

Explaining Economic Openness.  
The Political Sustainability of Internationalization  
in Latin America and Europe.

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## I. Introduction.

By now, politicians, political commentators, scholars, policy advisors and new economy gurus alike have almost convinced us all of the existence of a new fact of life: globalization. Globalization is an unstoppable process that affects governments, firms, and societies in fundamental ways. Even though this view does not provide a clear account of the ultimate causes of globalization (which are usually depicted as a confusing milieu of decisions of powerful foreign governments, advances in communication and information technologies, the greater political leverage enjoyed by transnational corporations, and the pressures of international organizations), the conclusion is that globalization is something completely *exogenous* and thereby all we can do is to adapt our governments, firms and societies to these new changes. The academia has also adopted to a certain extent this *exogeneity* assumption. For instance, an emerging research agenda in political economy (Keohane and Milner, 1996; Garrett, 1998, 2000) deals precisely with the domestic consequences of these internationalization trends.

My point of departure is to question this *exogeneity* assumption. In my view, it is sensible to hypothesize that certain features of the domestic political economy and, ultimately, governments' policies, have had an impact in the recent economic internationalized world. As a matter of fact, governments have direct control of some variables that arguably have fostered the internationalization trends: trade policies, that have been increasingly liberalized, or controls on international movements of capital that have been lifted. To be sure, there has been great variation in the rhythm and the size of these liberalizing policies across time and space (Garrett, 1999). And this is reasonable. If the increased international exposure of our economies has strong consequences domestically, it is reasonable to study whether differences in these domestic consequences has affected the governments' propensities to embrace in this internationalization policies. By explaining the decisions of governments to liberalize based on their domestic political-economy constraints, this project aims to build a more meaningful and politically based account of the process of economic internationalization.

Let me advance here very roughly my main hypothesis. In order to be adopted and prompted by governments, economic openness must be politically sustainable. Governments will be more eager to open up economically when openness would not generate a net 'loser' group in the polity that is politically relevant (in a democracy, we can think of this group as the majority of the population, generally), This will happen when either a) the distributive impact of internationalization does not harm this group or b) the group is compensated. Because countries differ in the distributive effects of openness and in their capacity to allocate resources through government action, the decisions to liberalize will not be equally adopted in all countries.

In this paper I attempt to do the following. First, I criticize the very extended but still rather undertheorized 'compensation hypothesis' that links the size of government with the level of economic openness. I highlight the fact that, against what this hypothesis assumes, and according to standard economic theory, the distributive consequences of internationalization vary cross-nationally. Based on this critique, a new –less parsimonious but more theoretically meaningful-- compensation hypothesis is generated. Next, I introduce the first policy variable that filters in crucial ways the real effect of openness: currency policy. When exchange rates can be used as a compensation device, it is easy to reconstruct the pro-openness coalition. Finally, I argue that the capacity of the state to transfer resources from internationalization winners to losers will become essential to sustain politically the liberalization move.

The methodology section is divided in two parts. First, I show some data from my recent work on Latin America, providing reasonable support from the ideas developed before. Latin American countries are particularly interesting because along with the overall dramatic process of economic liberalization in the region during the last two decades, it is possible to find variation in the variables in which we are interested. Second, I discuss a possible additional test of the theory: the variation on form that economic integration has taken in Latin America and Europe. Whereas internationalization in Europe has been accompanied by a tendency to fix exchange rates that has culminated in the creation of a monetary union, trade liberalization in Latin

America has gone together with the increasing prevalence of floating regimes. My contention is that a political account based in this new theory may help us in understanding this divergence.

## **II. Theory. The domestic consequences of openness: towards a new theory of compensation.**

A first possibility to understand why governments may be more inclined to open up the national economy to international markets is simply to turn the traditional compensation hypotheses upside down. Since Cameron (1978), a sizeable literature on comparative political economy has developed some arguments to explain the apparently consistent finding that international trade dependence was associated with higher levels of government intervention in the economy. This literature has tried to give explanations for such relationship<sup>1</sup>.

