PART I

BUILDING OPEN ECONOMY COALITIONS

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Excerpt
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Optimal Use of Pork, Policy, and Institutional Reforms

What accounts for the dramatic reduction in barriers to foreign trade after World War II? Postwar trade liberalization is a puzzle because governments initiated liberalization in places and at times that appeared the least likely: in newer, politically in flux democracies with strong legacies of import-substitution strategies. Governments around the world, especially in East Asia and Latin America, that faced pressures from new electoral competition and vested interest groups have reduced barriers to trade. What makes the postwar liberalization even more puzzling, moreover, is that the bulk of the liberalization was achieved unilaterally – that is, governments lowered trade barriers without bilateral or multilateral trade agreements that rest on the principle of reciprocity.[1] This book unravels political foundations of free trade.

Figure 1.1 documents the dramatic reduction in countries' barriers to trade, measured by simple average tariff rates from 1981 to 2010 for developing and industrialized countries (World Bank 2011). Figure 1.2 shows Martin and Ng's (2004) estimates of the proportion of unilateral versus multilateral trade liberalization that had contributed to overall tariff reduction for a set of developing economies that constituted more than 90 percent of import values around the world between 1983 and 2003. It shows that, on average, governments' unilateral liberalization contributed to 73 percent of tariff reduction between 1983 and 2003, while the Uruguay Round negotiations of the World Trade Organization (WTO) contributed 27 percent (Martin and Ng 2004; Baldwin 2010).[2] Two further patterns stand out. First, contrary to the conventional

[1] Rodrik (1994); Milner (1999); Baldwin (2010).

[2] Unilateral liberalization includes tariff reduction via loan agreements with the International Monetary Fund (IMF) and tariff reduction via WTO accession. Figure 1.2 does not imply that General Agreements on Tariff and Trade (GATT) or WTO did not have substantial effects on international trade. Goldstein et al. (2007) and Tomz et al. (2007) show that membership in

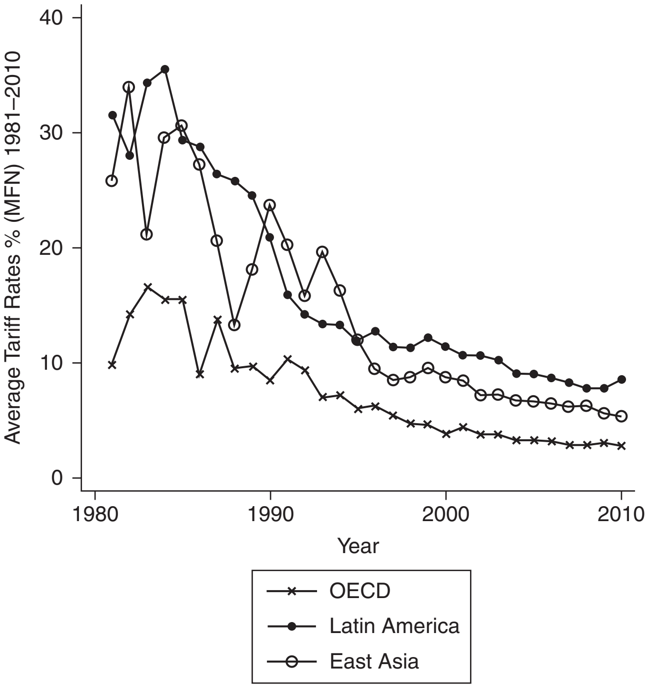

FIGURE 1.1. Postwar trade liberalization.

Source: World Bank, Francis K. T. Ng (2011), "Trends in Average MFN Applied Tariff Rates in Developing and Industrialized Countries, 1981–2010." Available at World Bank's Data Bank.

Note: Tariff rates are calculated by unweighted, simple average. East Asia includes China, South Korea, Indonesia, Japan, Laos, Malaysia, Mongolia, Philippines, Singapore, Taiwan, Thailand, and Vietnam. Latin America includes Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Paraguay, Peru, Uruguay, and Venezuela. Missing data are excluded from the mean calculation.

wisdom that political institutions affect countries' *levels* of trade protection (Nielson 2003; Kono 2006), political institutions have very little to do with the magnitudes of tariff *reduction over time*. Countries with or without democratic elections and countries with candidate-centered or party-centered electoral systems (Figure 1.3) similarly reduced the bulk of their trade barriers over time.

