calculations about its effects. It therefore falls within the large literature on rationalist models of cooperation and international institutions (e.g., Krasner 1983; Keohane 1984; Goldstein et al. 2001; Koremenos et al. 2004). Unlike much of this literature, however, we

link the role of international institutions back to domestic politics. We also focus on leaders' motivations for signing an international agreement.

Further, we contribute to the research on the design of international institutions (Koremenos et al. 2004; Hawkins et al. 2006). We ask what motivates leaders to agree to join different types of PTAs and what makes them include dispute settlement mechanisms. While PTAs all have the same primary function—that is, reciprocal trade barrier reduction—some go much further in this direction than others. We try to explain this diversity of form in terms of variations in the domestic institutional environment. We thus relate domestic politics to international cooperation and the diversity of forms it can take.

Like much recent research in the fields of international relations and comparative politics, we focus attention on domestic institutions (e.g., Shepsle 1979 and 1989; North and Weingast 1989; Acemoglu et al. 2001; Bueno de Mesquita et al. 2003). In the comparative politics field, the role of democracy has been especially important in understanding economic growth and development (North and Weingast 1989; Barro 1996; Acemoglu et al. 2001; Keefer 2004; Aghion et al. 2007). In international politics, there is a large literature on the “democratic peace” (Doyle 1983a and 1983b; Russett and Oneal 2001; Mansfield and Snyder 2005), the alliance behavior of democracies (Gaubatz 1996; Weart 1998), and whether democracies tend to win the wars they start (Lake 1992; Reiter and Stam 2002). Work on the international political economy has analyzed whether democracies trade more and are less protectionist than other countries (Mansfield et al. 2000 and 2002; Milner and Kubota 2005; Eichengreen and Leblang 2008; Milner and Mukherjee 2009). The importance of democracy for international relations and comparative politics is still debated, but many observers have concluded that democracies are distinctive in various ways. Our argument advances the main claims of this research program.

A large body of recent research on both comparative politics and international relations has also emphasized the role of veto players (Tsebelis 1995 and 2002; Henisz 2000 and 2002; Hallerberg 2002; Keefer and Stasavage 2003; Henisz and Mansfield 2006; Mansfield et al. 2007). Many of these studies have found that veto players affect a wide variety of important economic outcomes, such as economic growth, investment, and trade policy. Nonetheless, the impact of veto players remains the subject of fierce debate. We enter this debate by offering one of the first assessments of how this institutional feature affects PTA formation.

## ORGANIZATION OF THE BOOK

The rest of this book is organized as follows. Chapter 2 lays out our argument and the theory underlying it. We develop in detail our argument about the domestic political costs and benefits of trade agreements and explain why democracies are more likely to form PTAs and highly integrative arrangements

than nondemocracies. Furthermore, we explain why PTAs are less likely to be established by countries that have a large number of veto players, which are in turn particularly likely to inhibit the formation of arrangements that aim to promote more extensive integration.

Chapters 3, 4, and 5 contain the empirical portion of our analysis. Much of the empirical work on the political economy of PTAs has been cast at the international or systemic level of analysis. In chapter 3, we introduce and test various arguments about the impact of the distribution of power and the spread of democracy in the international system on the formation of PTAs. These systemic arguments about PTA formation are important because we need to account for the key international factors affecting PTAs once we turn to our analysis of domestic political factors in chapters 4 and 5. Our analysis shows that certain systemic factors have contributed heavily to global patterns of commercial agreements: hegemony, the spread of democracy, and strategic interaction among both states and PTAs have been especially influential in this regard.

In chapter 4, we turn to a test of our argument about the effects of regime type and veto players on the formation of PTAs. Here we focus on the country-level decisions to join and ratify a PTA. Our new dataset provides ratification dates on all PTAs between 1951 and 2004, and allows us to examine the domestic and international forces that lead to a country's decision to sign and ratify an agreement. In chapter 5, we examine the auxiliary hypotheses that flow from our main argument. We analyze the effects of PTA membership on a leader's political survival, the role of partisanship, the interaction of democracy with a country's dependence on trade, the depth of integration that a PTA aims to achieve, the effects of veto players on the length of time between the signing and ratification of a PTA, and the impact of political competition on whether autocracies sign PTAs. Chapter 6 summarizes the key findings and discusses the implications of our results for the study of international relations and international trade. There we return to many of the major themes we outlined in this chapter.

International trade agreements are undoubtedly important elements of the international political economy; world politics would look quite different without the EU, Mercosur, or NAFTA, for example. These agreements have had a wide range of political and economic effects, from reducing conflict to increasing foreign investment and helping enforce human rights across the globe. Gaining a better sense of why governments enter these agreements is likely to promote a fuller understanding of PTAs, the sources of international cooperation, and the evolution of the international political economy.