The most common argument used to explain the link between economic openness and higher public intervention in the economy is what I would call the ‘risk-avoidance’ argument. The logic is quite simple: the more internationalized the economy becomes, the greater the consequences of exogenous risks –because the domestic economy is highly dependent on forces beyond its control-- . As a response to this increased risk, governments enlarge the public economy as an insurance device (Rodrik, 1997; Bates et al. 1991). In Katzenstein’s (1985) framing, the very existence of this national-based insurance mechanism makes domestic actors more prone to specialize in their comparative advantage, and this in turns enables them to extract larger gains from international trade. The risk-avoidance argument is certainly pervasive, but it has to be noted that in the limit, fails to address the distributive struggle that economic openness may bring about. Insurance against risk is seen as a public good that enhances overall welfare. But if we are to derive a theory about compensation derived from the asymmetrical distributive consequences of internationalization, something more than insurance against external risk is needed.

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<sup>1</sup> See Adserà and Boix (2001) for a review of these different theoretical arguments.

A richer approach must take these asymmetrical distributional consequences into account. The basic argument is the following. Even if—as international trade theory shows—greater openness enhances overall welfare, it will also generate domestic ‘winners’ and ‘losers’. Losers, provided they are politically powerful, will demand and eventually achieve some type of compensation in exchange of their support for free trade policies. This compensation may take many different forms, but the most common is redistribution through a larger public sector. This would explain why, for instance, in democratic polities, greater levels of economic internationalization are associated with higher levels of public revenues (Adserà and Boix, 2002)<sup>2</sup>.

The compensation hypothesis is readily extensible to the ‘endogenous globalization’ view: Those countries better able to compensate for the potential negative consequences of international exposure will be also more likely to embrace openness, since compensation will make the pro-liberalization coalition politically powerful<sup>3</sup>. But is it compensation through public transfers always needed? As we will see below in the Latin American case, the recent history of foreign economic liberalization is full of cases in which liberalization is not accompanied by larger state-based income redistribution.

## **II.1. The differential effect of internationalization across countries.**

What, in last instance, makes redistribution an useful tool for obtaining support for liberalization? Let us depart from the distributional conflict brought about by

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<sup>2</sup> It is worth noting that, along with the ‘compensation view’, there are also theoretical reasons to expect the opposite relation between economic openness and the size of the public sector. The ‘efficiency hypothesis’ suggests that greater openness intensifies the competitiveness pressures that firms must face. This increased competitiveness forces companies to oppose policies that impose high costs on their balance sheets. Governments, interested in maximizing national firms’ profitability, respond by reducing payroll taxes, social security contributions, capital taxes and, in general, any kind of ‘distortions’ that they have introduced in the economy. As with most simplistic arguments, the efficiency hypothesis has its own pitfalls. First, many government interventions in the economy that go beyond law and order such as provision of infrastructures or human capital through public education may go in the interests of firms (Garrett, 1996, 1998). Moreover, as the most recent ‘varieties of capitalism’ literature suggests (Hall and Soskice, 2001), if national comparative advantages are embedded into complex systems of industrial relations, social policies, and economic regulations that complement each other, there is no reason to expect that greater international competitiveness will bring about convergence in governments’ economic policies. Rather, the opposite scenario—that is, divergence—is more likely to prevail.

<sup>3</sup> To be sure, this view is not that original. This is actually at the core of Ruggie’s (1982) notion of ‘embedded liberalism’ and underlies Katzenstein’s (1985) view of the small open corporate European states.

economic internationalization. The argument is that economic openness generates domestic ‘losers’. These losers, *whoever they are*, will ask for redistribution and governments, accordingly, will respond by increasing expenditures, social security transfers, or public consumption if they want to silent opposition to internationalization. Presented like this, the argument appears to apply in the same way to all countries that any under any circumstances deciding to open up their economies to international markets. Note that this implies that we are making an additional assumption, namely, that economic internationalization has the same distributive consequences and produces always the same type of losers everywhere. This is unreasonable given existing trade theory, that indicates that the domestic effects of trade are conditional on country characteristics (O’Rourke, 2001) Since we have well defined theories informing about the nature of those who will be the losers in every country, and we also know that domestic characteristics will affect which groups will benefit and which one will be harmed by openness. By using these well-known theories about the asymmetrical impact of economic openness, we can develop a more meaningful theory of compensation<sup>4</sup>.