Second, the best predictor of the magnitude of tariff reduction over time is the countries' initial levels of applied tariff (weighted) as of 1983, which

GATT and WTO increased dyadic trade flows among members when membership includes colonial states and such, whereas Rose (2007) shows that members and nonmembers did not differ systematically regarding their dyadic trade flows. My point here is simply that WTO was not the main locus of tariff reduction for major developing economies since 1983.

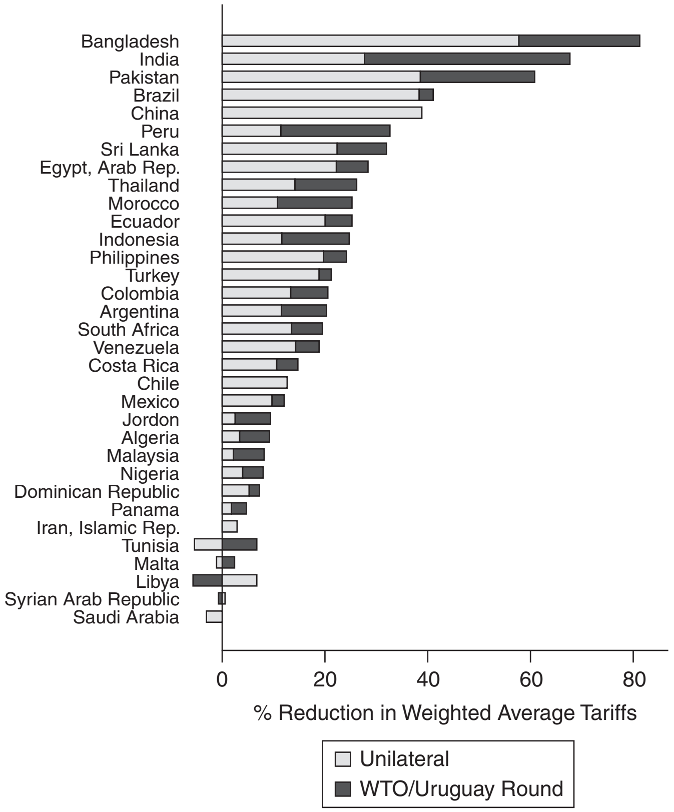

FIGURE 1.2. Unilateral versus multilateral trade liberalization, 1983–2003.

Source: The author made this figure using data used in Martin, Will and Francis Ng (2004), "A Note on Sources of Tariff Reductions in Developing Countries, 1983–2003," Background paper for Global Economic Prospects 2005 – Trade Regionalism, and Development. Washington, DC: World Bank.

Note: Martin and Ng used changes in weighted average of tariffs using United Nations Conference on Trade and Development (UNCTAD)'s Trade Analysis Information System (TRAINS) data from 1983 to 2003 and calculated the proportion of tariff reduction for each of the three sources: unilateral, preferential trade agreements, and WTO Uruguay Round. The figure omits tariff reduction by preferential trade agreements, because it constituted only an average 0.22 percent point reduction in weighted average tariffs during this period. Unilateral liberalization includes tariff concession through the International Monetary Fund (IMF)'s loan programs and tariff reduction preceding WTO accession. See Martin and Ng (2004) for details.

accounts for greater than 90 percent of cross-national variations in the magnitudes of tariff reduction (Figure 1.4). In other words, major importing countries eventually got rid of most, if not all, of their initial tariff barriers.

The patterns of postwar trade liberalization described in the preceding text force us to redefine the puzzles scholars have sought to solve. First, the real

