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# **Explaining Formation and Design of EU Trade Agreements: The Role of Transparency and Flexibility**

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## **Abstract**

What political factors explain the selection of countries for preferential trade agreements by the European Union? I argue that when forming a trade agreement the EU is more likely to target countries that have a higher degree of political and economic transparency than other developing countries. In highly transparent countries the EU is able to monitor effectively whether or not these countries follow its forms of conditionality, which is the main rationale of EU regionalism. Moreover, economic and political transparency plays a particularly important role in determining the degree of flexibility in trade agreements. Evidence based on data from 138 developing countries supports these arguments.

**Key Words:** EU foreign relationship, preferential trade agreement, transparency, flexibility, selection model.

## **Introduction**

What political factors explain a decision by the European Union to enter into a preferential trade agreement with a developing country? The European Union (EU)

has been central to the proliferation of preferential trade agreements (PTAs) in the current wave of “new regionalism” (Mansfield and Milner, 1999).<sup>2</sup> For instance, of the 109 notifications of PTAs to the World Trade Organization as of 1 January 1995, no less than 76 were with the EU or between European partners (Pelkmans and Brenton, 1999). This emphasis of the EU on PTAs has been explained in part by the fact that rather than being limited to trade policy, bilateral agreements serve as crucial instruments of the EU’s foreign policy (Brenton and Manchin, 2003; Messerlin, 2001). Specifically, EU bilateralism is the principal tool through which the EU shapes the structure of the international system in general, and the political and economic systems of developing countries (Least Developed Countries) in particular. However, this is just part of the story. From the perspective of LDCs, several studies emphasize that EU PTAs may also act as a tool of development (Woolcok, 2004; Whalley, 1998; Rodrik, 1989).<sup>3</sup> Indeed, by joining a PTA with the EU, LDCs can gain access to one of the largest and richest markets, lock in political and economic reforms, and improve their competitiveness in the global economy. This combination of elements of foreign policy and development shows that the EU’s selection of trade partners has crucial political implications.

Despite the magnitude of EU bilateralism and its importance for the international trade system, to date, most work on the topic has focused almost exclusively on economic drivers, such as economic size and the level of economic development of LDCs (Pelkmans and Brenton, 1999). A number of recent studies on the EU has explored the role of key interest groups in the formation of PTAs (Aggarwal

and Fogarty, 2007; Bechtel and Tosun, 2009; Dür, 2007). However, from the perspective of governance, the EU uses PTAs to push LDCs to implement political and economic reforms (Schimmelfennig and Sedelmeier, 2004). If conditionality is not effective due to enforcement problems, EU PTAs are lacking as instruments of foreign policy and as tools of development. A vast body of literature (Koremenos *et al.*, 2001; Rosendorff and Milner, 2001; Svobik, 2006) suggests that cooperation problems may be mitigated by states' domestic features and by the design of the agreement. Accordingly, the EU's decision to pursue PTAs is affected not only by internal factors, such as the political conflict among interest groups in Brussels, but also by domestic features of LDCs that in turn influence the design of EU bilateralism. As EU Trade Commissioner Mandelson has noted, the EU must construct ambitious bilateral trade agreements with "carefully chosen partners" (2006: 2).

Focusing on the role of domestic institutions, I empirically address the rationale for EU bilateralism. Using a political economy perspective, I argue that political and economic transparency in an LDC affects both the probability of securing a PTA with the EU and the design of the trade agreement. First, it influences PTA formation because high transparency makes it easier for the EU to monitor the fulfillment of the agreement. Second, it affects the design of the PTAs by leading to a high incidence of discretionary provisions, allowing the EU to correctly identify causes of deviation on the part of LDCs. To investigate these two dependent variables, *i.e.* the probability of forming a PTA and the design of a PTA, I use a two-stage bargaining model that explicitly takes into account the selection bias problem. I test my

argument using a newly compiled dataset covering 138 developing countries, from 1990 to 2005.

The results of the analysis support my claim that the formation and the design of PTAs between the EU and LDCs are logically connected. Furthermore, my findings point to the decisive role of transparency in the probability of an LDC being selected as a trade partner by the EU. Finally, my results shed light on the determinants of incomplete contracts in international cooperation. By allowing for the differentiation between involuntary defection (Putnam, 1988) and opportunism, transparency significantly increases the probability of designing flexible agreements.

## **Background**

### **EU regionalism and Conditionality in Trade Policies**

The new wave of regionalism features arrangements that involve not only the reduction of barriers and what is generally defined as merchandise trade, but also arrangements that regulate trade-related areas. Agreements on issues such as services, investment, intellectual property, and temporary movement of labor are becoming common in PTAs. In this regard, the EU has been the most important driver of this new kind of agreement. In a broad sense, the EU offers access to its large markets for goods in exchange for access to service markets in LDCs, the LDCs' acceptance of rules governing investment and intellectual property rights, and their improvement

of human rights (Global Economic Prospect, World Bank, 2005). In the literature this is known as a conditional agreement. Examples of conditionality include the Copenhagen conditions, in which the EU required former communist countries to achieve stability of institutions guaranteeing democracy, human rights, and minority rights, to create a functioning market economy, and to cope with competitive pressure and market forces (Grabbe, 1999) and the Barcelona Process, which set the rules of the economic cooperation between the EU and the Mediterranean countries (Baert, 2003).

Despite the well-known importance of economic factors, *e.g.* reaping benefits from economies of scale and reducing transaction costs (Mattli, 1999), as recent studies have pointed out (Maur, 2005; McQueen, 2002; Holland, 2002), political conditionality has become one of the key issues between the EU and LDCs. The EU demands greater accountability by having the LDCs adopt of a series of related principles that are then evaluated by the EU, such as good governance, democracy, human rights, and a free market (Holland, 2002: 112). Conditionality can be categorized in several ways: by political and economic aspects; internal and external supervision; and positive and negative sanctions. Political conditionality remunerates the implementation of policy in an LDC that promotes the goals of democracy, human rights, and good governance. Economic conditionality links rewards with the adoption and promotion of specific microeconomic and macroeconomic policies, such as structural adjustment programs and liberation. Typically, both political and economic conditionality are intensively monitored by the EU (Holland, 2002: 119).