The literature on the determinants of preferences towards openness can be very informative here<sup>5</sup>, since knowing the reasons for being in favor or against commercial liberalization is the same that identifying who is going to be affected by this policy, and in what sense. Depending on the degree of asset specificity we believe to exist (Hiscox 2001), different types of groups will emerge as winners and losers of internationalization. If asset specificity is low (or if we look at the long-run, where no asset is production-specific), we are in the Heckscher-Ohlin world. Owners of factors of production with which the country is comparatively well endowed will benefit from reduction to barriers of trade; local owners of scare domestic factors will be harmed by liberalization. Politically, trade policy coalitions will be formed across classes (factors) (Rogowski,

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<sup>4</sup> Burgoon (2001) is a nice of example of the how meaningful is to relax the homogeneity assumption. He convincingly shows that, as different dimension of openness generate different types of demands, the domestic conflict produced by internationalization should vary across the different dimensions of the liberalization process.

<sup>5</sup> Alt et al. (1996) provide a review of this literature. Scheve and Slaughter (2001) have found that in the U.S. individuals tend to derive their preferences over trade policy from their endowments in terms of factor of production. Mayda and Rodrik (2001), and O’Rourke and Sinnott (2001) also find on a cross-national survey that preferences are based factor endowments, and that cross-national differences can be explained in terms of each country’s degree of relative abundance and scarcity of factors of production.

1989). If asset specificity is high, we move to the Ricardo-Viner world. Here, the distributional consequences of openness do not benefit or harm entire classes, but particular industries or sectors, facilitating the building of cross-class coalitions along sectoral lines (Frieden, 1991). Both models show that the asymmetrical consequences of economic openness are not the same across countries. In fact, the very notion of comparative advantage indicates that beneficiaries and losers of openness *must* differ across countries.

What do these cross-national differences in winners and losers imply for redistributive politics? According with the classic Meltzer and Richard's (1981) model, we should expect more demands for redistribution the larger the increases in inequality<sup>6</sup>. If we further assume that the size of the public sector and/or of some social policy expenditures captures the size of the publicly allocated redistribution of resources among the citizenry<sup>7</sup>, then we are ready to hypothesize the different impact that economic openness will have on governments' fiscal policies. Whenever commercial openness will increase income inequality because it will harm the low-income groups, the need to redistribute through the public sector will increase. However, if the consequences of trade openness ameliorate the distribution of income by benefiting the less affluent groups of the society, this need will be less critical, and it could be hypothesized that it would be reduced.

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## II.2. The role of exchange rates.

Arguably, a possible tool that governments can use to filter the real consequences of economic openness is exchange rate policy. Since exchange rate overvaluation and devaluation can be understood as substitutes for protection and liberalization across-the-board, when currency policy is available to the government, liberalization harmed groups

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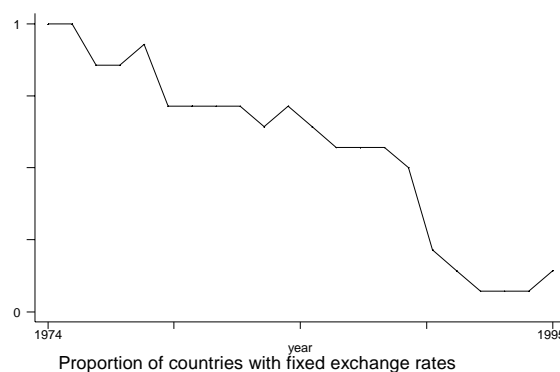
<sup>6</sup> Meltzer and Richard's argument is very simple: as long as the median voter determines government's policies, the larger the distance between the median income and the mean income, the larger will be the government redistribution package. Increases in income inequality imply a skewed distribution of income, and thus higher demands for public redistribution.

<sup>7</sup> To be sure, this is a big assumption to make. Particularly in Latin America, where it has been broadly argued that the public sector has been very little redistributive, and the great beneficiaries of Latin American welfare states have been politically powerful middle and higher classes. In any case, I contend that even in Latin America, it still seems reasonable to assume that more state produces more redistribution than less state.

can be ‘compensated’ with this policy. From the political sustainability perspective, the argument can be framed as follows: when governments keep control of the exchange rate, trade liberalization will be more easily embraced than when exchange rate policy is not available<sup>8</sup>.