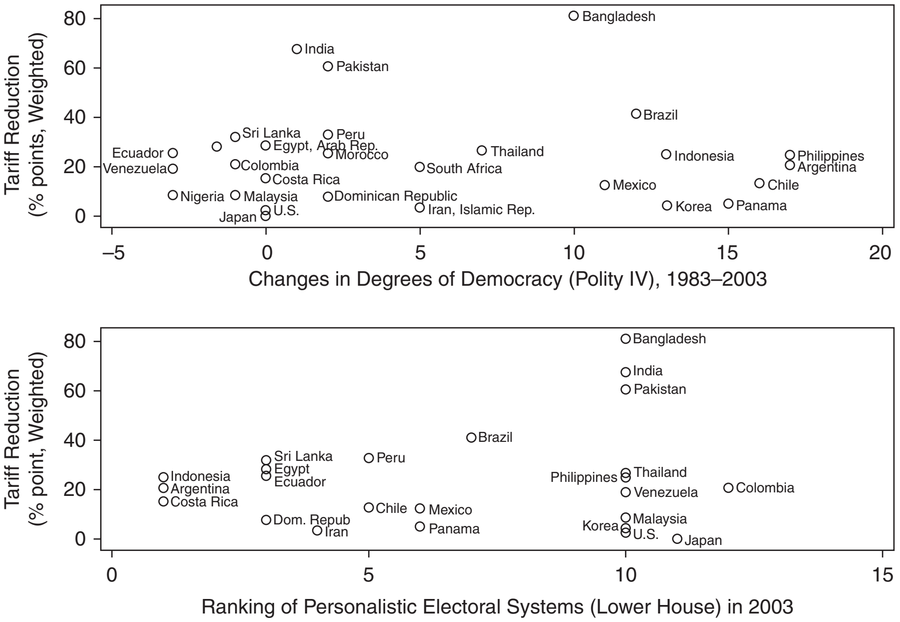

FIGURE 1.3. No systematic effects of regime types and electoral systems on tariff reduction (weighted).

Source: Tariff data are from Figure 1.2 and I added data for South Korea, Japan, and the United States. Polity IV data are from Marshal and Jagger, Version 2010, available at http://www.systemicpeace.org/inscr/inscr.htm (accessed June 2012) and I calculated change between 1983 and 2003 for each country. Positive values mean that a country became more democratic, negative values indicate that a country became more authoritarian, and zero indicates no changes. Personalistic electoral system ranking is from Wallack et al. (2003) and ranges from 0 to 12. The higher the number, the more candidate-centered the electoral system was in 2003. Bivariate regressions show that changes in regime types have no systematic effects on the magnitudes of tariff reduction (coefficients, 0.035; standard errors, 0.589; and *t*-statistics, 0.06) and candidate-centered electoral system ranking as of 2003 has no systematic effects, either (coefficients, 0.795; standard errors, 1.025; and *t*-statistics, 0.78 for 2003). The bivariate results for electoral system ranking hold the same for 1983 data.

variance to be explained is the liberalization over time, not cross-national variance in levels of trade protection. Second, we should be asking *how* these countries achieved trade liberalization, rather than to what extent. How did these newer democracies, which were exposed to electoral competition and vested interests after World War II, achieve this? Not only did these governments initiate liberalization, but they have also shown remarkable commitment to an open economy and provoked very little backlash against globalization during hard times, such as the energy crises in the 1970s and financial crises in the 1980s and the 1990s.

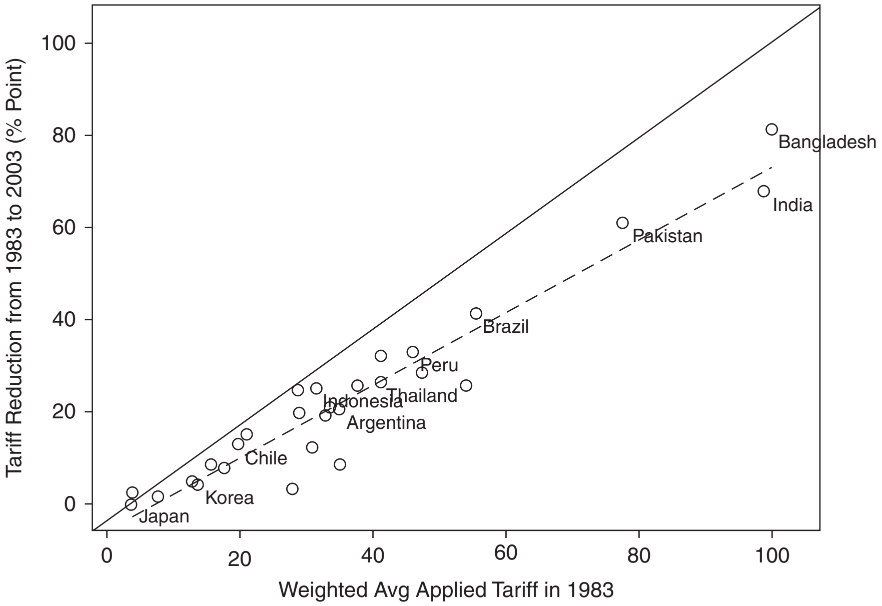

FIGURE 1.4. Initial levels of tariff predict 92 percent of the variance in tariff reduction (weighted).