Positive and negative forms of conditionality entail added benefits for adhering to specific policy guidelines or the threat of disciplinary sanctions in the event that such guidelines are flouted.

The underlying rationale for the EU using political and economic conditionality in negotiating bilateral trade agreements with LDCs has three facets. First, the EU aims to promote its rules with the partner country, dictating a hegemonic harmonization of regulatory policies (Lawrence, 1996). As the former EC Trade Commissioner Pascal Lamy (2004) put it, “we always use bilateral trade agreements to move things beyond WTO standards. By definition, a bilateral trade agreement is WTO-plus.” In other words, the EU exports its own designed policies to gain bargaining power vis-à-vis the US at a multilateral level, *e.g.* in a WTO round. Second, by exporting its own regulatory standards, the EU strengthens the international competitiveness of its firms. Specifically, the application of EU regulations by an LDC creates a competitive advantage for European producers, making it more difficult for other producers, *e.g.* US producers, to sell their products. Third, the EU aims to stabilize individually unsettled neighbors by connecting them more closely to the European bloc, and to encourage regional stability through integration (Maur, 2005: 1578). Good governance, for instance, has become a fundamental prerequisite for sustainable development (Holland, 2002: 121).

## **LDCs: Credibility and Adjustment Costs**

Despite some limitations on the choice of their own domestic policies, LDCs reap several benefits from concluding a trade agreement with the EU. First, and most importantly, forming a bilateral trade agreement with the EU enhances an LDC's policy credibility (Whalley, 1998). According to Schiff and Winters, "entering a PTA entails political sunk costs, and if it requires liberal or sound policies to make sense, entry provides the government with a signal device, for only a government with liberal intentions would sign" (2003: 111). Thus, in the presence of asymmetric information about the government, a PTA with the EU can improve credibility. Although the benefits of North-South PTAs are still a matter of debate among scholars, there is a wide consensus that by signing these agreements LDCs bolster their reputation in the global economy and send a positive signal to investors and companies (Ethier, 1998; Rodrik, 1989). Moreover, Maur (2005: 1578) argues that improving their existing regulatory framework using the EU template helps LDCs to correct market failures. Finally, according to McQueen (2002: 1383), an agreement with the EU can significantly lower transaction costs and uncertainty through the presence of a regulatory framework. These benefits apply not only to relations with the EU, but also with the rest of the world.

Increasing policy credibility and political and economic certainty and decreasing transaction costs are necessary conditions to attract investment and multinational corporations. In turn, attracting foreign capital and foreign companies allows LDCs



access to knowledge, markets, and networks. In particular, financial support and technical assistance may bolster reforms resulting in a further improvement of credibility and political and economic certainty. Indeed, recent studies (Medvedev, 2006; Velde and Bezemer, 2004; Globerman, 2002; Chakrabarti, 2001) have shown that PTA membership is associated with a positive change in net FDI inflows and financial aid and that this positive change is stronger if an LDC enters a bilateral trade agreement with a developed economy. For instance, according to Benedict de Saint-Laurent, director of ANIMA, a network of inward investment agencies for Mediterranean countries, political and economic partnership with the EU has prompted economic, financial, and fiscal reforms in these countries, which have opened up their economies significantly (Economist, 2008, page 75).

According to the above explanations, both the EU and LDCs have an incentive to form a PTA. However, carrying out the reforms that the EU demands through political and economic conditionality involves adjustment costs and it may be reasonably expected that not every LDC is ready to sustain such costs. Specifically, under circumstances where product and factor prices adjust immediately and resources can be reallocated without cost, the optimal policy would be the simultaneous removal of all distortions. However, in reality things are more complicated. Indeed, resources cannot be reallocated instantaneously without incurring costs in different sectors of the economy (Nsouli *et al.*, 2005: 741). Moreover, different markets adjust to policy changes and price signals at different speeds. For instance, the response of the production structure, investment, and ownership patterns to economic reforms

tends to be much slower than the response to financial policies and reforms in such areas as privatization, tax, and trade.

There are several adjustment costs that an economy may face due to conditionality-driven reforms. First, since labor and capital are sector specific and thus not readily transferable between sectors, economic reforms may generate short-term costs in terms of unemployment and income distribution (Little *et al.*, 1970; Gavin, 1996). Second, when the budgetary cost of reforms is high, as may be expected when an LDC wants to honor EU economic conditionality, a reform process may result in inflationary pressure (Dewatripont and Roland, 1992; 1994). Third, there is a general consensus that trade liberalization may lead to loss of government revenues, which are an important part of an LDC's budget, as trade taxes are reduced or eliminated (Baunsgaard and Keen, 2005). In turn, to maintain macroeconomic stability and to avoid a severe imbalance of payment, governments may be forced to cut social security and welfare or to raise taxes (Ebrill *et al.*, 1999). Thus, in this scenario, the majority of the population may show a status quo bias that makes reforms unfeasible at both political and economic levels.

To conclude, three considerations are crucial for understanding the negotiations between the EU and LDCs in the context of conditionality. First, adjustment costs are not trivial in the decision of a developing economy to join a PTA with the EU and, in the short term, may actually offset the benefits of joining it. For example, the negotiations between the EU and the African Caribbean Pacific countries

(henceforth, ACP) to form a trade agreement have been deadlocked since 2002. This stalemate is due to the fact that the EU refuses to recognize regional differences across the ACP. Indeed, African and Pacific countries face significantly larger adjustment costs in meeting the EU's conditions than Caribbean countries do, making it difficult for them to enter into a PTA with the EU (Oxfam briefing paper, 2007). Second, conditionality-driven reforms introduce an element of *uncertainty* into an LDC's economic system, which may create political pressure for protection at home. For instance, 300,000 small Algerian firms currently at risk from the competition of European commodities are lobbying protectionist trade policy to their own government (Magharebia, 23<sup>rd</sup> January 2008). Third, in relation to LDCs, a bilateral trade agreement with the EU is likely to produce important distributional effects, leading to concerns about the division of long-term gains from the agreement. For instance, case studies show that unskilled workers in Mediterranean countries are often harmed by trade agreements with the EU (Francois *et al.*, 2005; Ghesquiere, 1998). In turn, groups that face major economic losses are likely to be highly mobilized against economic reforms that threaten their interests.