The focus of most of the comparative political economy work on developed economies has tended to overlook the importance of this compensation mechanism in the liberalization process in developing countries. In Latin America, for instance, there is extensive evidence of the increase politicization of currency policies along with the liberalization shifts in commercial policy. In Colombia, for instance, ANDI, the industrial association, became militant in the 1990s asking for a ‘competitive’ exchange rate, after the liberalization trend seemed unstoppable (Jaramillo et al. 2001: 222-223). In Chile there is also evidence pointing at the same direction: “[F]rom 1974 to 1979 the [devaluing] exchange rate regime was consistent with the compensation needed to implement a deep trade reform and the drastic switch from import substitution to outward-oriented development” (de Gregorio, 2001). Taking into consideration this interplay between trade policies and exchange rate, it should not come as a surprise that the trend toward trade liberalization in Latin America almost perfectly coincided with an increased adoption of floating exchange rate regimes in the same countries, as Figure 3 indicates.

Figure 3. Proportion of countries with fixed exchange rates.



<sup>8</sup> It is certainly true that the choice of the exchange regime is also endogenous to the political process (see Eichengreen, 1995; Bernhard and Leblang, 1999; Frieden and Stein, 2001). But there may be causes unrelated to commercial liberalization, such as the need to obtain credibility for monetary policy in the presence of hyperinflation -as in the Argentinean convertibility plan of 1991, (Bonilla and Schamis 2001)-, or the political commitment to an economic union -as in Europe’s succession of fixed exchange rate regimes).

Whereas in 1974 all the fourteen Latin American countries included in the sample had a fixed exchange rate regime, the mood changes dramatically during the twenty-one years time span, and by the 1990s almost all countries had moved to some type of floating regime<sup>9</sup>.

To sum up, exchange rate policies may help to alleviate the distributive consequences associated with commercial liberalization, because in the extreme, currency devaluation can be interpreted as a substitute for protection. And as long as the real impact of liberalization depends critically on the exchange rate regime in place, we should expect the demands for compensation that governments would eventually have to face to be filtered by the type of the exchange rate. More precisely, when the exchange rate is not fixed, currency policies may alleviate commercial liberalization decisions. On the other hand, when the exchange rate is fixed, the demands for state-based compensation programs responding to increased internationalization levels should be larger.

Three basic testable hypotheses emerge from this exercise. I write them down here.

**H1.** The pressures to compensate internationalization losers will be weaker under a flexible exchange rate regime, since currency policy can be used a substitute for trade policies and therefore can be used as a tool to mitigate the distributional dislocations that openness may create. *Ceteris paribus*, under fixed exchange rates, greater amount of transfers will be necessary to make openness politically sustainable.

As long as liberalization have different distributive consequences depending on characteristics of the domestic economy, the amount of compensation needed to sustain liberalization does not have to be the same across countries.

**H2A.** Under the Heckscher-Ohlin perspective, where national factor endowments are further away from world averages (as in the lower income countries), trade liberalization will generate less inequality and then the pressures to redistribute will be smaller.

Liberalization will be possibly embrace without transfers.

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<sup>9</sup> It has to be noted that in Latin America, fixing the exchange rate and overvaluing the currency are almost synonymous, since the country of the anchor currency, the dollar, sustain systematically lower inflation rates than all this countries. Floating, therefore, always entail depreciation.

**H2B.** Following a sectoral approach, the size of sectors that will be directly damaged by openness (in Latin America, manufactures) will affect the size of the compensation package induced by commercial liberalization.

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### **III. Methodology.**

This section is twofold. I discuss two ways of testing the theory developed in the previous section. First, I look at the process of trade liberalization in Latin America in the last three decades. I attempt to show how the ideas developed before can help us in understanding this process by highlighting the centrality of the political sustainability argument. Second, more speculatively, I discuss how the same theoretical framework may provide substantive leverage for the understanding of the different form that economic integration has taken in Latin America and in Europe.