Note: Data are the same as in Figure 1.3, which includes 28 countries (country labels shown selectively). The solid black line at 45 degrees indicates a hypothetical scenario where the initial levels of tariff explain 100 percent of variance in tariff reduction between 1983 and 2003. The dotted line is fitted from a linear regression and indicates the actual pattern of reduction, which still explains 92 percent of the variance (coefficients, 0.790; standard errors, 0.045; and *t*-statistics, 17.48).

Despite the high magnitude of liberalization after World War II, scholars have paradoxically invested more effort toward explaining the cross-national and cross-industry levels of protectionism, not the shift over time to an open economy. Economists have probably led this lopsided attention to the study of protectionism, as they found governments' choice to limit trade puzzling given the conventional wisdom that free trade increases the general welfare of citizens.[3] The majority of studies on protectionism emphasize the collective action capacity of interest groups – that losers from liberalization are concentrated and well-organized, while beneficiaries are diffuse.[4] Reelection-seeking legislators, studies have further shown, are more likely to respond to the protectionist demands from losers because they lobby harder. These explanations,

[3] Milner (1999).

[4] Schattschneider (1935); Olson (1965); Magee, Block, and Young (1978); Grossman and Helpman (1994); Baldwin and Nicoud (2007).

however, are of little help in making sense of how governments were able to shift toward policies favoring an open economy. I thus flip the economists' puzzle and ask: How did newer democracies achieve postwar liberalization when protectionism seemed politically optimal? This book thus seeks to understand better the relatively unknown political foundations of the open economy.

Three theories have sought to explain when governments initiate and commit to an open economy. The first focuses on the role of reciprocity embedded in supranational institutions and international agreements, such as the General Agreements on Tariff and Trade (GATT), in mobilizing pro-trade interests. The second argument emphasizes the role of external pressures to open the market, coming from major exporters such as the United States or financiers of economic development, such as the International Monetary Fund (IMF).[5] Although these external actors provided a powerful impetus for postwar liberalization, these accounts fail to address the fact that the bulk of postwar liberalization occurred unilaterally. The third account turns to domestic politics and emphasizes the role of delegation of trade policymaking power from legislators to the executive branch (such as the president) and the bureaucracy.[6]

What these theories have in common is twofold. First, they consider politicians to either play a trivial role in, or serve as an obstacle to, the process of liberalization. They view politicians to be powerlessly entrenched in a web of special interest groups and voters. Second, these studies accordingly emphasize the importance of governments' abilities to insulate the trade policymaking process from interest groups and from rank-and-file legislators through a mechanism of delegation.

These insulation arguments, however, miss one of the key ingredients of democracy: policy changes, such as lowering tariffs and signing trade and investment agreements with foreign countries, require majority approval from legislators.[7] Even in the extreme cases in which bureaucrats or the executive branch set policies without legislators' input, the majority of legislators still need to pass these bills into law. If legislators are powerless and captured by protectionist interests, as the insulation arguments have portrayed, how do they build majority support for an open economy on the floor?

I argue that legislators serve two essential functions: constituency service and law making. The insulation arguments, however, consider legislators' jobs to be only about constituency service, with the implication that legislators respond sincerely to districts' demands. As Gilligan (1997:1) succinctly summarizes American trade policy before the New Deal: "import-competing industries asked for protection, legislators gave it to them." Legislators, however, also take policy positions to make laws. They often push liberalization

[5] Schoppa (1993, 1997).
[6] Goldstein (1986), Gilligan (1997), and Hiscox (1999) on the United States; Ramseyer and Rosenbluth (1993) on Japan.
[7] Gilligan (1997); McGillivray (1997); Mansfield, Milner, and Rosendorff (2000).

bills that provide collective benefits to the party, the government, or general citizens in the long run, while hurting their own districts' interests at least in the short run. How do legislators achieve this?

This book develops a novel approach, *Globalization as Legislation* (hereafter GL), that provides an answer to this puzzle. GL views trade liberalization as a series of "general interest legislation"[8] – that is, policies that collectively increase the general welfare of citizens and raise the government's resources for political mobilization over the long run (Evans 2004).[9] The collective benefits to citizens and the parties in power, however, come with the private costs of liberalization (i.e., income loss of industries and voters) imposed on some electoral districts, and hence on some legislators, but not on others. Thus, legislating globalization presents a classic collective goods dilemma for politicians: legislators are collectively better off committing to liberalization, but the distribution of costs and benefits across districts makes their collective action difficult. How do legislators overcome this collective action problem and build a majority coalition that commits to an open economy?