## **Transparency and Flexibility in EU Trade Bilateralism**

While the EU wants to maximize conditionality, for an LDC there is a clear trade-off. On one hand, LDCs benefit from signing a PTA with the EU in terms of

enhancing their credibility in the global economy. On the other hand, LDCs face high adjustment costs in carrying out the reforms that the EU dictates through economic conditionality. This trade-off creates two different, albeit related, problems: the first concerns the enforcement phase of the agreement; the second involves the design of the agreement. Each of these two issues are addressed and developed in further detail in the following two sections.

## **Credible Commitments and Transparency**

Forming a PTA is consistent with the logic of a two-stage cooperation problem. As several authors argue (Fearon, 1998; Bearce, 2003), the decision to form an agreement and the decision to fulfill an agreement are strongly connected. If the EU anticipates that impediments to monitoring and enforcing an agreement would make a cooperative agreement unstable, it has a low incentive to negotiate (Fearon, 1998: 279), and thus such a cooperative agreement is unlikely to be formed (Leeds, 1999). In other words, in relation to the formation of an agreement with the EU, LDCs face a classic time-inconsistency problem that, in turn, undermines the credibility of LDCs' commitments. Indeed, in line with LDCs' previously described preferences, time-inconsistent policies would lead to higher utility than time-consistent policies. Specifically, LDCs turn to the EU seeking to gain credibility in the international economic system. In exchange, they offer the promise of some domestic reforms. EU conditionality ensures that reforms are implemented despite the temptation to postpone these reforms or to forego them altogether.<sup>4</sup>

Since an LDC has this incentive to renege upon a PTA, the EU must have instruments to detect and sanction opportunistic behavior. As a large body of cooperation literature claims, monitoring is as necessary and important as sanctioning, since “applying the proper sanctioning strategy is difficult when compliance is difficult to monitor” (Morrow, 1994: 387). More specifically, in the absence of the capability to monitor and sanction, commitments would not be credible and the EU would have no incentive to reach an agreement with an LDC. I argue that transparency in economic and political institutions can provide the necessary monitoring and enforcement functions. When the political and economic system is transparent, governments will face greater difficulties hiding their actions and avoiding the cost of opportunism. Moreover, when a government’s preferences are unveiled by transparent political institutions, commitments may be credible even in the presence of time-inconsistency problems (Broz, 2002). Finally, transparency in governments’ actions is an effective way to bolster the reputation of LDCs, which is crucial in the case of time-inconsistency problems (Rodrik, 1992). Hence, the first hypothesis can be stated as follows:

H1: The probability of the EU and an LDC forming a PTA increases with the political and economic transparency of the LDC.

## **Flexibility**

As explained above, in implementing the conditionality dictated by the EU, LDCs face adjustment costs that increase uncertainty and distributional problems at the domestic level. In turn, uncertainty and distributional concerns increase the strength of the support for protection at home. I argue that uncertainty is particularly high in cases of EU bilateralism, since these PTAs are tightly linked to the implementation of important economic and political reforms. A recent body of literature (Fearon 1998; Koremenos, Lipson, and Snidal 2001; Kucik and Reinhardt, 2008) emphasizes the uncertainty that states face about the future costs of compliance in a repeated-game context. In line with these works, I claim that uncertainty may endanger the prospects for a bilateral trade agreement in the present, despite the fact that potential benefits are high for both actors.

To overcome this problem, almost every international agreement allows members the opportunity to temporarily escape contractual commitments without incurring excessive retaliation from other partners or without being compelled to renegotiate costs once they have been forced to withdraw from the agreement. These escape clauses are often referred to as flexibility provisions. According to Rosendorff and Milner (2001: 830), flexibility is “any provision of an international agreement that allows a country to suspend the concessions it previously negotiated without violating or abrogating the terms of the agreement.” As such, flexibility may encourage states to enter into cooperative agreements and sustain those commitments over

time (Kucik and Reinhardt, 2008). *Efficient breach* clauses are also crucial in the case of EU bilateralism. Specifically, flexibility allows for the sustaining of cooperation under circumstances when defection by LDCs' governments is necessitated by excessively high costs of compliance.

There are two main provisions that are used in trade agreements to allow flexibility: anti-dumping protection and, more importantly, safeguard clauses.<sup>5</sup> The problem with flexibility is that domestic politics constitute private information, as do domestic political changes. Thus, there exists an incentive for LDCs to misrepresent their private information in order to achieve a more favorable outcome in the bargaining process with the EU. If the EU perceives that monitoring the domestic politics of an LDC would not be feasible or would be too expensive, it will not allow the inclusion of the flexibility clauses in the agreement in the first place. Indeed, the higher the political and economic transparency of the LDC, the lower the asymmetries of information are and, in turn, the more the LDC is credibly capable of communicating about "exceptional circumstances" that may occur domestically to undermine its capacity for compliance. This follows naturally from Bayesian updating, as the sources of any given defection can be seen as coming from either forced emergency measures or opportunism, and is in line with previous studies in the field (Pelc, 2009; Svolik, 2006). Hence, the second hypothesis can be formulated as follows:

H2: The degree of flexibility of a PTA between the EU and an LDC increases

with the political and economic transparency of the LDC.