#### **III.1. The Latin-American case: Why economic openness is not accompanied by larger public sectors?**

Even if the naïve ‘compensation hypothesis’ continues to receive empirical support from many studies (Rodrik 1998), there is growing skepticism in the academia about the robustness of such relationship. (Iversen and Cusack, 2000; Garrett and Mitchell, 2000). In my understanding, this lack of coherence on the empirical findings should not come as a surprise precisely because the undertheorization of the hypothesis. If the real consequences of liberalization diverge across countries, generating different demands for compensation and if the very compensating policies vary across governments, there is no reason to expect a uniform relationship between the size of the public sector and economic openness.

Latin America offers a very appropriate scenario to test these ideas. From being the harbor of the more protectionist governments of the world in the post-war era, the region has undertaken a sharp change in their commercial policies, adopting free trade practices in the last two decades. Has this process been accompanied by higher public

expenditures, as the compensation view hypothesizes? Somewhat surprisingly, and adding to the confusion of the more recent findings about the relationship between government size and economic openness, the only two studies available to date detect in fact a *negative* relationship between public spending and economic internationalization (Haggard and Segura-Ubiergo, 2001; Avelino, Brown and Hunter, 2001).

Figure 1. The evolution of commercial liberalization in Latin America.

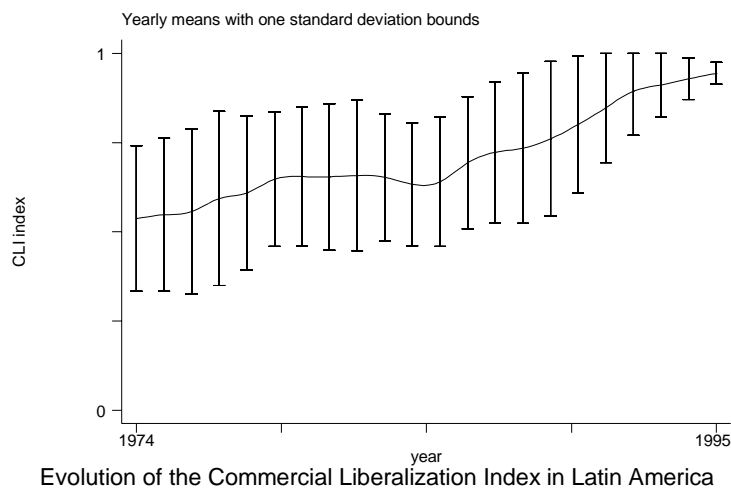
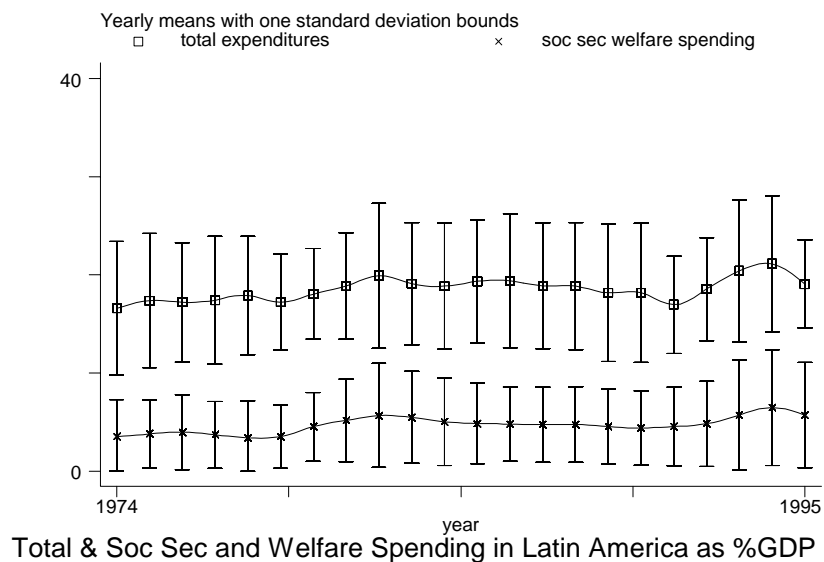


Figure 2. The evolution of total expenditures and social security and welfare spending in Latin America.



