

Hoppe, Martin

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DIW Roundup

Politik im Fokus

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On the Relation between Trade and Democratization

Martin Hoppe

On the relation between trade and democratization

Martin Hoppe | mhoppe@diw.de | Department of International Economics at DIW Berlin

Whether trade can achieve societal change is a contested topic and difficult to investigate. This round-up aims at summarizing recent empirical research on this topic while focusing on democracy and democratization as an important part of societal change. No robust results for change arising from trade can be found, but there exists an inverse causality, i.e., democratization leading to more trade. Further, reciprocal causality between democratic consolidation and trade agreements is found, meaning an influence of democratic instability on free trade agreements and vice versa.

Introduction

In 1969, West Germany (FRG) initiated the Neue Ostpolitik, condensed into the term “change through rapprochement” (“Wandel durch Annäherung”). The government’s stance was that the ever-increasing tensions with the Soviet bloc and specifically East Germany (GDR) could only be overcome by cooperation that consisted of concessions as well as gains from trade on both sides. FRG acknowledged the Soviet states and borders and also took up diplomatic relations with the GDR. The bloc states on the other hand signed the Helsinki Accords, thereby acknowledging respect for human rights and fundamental freedoms. The newly built relations further came with the establishment of new trade relations, and were thus successful through mutual collaboration both in the societal and economic realm ([Lau, 2021](#)). Since then however, the policy was simplified over time into the motto “change through trade” (“Wandel durch Handel”) and established itself in this form into the standard repertoire of German foreign policy. Simultaneously, faith in its efficacy has also slowly faded and the Russian invasion of Ukraine is only the most recent and biggest challenge to this policy. Now, Germany is forced to reconsider its stance on achieving change through trade. This round-up seeks to provide an overview of existing empirical literature on the causalities between trade and change, thereby concentrating on democratization as a main factor of societal change. It aims to shed light on the complex relationship between trade, democracy and democratic consolidation and provide insights into how they interact in shaping foreign policy outcomes. The structure is as follows: First, the round-up examines how trade affects democracy, then it looks at the inverse relationship, i.e., how democracy affects trade. Following that, reciprocal mechanisms of democratic stability and trade agreements are shown. The last section concludes and outlines the path ahead.

Change through trade

The main proposal of how change occurs through trade is an indirect causality. The argument goes that trade leads to economic development and this in turn leads to democratization. Both of these two relationships, however, are contested ([López-](#)

Córdova & Meissner, 2008). Further, it is difficult to empirically examine indirect causalities and thus, López-Córdova & Meissner (2008) test the direct impact of trade openness on democracy.

Although there had been research on the issue before, López-Córdova & Meissner (2008) criticize these earlier empirical studies on the basis that they insufficiently account for endogeneity. They do not consider the possible reverse effect of democratization on trade and can therefore not establish causality from trade to democracy (López-Córdova & Meissner, 2008). To that end the authors themselves employ an instrumental variable (IV) approach with a gravity equation as instrument. Gravity equations aim to explain likeliness of trade by means of exogenous geographical factors like vicinity and size and are well established in the literature. The authors find that in 1960 a one standard deviation increase of trade openness corresponds to almost a one standard deviation increase in democracy. Over the years however, this relationship deteriorates and becomes ever less significant both economically and statistically. Further, they use varying sample sizes and upon examining different aspects of democracy like Competitiveness and Regulation of Political Participation or Constraint on Chief Executive, the regressions show that trade openness affects democracy through different channels in different years, which suggests a more complex effect of trade on democracy. Lastly, for the instrumental variable method to be valid, the instrument has to be uncorrelated with the dependent variable. There exists a strand of literature which argues that regional democratic diffusion or clustering exists (O'Loughlin et al., 1998). This implies that distance is correlated with democracy and thus the exclusion restriction would be violated.

Trade through change

The relationship between trade and democratization can also be approached the other way around to see whether democracy facilitates trade. Yu (2010) argues that trade on the export side is dependent on product quality. He then makes out two explanations for why product quality is a function of democracy. Firstly because of a stronger maintenance of the rule of law in democracies which leads to both freer markets and better regulation and secondly because of higher protection of intellectual property, corresponding to more R&D expenses. These two channels benefit product quality in democracies and thereby export volume. On the import side, the author argues that

An increase of ... leads to...