## Empirical Analysis: Models and Case Selection

In the previous sections, EU bilateralism has been described as a process of selection related to domestic institutional features of LDCs. Due to this selection character of the causal mechanism, some estimation problems occur. Specifically, flexibility is observable if and only if a PTA is signed, thereby generating a selection bias problem. In order to deal with these issues and to test the previous hypotheses, I use the following specification of Heckman selection model known as the HECKIT model (Grier *et al.*, 1994; Heckman, 1979).

$$\text{Outcome Equation : } y_{ij,t} = \alpha X_{i,t-1} + \varepsilon_1 \quad (1)$$

$$\text{Selection Equation : } z_{ij,t} = \beta_1 Y_{ij,t-1} + \beta_2 W z_{i,t-1} + \varepsilon_2. \quad (2)$$

Where  $y$  and  $z$  are the dependent variables of the outcome equation and selection equation, respectively,  $X$  is a vector of an LDC's features that influence the level of a PTA's flexibility,  $Y$  is the vector of the explanatory variables that affect LDCs' and the EU's decision to form a PTA, and  $W z_{t-1}$  is a spatial weight matrix constructed from the number of preferential trade agreements in the sample. Spatial lags of a dependent variable fulfill a similar function as lagged dependent variables in models



that account for serial correlation. Instead of simply lagging the dependent variable in time, values on the lagged dependent variable are brought into the regression based on (the inverse of) the distance variable (Manger, 2005). A positive coefficient would indicate that countries are indeed driven to seek preferential agreements if their neighbors are doing so to avoid the trade diversion effect (Baldwin, 1997; Grossman and Helpman, 1995; Haggard, 1997; Hirschman, 1981). I label this variable Spatial PTA.<sup>6</sup> Moreover,  $\alpha$ ,  $\beta_1$ , and  $\beta_2$  are vectors of parameters, and  $\varepsilon_1$  and  $\varepsilon_2$  are i.i.d. error terms with a constant mean and finite variance.

## Outcome Equation

The dependent variable (DV) of the outcome equation is the variable *PTA Flexibility<sub>ij,t</sub>*. Since the operationalization of flexibility is intrinsically problematic, this variable is specified using two different indices. Although I acknowledge the difficulties in providing a systematic measurement of flexibility, the fact that the two specifications are highly correlated with each other ( $\rho = .6$ ) indirectly proves the robustness and coherence of my operationalization. The first indicator is constructed following Epstein and O'Halloran's (1999: 90-112) measurement of executive discretion. Another application of this method was implemented by Franchino (2004) to describe the delegating power of the EU. It is the discretion in applying legal provisions that a trade agreement leaves to each member country. More specifically, *PTA Flexibility<sub>ij,t</sub>* is the proportion of provisions in the trade agreement that delegate policy authority to member states. It is a continuous variable that ranges between 0 and 1 and varies

a great deal between different PTAs.

The second index is constructed using manual coding of the two aforementioned sources of flexibility: safeguard clauses and anti-dumping provisions.<sup>7</sup> Regarding the former, I look at the conditions under which LDCs are allowed to use escape clauses. For instance, some PTAs allowed LDCs to suspend cooperation when “serious difficulties produce major social problems” (Algeria-EU, 2002), whereas other PTAs include flexibility provisions in relation to sensitive sectors in LDCs, *e.g.* the steel industry (Hungary-EU, 1992). The higher the number of conditions under which cooperation may be suspended, the higher the degree of flexibility. Regarding anti-dumping provisions, I code whether the agreement includes only anti-dumping provisions or also incorporates countervailing duties and provisions against subsidies imposed by member countries. The rationale for considering anti-dumping laws as discretionary provisions is that a country can take advantage of them to suspend cooperation in the case of surging costs of compliance. Specifically, anti-dumping laws are contingent provisions that act as insurance to protect import competing sectors subjected to price shocks (Fisher and Prusa, forthcoming). As Prusa argues, “anti-dumping laws have nothing to do with economically harmful practices; rather, anti-dumping is just a cleverly designed form of protectionism” (2005: 683-684). Thus, the larger the number of policies, *e.g.* tariffs, duties, and subsidies, these clauses cover the higher the degree of flexibility. I group these two conditions in an index that captures the level of flexibility of a PTA and ranges between 0 and 1. The web appendix provides a more detailed explanation of the method and the

calculations that have been implemented to obtain these two variables.

The main independent variables of the Outcome Equation measure political and economic transparency. Specifically, I focus on two dimensions of transparency that are of primary interest herein since they are in line with the causal mechanisms previously suggested: predictability of domestic rules and procedures and efficiency of the political system. Helbe *et al.* (2009) has a similar specification of transparency. Predictability concerns rules and procedures applied in a consistent and uniform manner so as to minimize uncertainty. Efficiency refers to rules and procedures that minimize the possibility of delays in implementing policies, *i.e.* political failure, as well as the possibility to engage in fraudulent and anti-competitive behavior, *i.e.* market failure. As Powell and Whitten (1993: 398) point out, transparency is a tool to create “clarity of responsibility”, *i.e.* easing the task of attributing outcomes to the acts of political actors. As such transparency always has a political component. However, my operationalization of transparency goes further and is closely related to market issues, which play a crucial role in the enforcement phase of a trade agreement. This combination of political and economic elements is the reason why I refer to these variables as indices of both *political and economic transparency*.

Due to the difficulties of capturing domestic institutions, political and economic transparency has been operationalized in three different ways: using the level of corruption, of rule of law, and of government effectiveness. *Corruption* is a proxy for the predictability of a country’s legal environment and of irregular practices that

can have major importance during the stipulation of a contract. *Rule of Law* is a proxy of effective contract enforcement, of the extent to which laws are observed and enforced fairly and competitively, and more broadly of respect for the rule of law. *Government Effectiveness* takes account of the direct relationship between the capability of government to credibly commit itself in implementing policies and the transparency of the economic environment of a given society. All three indicators are built from the Kaufmann *et al.* (2006) data set. Since Kaufmann's indicators are available from 1996 to 2005, the most recent data available has been used for the previous years. The measure of political and economic transparency for potential EU partner countries grows with the values of the three indicators, which have been rescaled from 0 to 5. Moreover, the Pearson test suggests that these indicators show significant (at a 95 per cent level) correlation with each other (around .8 for each variable). Thus, three different models, each one including only one of the three variables, have been used to test the two hypotheses in order to avoid the collinearity problem.