In line with these findings, Figures 1 and 2 indicate that, whereas trade liberalization has expanded in the region, there seems to be not a parallel evolution of the average levels of government spending in the region. Although it is true that in the early 1990s there is an increase both in total expenditures and in social security and welfare spending, note that by those years most of the liberalizing move had been already done – for many countries, many years ago, indeed. The 1980s, the period in which the major liberalizing efforts in the region were undertaken, witnessed, if anything, a *reduction* of the size of the government. Unless we can develop an argument that makes government to respond to internationalization-induced demands for public sector expansion after several years the reforms are introduced, this first glance at the data indicates that Latin American governments have not accompanied the trade policy reforms they have passed with compensation packages in a systematic way.

It is possible to envisage three different hypothesis from the theoretical exercise developed before. The first relies on the factor endowments model. It might be hypothesized that Latin America would be rich in unskilled and semiskilled labor compared with the more skill-intensive developed countries (Little, 1982: 142). Would that be the case, intensification of international trade would benefit the low-income sectors of the population, and consequently, no increase in the need to redistribute should be needed to sustain openness. However, it is not clear that in most recent times factor endowments in Latin America differ significantly from the world average (Spilimbergo et al., 1999). The last two decades have witnessed the entrance in world markets of developing countries abundant in low-skill and semi-skilled labor. As a consequence, the world average composition of factors has become similar to the Latin American one. The fact that Latin America has embraced openness when these developing economies were already participating in international markets can explain that whereas openness had a clear egalitarian effect in the East-Asian experience, the same policies do not appear to have such neat egalitarian effects in Latin American countries (Wood, 1997).

However, even if Latin American countries share a lot of common characteristics, there is also a great deal of differences among them. And as had been explained before,

these differences should shape the consequences that economic openness will produce in each country. More precisely, it should be expected that the greater the abundance of factors related to lower income groups (unskilled labor), the further away that country would be from world average factor endowments, the more likely that trade openness will not increase inequality, so the less likely is that the liberalization process will be associated with demands for compensation. On the other hand, the richest Latin American countries, better endowed in skilled labor, can be considered middle-income countries by world standards. This in turn will make less likely that internationalization will generate income equality, so it is in these contexts where commercial liberalization will induce greater demands for redistribution<sup>10</sup>. In fact, different studies analyzing the inegalitarian effects of trade liberalization in Latin America suggest that the more negative impacts has been produced, as this discussion suggests, in the wealthier countries of the region.

Table 3. Summary of the results of the recent evolution of income distribution in Latin America.

Source	Findings
Edwards (1997)	No effect
Spilimbergo, Londoño, Székely (1999)	Effect conditional on factor endowments. Higher inequality in skill-abundant countries; reduction in capital-abundant countries.
Behrman, Birdsall, Székely (2001)	Less inequality but not statistically significant
Morley (2001)*	Higher inequality in Argentina, Chile, Mexico. Lower inequality in Bolivia, Peru.
Altimir (2001)*	Increase inequality in Argentina, Mexico, Chile before in the 90s. Decrease inequality in Colombia

\* These studies only look at the evolution of income distribution, but not specifically at the impact of trade liberalization on them.

Departing from the Ricardo-Viner world, a somewhat different perspective emerges. Under high levels of asset specificity –that is, when moving factors of

<sup>10</sup> To measure relative factor endowments in terms of skills of the labor force, I assume GDP per capita is a good indicator. Barro and Lee (1992) have data on education for the countries in my sample, but no yearly time series were available. However, the correlation of my proxy (GDP per capita) and the two basic indicators: percentage of the labor force with at least secondary education and average number of years of schooling were very high: r: .75 and r: .77, respectively.

production across sectors is very costly--, the groups that will stand as net winners and losers out of economic internationalization will not longer be owners of certain type of factors of production, but whole industrial sectors instead. In the Latin American context, we can reasonably argue that those sectors that were created and developed as a part of the ISI strategy and whose profitability depended critically on the protectionist policies that isolated them from international competition would be those at higher risk of losing under commercial liberalization. The clearer example of such a sector is manufactures. ISI policies exaggerated growth in this sector (Cardoso and Helwege, 1992). The fact that this sector felt very deeply threaten by international competition can be shown by looking at the impact that its size has had in imposing currency devaluations in the region (Brock Blomberg et. al, 1991).