I argue that party leaders can overcome this collective goods dilemma and build an open economy coalition by distributing side payments to buy off individual legislators. These side payments to legislators can take various forms: subsidies, public work projects, personnel appointments, and broader compensation policies. These side payments from the party leaders serve two interdependent goals of legislators: political survival and legislating policies. The first function of side payments is to mitigate the costs of liberalization imposed on some legislators to help them survive future elections. As shown in detail later, these side payments all work as substitutes for tariff protection by compensating for the electoral loss that some legislators incur from liberalization. Second, party leaders distribute side payments to bring swing legislators who are on the fence about liberalization into the majority coalition for an open economy. Side payments are thus used to entice legislators who might otherwise oppose liberalization.[10]

8 This argument builds on Evans (2004), but differs from hers in considering party leaders' choices across three strategies of coalition building, which I call *Pork*, *Policy*, and *Institutional Reforms* (described later in this chapter). This book also considers the distributional implications of these diverse strategies, which Evans (2004) leaves out. I elaborate on my argument in greater detail in the text that follows.

9 I fully substantiate why we can view trade and investment liberalization as "general interest legislation" in the text that follows. Abolishing tariffs and licensing regulations reduces the government's fiscal revenue. Yet globalization can also increase governments' revenues through other mechanisms, such as economic growth, increasing imports, and new investment entries. See Keen and Baunsgaard (2005) for a survey of the literature. Ebrill, Stotsky, and Gropp (1999) have found that trade liberalization led to increased trade revenues when it was associated with increased imports and thus some governments can liberalize trade without worrying too much about the revenue implications. See also Krueger (1974) and Milner and Kubota (2005).

10 Mayer (1992) and Friman (1993) studied the role of domestic side payments in facilitating international cooperation, yet their focus was on compensation for domestic industries that

This argument breaks away from the insulation arguments in three important ways. First, contrary to the conventional view of legislators as powerless and entrenched, my approach considers the role of party leaders in building the majority coalitions essential to liberalization. Globalization gives a renewed and powerful role to party leaders as builders of open economy coalitions through their use of side payments.

Counterintuitively, side payments can entice legislators to support liberalization because of the presence of interest group capturing and the entrenchment of legislators, not despite these pressures. In the presence of interest group pressure, legislators have greater rent extraction opportunities over the allocation of side payments than in the absence of such pressure. For example, legislators extract rents through influencing which construction company to use for a newly obtained public work project from the party leaders. Party leaders were thus able to channel legislators' rent-seeking incentives into majority coalition building for an open economy in allocating side payments. In Evans's term (1994), side payments grease the wheels of policymaking. The argument defies the conventional wisdom that interest group capture contributes to protectionism, not to free trade.

Second, the GL approach accordingly predicts how party leaders allocate side payments to achieve the majority coalitions. The approach predicts that governments distribute side payments based on the political needs of the party or legislators in power, *not* on the sheer economic needs of industries or voters who are hurt by liberalization, or their collective action capacity. I show that because the government uses side payments to bring fence-sitting, swing legislators into majority coalitions, the distribution favors legislators representing small net losers of globalization (i.e., those who incur marginal income loss), not big net losers. The prediction differs from the widely claimed and tested "compensation hypothesis," which predicts that big net losers of globalization, when they are sufficiently well-organized, obtain compensation (Cameron 1978; Garrett 1998; Rudra 2008).

Finally, the GL predicts party leader choices across a wide range of side payments for the purposes of majority coalition building. In particular, I focus on leader choices across three distinct forms of side payments, which I call *Pork*, *Policy,* and *Institutional Reforms*. *Pork* refers to legislator- and district-specific projects such as personnel appointments for legislators and public work projects for districts, in which benefits are excludable to other legislators or electoral districts. *Policy* refers to side-payment legislation that benefits broader constituents, such as social welfare policies and income compensation programs for depressed industries. Unlike Pork, the benefits of Policy are not contained in particular districts or directed to individual legislators; many districts

might have vetoed the ratification, not legislators. Goldstein and Martin (2000) consider the side-payment legislations as a consequence of increasing transparency in the multilateral negotiations, rather than as an instrument for building the pro-trade coalition.