Other control variables are *Other-Than-French Colony<sub>i</sub>*, *French Colony<sub>i</sub>*, *GDP<sub>i</sub>*, *GDPpc<sub>i,t-1</sub>*, *GDP Growth<sub>i,t-1</sub>*, *Trade<sub>ij,t-1</sub>*, *Democracy<sub>i,t-1</sub>*, and *US PTA<sub>i,t-1</sub>*. *Other-Than-French Colony<sub>i</sub>* and *French Colony<sub>i</sub>* score 1 if country *i* has been a colony of respectively any EU member but France, and France; 0, otherwise. Former colonies have often maintained close ties with the colonizer and often depend heavily on the former colonial power in terms of exports. Thus, the bargaining power of former colonies vis-à-vis the EU is expected to be lower and, in turn, this is likely to nega-

tively affect negatively the level of flexibility. I include a separate dummy for French ex-colonies since it is commonly thought that these may differ in terms of intensity of trade from non-French colonies (Francois *et al.*, 2006).  $GDP_{i,t-1}$  and  $GDPpc_{i,t-1}$  measure respectively the GDP and the GDP per capita of the LDC  $i$  in year  $t - 1$ . It may be argued that the level of economic development of LDCs impacts upon the degree of flexibility of PTAs. In other words, rich LDCs have more bargaining power vis-à-vis the EU than poor LDCs. By including these variables, I make sure that indicators of transparency do not proxy the level of development.  $GDP\ Growth_{i,t-1}$  is the value of economic growth of the LDC  $i$  at time  $t-1$ . This variable captures whether an LDC is risk-adverse, which has proved to be an important variable in explaining flexibility (Koremenos, 2005). Specifically, countries that experience low economic growth are supposed to be more risk-acceptant than countries that experience an economic upturn. The argument is that leaders who anticipate losing office due to economic downturn are more likely to implement adventurous policies.

$Trade_{ij,t-1}$  is the log of the value of exports from the EU to the LDC  $i$  and from the LDC to the EU in year  $t - 1$  in constant  $(t + n)$  dollars.<sup>8</sup> This is the most common way in which trade flows between pairs of countries are measured in the economic literature. The amount of trade is expected to influence the number of anti-dumping clauses. Since anti-dumping clauses have been presented as a index of flexibility in trade agreements, as trade between the EU and an LDC increases, so does the level of flexibility.  $Democracy_{i,t-1}$  is based on a 7 point scale that measures the nature of the regime of LDC  $i$  in the previous year. It has been built upon the

Freedom House data set. Thus, the more democratic the country, the more the EU trusts said country. In turn, this is expected to have a positive impact upon the degree of flexibility.<sup>9</sup>  $US\ PTA_{it}$  scores 1 if an LDC has signed a PTA with the US in  $t - 1$  or before. It may be expected that LDCs that have a PTA with the US have greater bargaining power in negotiations with the EU, since they have already gained access to a very important market. Thus, these LDCs should be able to sign a PTA with high flexibility.

## Selection Equation

The dependent variable of the selection equation is a dichotomous variable. Specifically,  $PTA_{ij,t}$ , is a dummy variable which equals 1 if country  $i$  and the EU are in a PTA in year  $t$ ; 0, otherwise. I take a conservative approach in selecting which bilateral trade agreements between the EU and LDCs to include in the analysis. I rely on three different databases, namely the list of regional trade agreements notified with the WTO, the Tuck Trade Agreements Database, and the McGill Faculty of Law Preferential Trade Agreements Database, but I exclude partial-scope agreements and agreements that envisage no conditionality, which is the crucial trigger for my mechanism. For instance, I do not include the Partnership and Cooperation Agreements between the EU and Kazakhstan (2005) and between the EU and Russia (2006). These two agreements contain only very general statements on the need to strengthen economic cooperation between the parties and no binding provisions. Moreover, these agreements include “only” 12 articles that are less than one third

of the shortest free trade area treaty signed by the EU, *i.e.* the PTA with Lebanon. I end up with 23 preferential trade agreements signed between 1990 and 2005.

Even in the case of the Selection Equation, the main independent variables are variables that measure political and economic transparency as described in the previous section. I include several control variables that prove to be important drivers of PTA formation in general, *i.e.* not specific to EU bilateralism. Regarding economic control variables,  $GDP_{i,t-1}$  measures the GDP of the LDC  $i$  in year  $t - 1$ . This variable captures the idea that the larger the market of an LDC, the higher is the benefit for the EU in joining a PTA (Baier and Bergstrand, 2004).  $Trade_{ij,t-1}$  has been previously described. As trade between the EU and an LDC increases, the traditional trade gains from tariffs removal increases for the EU and LDCs.

Regarding the political variables,  $Alliance_{ij,t-1}$  scores 1 if country  $i$  is an ally of at least one EU member at time  $t - 1$ ; 0 otherwise. This variable controls for the possibility that the EU signs a PTA with an LDC for foreign policy reasons (Gowa, 1994). As already said, former colonies have often maintained close ties with the colonizer and this is expected to make the formation of a PTA more likely. I include both *Other-Than-French Colony* $_i$  and *French Colony* $_i$ , which are both expected to have a positive coefficient. Moreover, since members of the WTO tend to have similar trade policies and similar legal provisions in terms of trade law, *e.g.* adoption of anti-dumping provisions, an LDC  $i$  that is a WTO members at time  $t-1$  should be more likely to conclude an agreement with the EU. I label this variable  $WTO_{i,t}$ .

Furthermore, previous research has shown that democratic pairs of countries tend to sign more PTAs than non-democratic or mixed pairs (Mansfield *et al.*). Thus, I include the variable *Democracy* also in the Selection Equation. Finally, the rationale for including  $US\ PTA_{i,t-1}$  is that the EU may react to a PTA signed by the US with an LDC, *e.g.* Mexico, to avoid losing trade with this country (Dür, 2007) or to push its own regulatory standard in the international system (Drezner, 2007).