Would the harm produced by trade liberalization in this sector increase income inequality? Note that in the Ricardo-Viner world the whole sector loses. So in principle we cannot really tell whether the crisis of the manufacturing will produce more or less inequality. However, there is still good reasons to expect a positive association between commercial liberalization and government redistribution when the size of the manufacturing sector is high. First, it is reasonable that the income distribution will be more affected by the loss of jobs and wages of workers in these industries than by the losses of managers and capital owners. And second, if we relax the assumption that government spending is purely income redistribution, it is reasonable to expect that the manufacturing sector, that has been traditionally well entrenched in Latin American political systems, will have an easier way to obtain compensation from governments, even if government intervention does not entail redistribution. Table 2 shows that, whilst manufacture-intensive countries have liberalized as much as the less manufacture-intensive ones, their fiscal and currency policies that have sustained this openness seem to have been significantly different.

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Table 2. Average Increases in Commercial Liberalization, Social Security and Welfare Spending, and Total Expenditures and choice of Exchange Rate Regime by Size of the Manufacturing Sector.

	Manufacturing Countries	Non-Manufacturing countries
$\Delta$ Commercial Liberalization Index (CLI <sub>t</sub> -CLI <sub>t-1</sub> )	<b>0.020</b>	<b>0.020</b>
$\Delta$ Social Security and Welfare Spending (%GDP)(SSW <sub>t</sub> -SSW <sub>t-1</sub> )	<b>0.122</b>	<b>0.012</b>
$\Delta$ Total Expenditures (% GDP) (TEXP <sub>t</sub> -TEXP <sub>t-1</sub> )	<b>0.306</b>	<b>0.044</b>
Proportion of country-years with fixed exchange rates	<b>0.448</b>	<b>0.682</b>

Manufacturing countries are defined as those with a share of the manufacturing sector in the economy above the region median between 1974-1995.

Concretely, countries with large manufacturing sectors increased their social security and welfare spending and their total expenditures significantly more than countries where this sector was smaller. Also, and consistent with the exchange rate argument, governments in ‘manufacturing countries’ have tended to opt more for floating regimes, that have permitted them to compensate for the expectable negative consequences that openness may have entailed for this sector.

Regarding exchange rate regimes, as suggested in the previous section, the following table shows that countries with fixed exchange regimes should be less prone to adopt commercial liberalization, because one of their hands (namely, currency policy) they have to tackle domestic demands for redistribution is tied.

Table 1. Average Commercial Liberalization by exchange rate regime (period means: 1974-1995)

	Floating Exchange Rate	Fixed Exchange Rate
Commercial Liberalization Index	<b>0.817</b>	<b>0.628</b>
$\Delta$ Commercial Liberalization Index (CLI <sub>t</sub> -CLI <sub>t-1</sub> )	<b>0.024</b>	<b>0.016</b>

Looking at these rough figures that do not control for the influence of any other factors, there seems to be some truth in this idea. As the first row indicates, countries with fixed exchange rates have had, on average, less liberal trade policies than countries with flexible currency regimes. Perhaps more importantly, the average annual liberalization effort is one third higher under floating regimes than under fixed ones. The aim here is not to detect the actual direction of causality, but rather to point out the close interconnection between currency politics and commercial liberalization in Latin America.

*The quantitative evidence.*

Statistical analysis of the evolution of these variables for a sample of fourteen Latin American nations from 1975 to 1995 seem to support these hypotheses<sup>11</sup>. The results indicate that the consequences of trade liberalization and the very decision to liberalize have to be understood in interaction with the domestic variables that are inherently related to openness. In fact, the rhythm that every country has followed in the liberalization process can be explained to a great extent by domestic political economy considerations: when trade openness is expected to produce more inequality, governments must be ready to address the expected demands for redistribution that internationalization will entail. The capacity to pursue egalitarian public policies will become crucial here in this scenario. On the contrary, countries whose income distribution would not get worsened by commercial liberalization can keep the size of their governments small, and proceed to liberalize easily. Finally, the ability to pursue currency policies may become crucial to mitigate the economic dislocations associated with openness.