Regarding geographical factors,  $Distance_{ij}$  measures the log of distance in kilometres between Brussels and the capital of the LDC  $i$ . Indeed, several authors (Krugman, 1991; Baier and Bergstrand, 2004) claim that the formation of PTAs is more likely between countries that are geographically proximate. Table 1 of the web appendix summarizes the descriptive statistics of the variables and their sources.

Mirroring the theoretical framework, the empirical analysis follows a two-stage process. In the first stage, I endogenize the EU's decision to select an LDC using the level political and economic transparency as the main explanatory variable. The estimated probability of selection is then used as a regressor in the second stage for analysing the impact of political and economic transparency on the degree of flexibility included in the trade agreement. The previously outlined causal mechanism implies that political and economic transparency allows LDCs to bargain for more flexible PTAs with EU. However, since the degree of flexibility of a PTA has an impact upon the probability of its being signed, excluding countries that do not have a PTA with the EU would cause a severe estimation bias that might lead to incorrect



inferences. The econometric logic of the Heckman model allows conditioning the estimated mean function in the second stage on the selection process of first stage. Moreover, it takes into account that for an LDC the probability of being selected by the EU affects the likelihood of signing a PTA that includes flexibility provisions. Furthermore, to account for the duration dependence of the dependent variable in the selection model, natural cubic splines (with three knots) are included. For the sake of conciseness, splines are not reported in the econometric analysis. Finally, since the data set is a panel, to control for potential heteroskedasticity across countries, the robust Huber-White sandwich estimator is employed.

As mentioned above, the model is tested for a large number of countries. The unit of observation (country-year) consists of all un-directed dyads between the EU and LDCs that have available data on institutional indicators. This model is known as an unbalanced panel. Un-direct dyads are employed here since the first country in the dyad is considered the country that is targeted, whereas the second is the EU. The statistical analysis includes 138 countries in the first step. In the second stage, I exclude countries that did not sign a PTA from the data set leading to a sample population of 23 countries. The period under observation spans from 1990 to 2005. This leaves me with 2146 observations (country-years) in the first stage and 175 observations in the second stage.

## Empirical Findings

As previously stated, the first stage of the Heckman model tests whether or not LDCs form a PTA with EU, analyzing the universe of cases. Results for the two specifications of PTA flexibility are very similar. In both cases, all three operationalizations support the argument that high political and economic transparency of an LDC increases the probability of forming a PTA with the EU with the coefficients having the right sign and being statistically significant at the .01 levels (see Table 1 and Table 2). Moreover, with the exception of Other-Than-French Colony the sign of all the control variables, which are statistically significant in the models, is in line with previous studies, giving added plausibility to the findings. The negative sign of Other-Than-French Colony is driven by East European countries, which were party to half of the PTAs under investigation and, are not former EU colonies.

TABLE 1 ABOUT HERE

TABLE 2 ABOUT HERE

Since in the probit model the value of the coefficients is not meaningful, looking exclusively at the sign and the significance of the coefficient does not allow us to know the effect of the main explanatory variables on the probability of forming a PTA. Thus, the predicted probabilities are showed in Table 3 below. Since results are similar for the two specifications of the dependent variable, I focus the analysis only on the first. Moving from the minimal value to the maximum value and holding

the other variables at their averages, the probability of forming a PTA increases by 1.3 (0.4, 2.3) per cent in case of *Corruption*, by 2.4 (0.4, 5.1) per cent in case of *Rule of Law*, and by 2.1 (0.4, 4.7) per cent in case of *Government Effectiveness*. Since the formation of PTAs is a rare event in a dyadic setting, these findings are quantitatively large. For instance, expressed in terms of number of dyads forming a PTA, my results indicate that 1.2 countries with a high level of rule of law, such as Estonia or Slovenia, are expected to enter into a trade agreement with the EU in an average year. This number is noteworthy considering that the EU signed 23 trade agreements in the period under investigation.<sup>10</sup> In addition, the magnitude of these results is comparable to (and in fact, higher than) the impact of other important control variables, such as *Trade*, *Democracy*, and *WTO* (Table 3).

#### TABLE 3 ABOUT HERE

Since a probit model is implemented in the first stage, this allows us to verify the number of PTAs correctly predicted. In the context of discrete choice models, McFadden (1984) suggests that if the predicted probability of an event, *e.g.* a PTA, for a country pair exceeds one half, this suggests that we should observe that event for the country pair. Accordingly, the model predicts 19 of the 23 country pairs with PTAs with a sensitivity of 80 per cent. The model predicts some agreements (*e.g.* between the EU and Turkey) that the Baier and Bergstrand (2004) model, which has a similar specification, did not predict. Three PTAs between the EU and LDCs were not predicted: Egypt, Lebanon, and Syria. Interestingly, two (Lebanon and

Syria) of these three countries are former French colonies, suggesting that France “rewards” former colonies with PTAs more than other colonizers though *French Colony* is not statistically significant in the selection equation. Finally, our qualitative choice model also allows us to identify for which country dyads bilateralism might be considered insufficient. Following Baier and Bergstrand (2004: 57), bilateralism is designated *insufficient* if a PTA is predicted but does not yet exist. Of 115 country dyads without a PTA, 2 pairs were not predicted correctly: Ukraine and Serbia. Interestingly, the latter country and the EU established a free trade zone for industrial and agricultural products on 29 April 2008. Table 4 summarizes these findings graphically.

#### TABLE 2 ABOUT HERE

The second stage of the Heckman model tests the impact of political and economic transparency on the degree of flexibility of a PTA, analyzing a self-selected sample. Even in the outcome equation, all three operationalizations support the argument that a high political and economic transparency of an LDC increases the level of flexibility of a PTA between the EU and an LDC with the coefficients having the right sign and being statistically significant at the .01 levels. Moreover, the impact of the three variables on flexibility is noteworthy. If Corruption rises by 1 unit, the degree of flexibility of a PTA increases by 8 per cent (Model 1) and 13 per cent (Model 4). In the case of Rule of Law, if this variable increases by 1 unit, the level of flexibility of a PTA rises respectively by 9 per cent (Model 2) and 15 per

cent (Model 5). Finally, if *Government Effectiveness* rises by 1 unit, the degree of flexibility of a PTA increases by 10 per cent (Model 3) and 14 per cent (Model 6).

Among the other control variables, which are statistically significant, *Other-Than-French Colony*, *US PTA*, *GDP Growth*, and *Trade* have the expected sign in the first specification of *Flexibility*. Conversely, there is no evidence that the level of development of LDCs impacts upon flexibility. Moreover, results demonstrate the superiority of the Heckman model over competing specifications. Specifically, since  $\rho$ , which measures the correlation between the errors of the first and second stage, differs significantly from 0, a Heckman model is the only efficient and unbiased estimator in light of the theoretical framework developed in this paper. Finally, to check the robustness of the empirical results, a series of changes were made to the base models. For all these cases, the results are roughly comparable to those presented above and are available in the web appendix

## Conclusion

This paper makes three contributions to the international political economy literature. First and foremost, I have offered an empirical argument to explain the formation and the design of bilateral trade agreements between the EU and LDCs. Specifically, political and economic transparency in LDCs allows the EU to distinguish whether a defection is a result of serious domestic circumstances or opportunistic behavior. This is a crucial finding given the importance of flexibility in

the cooperation literature. Indeed, as several recent studies have shown (Kucik and Reinhardt, 2008; Svulik, 2006), formal provisions for breaking treaty commitments may counter-intuitively boost cooperation relative to what would otherwise be possible. Second, I show that domestic variables are important drivers in the formation of trade agreements. Although economic features of LDCs, as well as systemic factors, prove to be important drivers of EU bilateralism, high economic and political transparency in LDCs makes them more likely to reach a trade agreement with the EU. In this sense this article is in line with the findings of recent studies that stress the importance of domestic institutions in economic cooperation (Mansfield *et al.*, 2002; 2007; 2008). Third, I provide consistent and generalizable measurements of flexibility that may be used in analysis of other international organizations outside of the realm of trade agreements.

Finally, the paper has interesting policy implications. It suggests that North-South PTAs may act as a complementary tool of development, but not as a substitute for endogenous political and economic reforms. Specifically, in order to be appealing economic partners for major economies in general, and for the EU in particular, LDCs have to reach a certain level of quality of institutions through transition to a market-economy. The initial steps of this transition must be implemented endogenously and are crucial for further development. Indeed, the quality of the institutional framework - the level of transparency exhibited - conditions LDCs' ability to be selected as trade partners by a major economy, *e.g.* in this paper, the EU. Moreover, LDCs' political and economic transparency conditions the degree of

flexibility at their disposal to pursue specific development objectives in the light of specific circumstances. In sum, LDCs seem to perform in a Markovian multi-state process in which the transition to a higher state of development is a function of the ability to reach a certain threshold in terms of quality of institutions.

## Notes

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<sup>2</sup>Broadly speaking, a preferential trade agreement is an arrangement that liberalizes trade between members. Here, the term “preferential trade agreement” and the term “bilateral trade agreement” are used synonymously.

<sup>3</sup>Using the World Bank classification, I define low-income economies and middle-income economies as LDCs.

<sup>4</sup>It may be argued that is more harmful to an LDC’s reputation to not honor an agreement than to not sign it in the first instance. However, empirical evidence does not support this argument. Several studies (Steunenberg and Dimitrova, 2007; Anastasakis and Bechev, 2003) show

that despite a strong wave of North-South agreements, there is a mixed record on compliance with such agreements. These findings seem to imply that LDCs prefer to secure North-South PTAs and to obtain the “seal of approval” from developed economies, especially the EU and the US, though they are not always ready to honor every clause of these agreements.

<sup>5</sup>All EU trade agreements include safeguards (Woolcock, 2007: 7). There are three forms of safeguards. Permanent safeguards take the form of a reaffirmation of the EU’s rights under the WTO. Transition safeguards are those that grant the EU (and its preferential partners) rights to impose import controls should the FTA lead to an unexpected rapid increase in imports during its implementation. Finally, there are special safeguard measures that the EU uses for sensitive sectors, such as agriculture, and offers as special and differential treatment for developing countries.

<sup>6</sup>Because of the inclusion of a lagged dependent variable, all coefficients computed from this point estimate need to be interpreted as one period effect (Wooldridge, 2001: 279).

<sup>7</sup>Kim and Hicks use a similar coding scheme to measure the depth of coverage, *i.e.* synonymous with flexibility in their study, regarding 57 PTAs signed by Asian countries.

<sup>8</sup>Note that the EU is considered the sum of all the member countries in that particular year, *i.e.* 12 members until 1993, 15 members from 1994 to 2003, and 25 from 2004.

<sup>9</sup>The results reported below do not change when using other data sources, such as the Polity IV score. The correlation between these two measurements of democracy and the three indicators of transparency is around .4.

<sup>10</sup>Following Mansfield *et al.* (2002), these figures are computed by multiplying the predicted probability of a dyad forming a PTA by the total number of observations (2146) and then dividing that product by the number of years in the sample (16).



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Table 1: The formation of preferential trade agreements, Heckman Model - PTA Flexibility 1. Standard errors are in parentheses. \*\* significant at 1 per cent, \* significant at 5 per cent, † significant at 10 per cent.