*The qualitative evidence.*

Along with the quantitative evidence, some anecdotal historical evidence seem to fit reasonably well into the arguments developed here. The huge problems that Argentina face nowadays can be understood under this framework. This is the country in the region

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<sup>11</sup> For obvious space limitations, I do not show these results. I will make them available at the EPIC meeting, and always by e-mail.

that –according to my data— faces a greater need to compensate out of liberalization. One alternative –currency policy— had been removed due to the convertibility plan. In my framework, it seemed difficult to avoid the expansion of public spending. This is precisely what happened in the late 1990s. However, the limited tax base, and the problems that deficit created for the functioning of the currency board regime make the system collapsed. The first alternative --currency devaluation—emerged. Another finding that also fits is the fact that the less developed countries have been those were trade liberalization appear to have encountered less resistance also make sense under these prepositions. Finally, the main example in the region that explicitly pursued a strategy of compensation originated in the decision to liberalize is Mexico, with its Plan of Economic Solidarity that followed the tariff reduction in 1986 (Astudillo, 1999; Buendía Laredo, 2001). And arguably, Mexico would be another country in which, because of its domestic characteristics, we would expect a strategy of government-led compensation. While these findings are not strong support for the theory, they suggest the eventual usefulness of future detailed qualitative work along these lines.

### **III.2. Latin America versus Europe. The political underpinnings of economic integration.**

This last section is much more speculative. The idea is that this theoretical framework may provide great leverage to understand why economic integration has taken different forms in Europe than in Latin America. Whereas in Latin America, as has been already emphasized, economic openness has gone hand in hand with politicization of the exchange rate regime and thus the erosion of the fixed exchange rate regimes prevalent in the 60s, in Europe, efforts to reach the gains of economic openness has motivated governments to establish fixed exchange rate regimes and, ultimately, a monetary union among twelve of the fifteen European Union countries. How can we account for this difference?

I have suggested that currency policy may serve as a cushion for the effects of liberalization, hence may help to make it politically sustainable. But openness with

floating regimes is a lower level of internationalization. In fact, one of the big rationales for the creation of a common currency in Europe is to obtain all the benefits from economic integration (see Rose and van Wincoop, 2001). However, if the political sustainability argument developed here stands, internationalization without currency policy availability will only be undertaken if a) internationalization do not harm powerful sectors, or b) extensive compensation policies are readily available. Europe may have an advantage in these two dimensions with respect to Latin America. Regarding the former, liberalization in the continent is selective so it does not harm politically powerful groups (as farmers). Regarding the latter, most developed taxation systems and the extensive European welfare states may serve as a basis for the needed redistribution needed to keep liberalization politically sustainable.

#### **IV. Summary.**

Against the common globalization wisdom, this project contends along with Brazilian minister Bresser-Pereira (1996) that “the decision to open the economy was essentially a domestic one”. If that is the case, it is reasonable to believe that the consequences that internationalization will produce domestically depending on the position of the country and the capacities of governments to respond to these new challenges will be central elements in the decision to internationalize the economy. It is broad idea what I have to try to develop here. The asymmetrical distributive impact of openness across countries, on the one hand, and the availability of exchange rate policy and compensation policies on the other, may explain the variation I countries’ propensities to undertake foreign economic liberalization. A detailed analysis of the process of trade liberalization in Latin America suggests how fruitful this approach may be. Finally, this framework may also explain the variation in form that economic integration has taken in Latin America and in Europe.

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### Appendix. Data Sources.

Variable	Source
GDP per capita (constant 1995 US dollars)	World Bank. <i>World Development Indicators</i>
Size of the Manufacturing Sector. Added value as % GDP.	World Bank. <i>World Development Indicators</i> .
Total expenditures as % GDP	IMF <i>Government Finance Statistics</i> , various years.
Social Security and Welfare Spending as % GDP.	IMF <i>Government Finance Statistics</i> , various years.
Exchange Rate Regime	IMF <i>Annual Report on Exchange Arrangements and Restrictions</i> , various years. 1 fixed, 0 float.
Commercial Liberalization Index	Morley, Machado and Pettinato (1999)