Covariates	Model 1	Model 2	Model 3
II Stage: PTA Flexibility 1.			
Corruption	0.08** (0.03)		
Rule of Law		0.09** (0.03)	
Govern. Effect.			0.10** (0.02)
French Colony	0.002 (0.03)	0.01 (0.03)	-0.03 (0.04)
Other-Than-French Colony	-0.02 (0.03)	-0.02 (0.03)	-0.03 (0.03)
GDP Growth	0.005** (0.002)	0.005** (0.002)	0.003† (0.002)
Trade	0.02** (0.004)	0.01** (0.004)	0.01** (0.004)
US PTA	0.07 (0.07)	0.07 (0.07)	0.06 (0.07)
Democracy	0.01† (.008)	0.02* (0.008)	-0.01 (0.01)
GDP	-0.04** (0.01)	-0.03* (0.01)	-0.04** (0.01)
GDP per Capita	0.001 (0.002)	0.002 (0.002)	0.001 (0.002)
$\varrho$	0.48** (0.09)	0.47** (0.10)	0.46** (0.10)
$\sigma$	0.14** (0.007)	0.14** (0.007)	0.14** (0.007)
$\lambda$	0.07** (0.01)	0.07** (0.01)	0.06** (0.01)
Rho $\geq \chi^2$	16.06**	16.19**	15.85**
Prop $> \chi^2$	0.00	0.00	0.00
I Stage: PTA Formation			
Corruption	0.47** (0.16)		
Rule of Law		0.73** (0.14)	
Govern. Effect.			0.67** (0.16)
GDP	0.17** (0.07)	0.20** (0.07)	0.17** (0.06)
Alliance	0.33 (0.30)	0.36 (0.30)	0.43 (0.30)
Democracy	0.16** (0.05)	0.16** (0.05)	0.14** (0.06)
GATT/WTO	0.90** (0.23)	0.86** (0.23)	0.91** (0.23)
French Colony	0.19 (0.20)	0.39 (0.27)	0.25 (0.27)
Other Than French Colony	-0.26* (0.27)	-0.63* (0.25)	-0.66** (0.25)
US PTA	1.87** (0.28)	1.84** (0.28)	1.86** (0.29)
Trade	0.11** (0.03)	0.10** (0.03)	0.09** (0.03)
Distance	-0.98** (0.14)	-1.02** (0.14)	-1.02** (0.14)
Spatial PTA	59.12** (13.74)	60.34** (13.40)	58.72** (13.16)
Constant	4.15** (1.14)	4.03** (1.10)	4.20** (1.06)
Number of Observations	2146	2146	2146
Number of Censored Observation	175	175	175

Table 2: The formation of preferential trade agreements, Heckman Model - PTA Flexibility 2. Standard errors are in parentheses. \*\* significant at 1 per cent, \* significant at 5 per cent, † significant at 10 per cent.

Covariates	Model 4	Model 5	Model 6
II Stage: PTA Flexibility 2.			
Corruption	0.13** (0.02)		
Rule of Law		0.15** (0.02)	
Govern. Effect.			0.14** (0.01)
French Colony	0.04 (0.04)	0.06 (0.04)	-0.02 (0.04)
Other-Than-French Colony	-0.10** (0.02)	-0.11** (0.02)	-0.11** (0.02)
GDP Growth	0.001 (0.002)	0.003 (0.002)	0.0003 (0.002)
Trade	0.01** (0.003)	0.01** (0.003)	0.01** (0.003)
US PTA	0.25** (0.05)	0.26** (0.05)	0.02* (0.007)
Democracy	0.02** (.007)	0.03** (0.007)	-0.01 (0.01)
GDP	-0.01 (0.09)	-0.004 (0.08)	-0.008 (0.009)
GDP per Capita	-0.0002 (0.002)	0.0001 (0.002)	0.001 (0.002)
$\varrho$	0.23** (0.10)	0.23** (0.10)	0.21** (0.10)
$\sigma$	0.11** (0.007)	0.11** (0.007)	0.11** (0.007)
$\lambda$	0.02** (0.01)	0.02** (0.01)	0.02** (0.01)
Rho $\geq \chi^2$	4.75*	4.78*	3.75*
Prop $> \chi^2$	0.03	0.03	0.05
I Stage: PTA Formation			
Corruption	0.41** (0.16)		
Rule of Law		0.69** (0.14)	
Govern. Effect.			0.62** (0.16)
GDP	0.17* (0.07)	0.20** (0.07)	0.17** (0.06)
Alliance	0.28 (0.30)	0.32 (0.30)	0.39 (0.30)
Democracy	0.16** (0.06)	0.17** (0.05)	0.15** (0.06)
GATT/WTO	0.90** (0.24)	0.84** (0.24)	0.88** (0.24)
French Colony	0.28 (0.28)	0.39 (0.28)	0.28 (0.27)
Other Than French Colony	-0.61* (0.27)	-0.65** (0.25)	-0.66** (0.25)
US PTA	1.75** (0.29)	1.74** (0.29)	1.73** (0.29)
Trade	0.11** (0.03)	0.09** (0.03)	0.09** (0.03)
Distance	-1.02** (0.14)	-1.05** (0.14)	-1.05** (0.14)
Spatial PTA	61.63** (13.70)	63.10** (13.45)	61.79** (13.23)
Constant	4.80** (1.13)	4.50** (1.09)	4.62** (1.07)
Number of Observations	2146	2146	2146
Number of Censored Observation	175	175	175



Table 3: Entries are changes in the predicted probabilities of Corruption, Rule of Law, Government Effectiveness, Trade, Democracy, and Distance. All values are evaluated at the average value of the other control variables. First differences of Trade, Democracy, and Distance are calculated in Model 3. 90 per cent confidence intervals are in parentheses.

Economic and Political Transparency	[min, max]
Corruption	1.3 (0.3, 2.3)
Rule of Law	2.4 (0.4, 5.1)
Govern. Effect.	2.1 (0.4, 4.7)
Main Control Variables	[min, max]
Trade	0.5 (0.01, 1.3)
Democracy	0.4 (0.1, 1.5)
WTO	0.3 (0.1, 0.5)
Distance	14 (4, 27)

Table 4: Cases correctly predicted by the models, cases not predicted, and case of insufficient bilateralism.

PTAs correctly predicted	PTAs not predicted	Insufficient Bilateralism
Algeria	Egypt	Ukraine
Bulgaria	Lebanon	Serbia
Chile	Syria	
Czech Republic		
Estonia		
Croatia		
Hungary		
Jordan		
Latvia		
Lithuania		
Macedonia		
Mexico		
Morocco		
Poland		
Romania		
Slovakia		
Slovenia		
Tunisia		
Turkey		
South Africa		