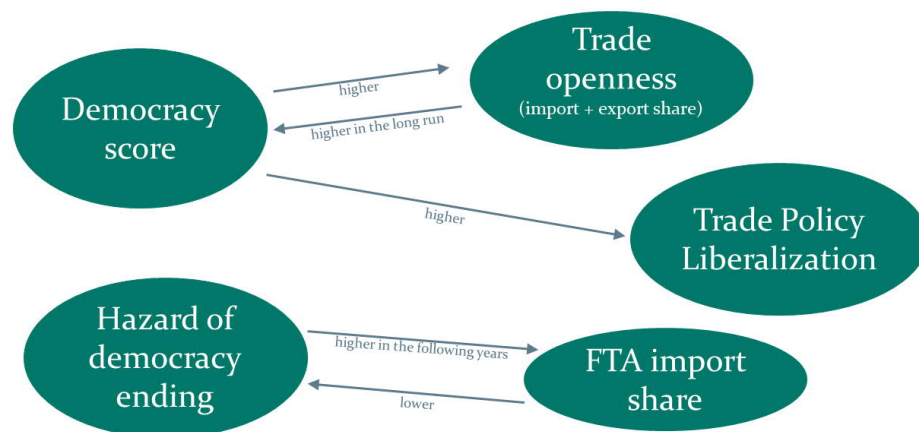


Figure 1: Visualization of relationships between trade and democracy, Illustration: Own

less developed democracies implement lower tariffs to benefit the working population. These in turn lead to more capital-intensive imports following the Stolper-Samuelson theorem. But Yu also admits that in rich democracies, imports could be restricted due to tariffs for protection of either the labor force or domestic sectors with high product quality. Both of these factors influence the import side of trade in democracies in contrary ways. The author proves his arguments by examining directional imports of firstly capital-intensive goods from developed countries (DC) to less developed countries (LDC) and secondly labor-intensive goods from LDCs to DCs.

Yu (2010) finds robust evidence that higher democracy in LDCs leads them to import more capital-intensive goods from DCs. Similarly, democratization in LDCs corresponds with higher volume of labor-intensive exports, but simultaneously higher democracy scores in DCs have a negative impact on these imports. Altogether, the author shows that democratization alone accounts for 3.6% of overall global trade growth from 1962-1998. Yu employs an IV estimation method similar to López-Cordova & Meissner (2008) with a gravity equation, but encounters problems of finding good instruments for democracy. He ends up choosing infant mortality as lone instrument, which may be contested.

Another paper by Milner & Kubota (2005) examines the same relationship, but argues differently. They propose that after a transition the selectorate, the subset of the population on which an incumbent is dependent on to remain in office, is enlarged. This would lead them to support more liberal trade policies in favor of the new members of the broader selectorate, which now consists of all the people that are eligible to vote. The authors show that in fact public support for trade liberalization was comparatively strong in less developed countries.

Milner & Kubota (2005) look at the democratization wave of the 1980s and the subsequent global trade liberalization. The authors find evidence of regime type influencing trade policy, but are not able to fully account for endogeneity as their instruments might be correlated with the error term. Interestingly, by checking robustness they cannot find an effect of trade policy causing regime change. This would again argue against the slogan "change through trade".

Consolidation through trade

As delineated above, describing a general relationship between change and trade is difficult. Liu & Ornelas (2014) study more specific aspects of democracy and trade, namely democratic consolidation and participation in free trade agreements (FTA). They find strong evidence for two hypotheses. Firstly, that FTAs reduce the probability of a democracy being overturned and secondly, that democratic instability induces governments to seek the arrangement of FTAs. The author's argument goes via protectionist rents: Economic elites favor protectionism because of their accrued rents. As authoritarian governments are more likely to support protectionism, elites would thus support authoritarian uprisings. Given this mechanism, democratic governments, especially new and unstable ones, try to increase the opportunity costs of introducing protectionist trade barriers by forming FTAs. These have a kind of lock-in effect because of the costliness of reversing them. In a nutshell, unstable democratic governments reduce the incentives to support authoritarian uprisings by destroying future protectionist rents.

Liu & Ornelas (2014) find that a one standard deviation increase in the import share from FTAs reduces the average overall hazard of a democracy failing by 67%. Endogeneity biases against the hypothesis and in line with that, they reinforce their

results with an instrumental variable regression using FTA contagion. Regarding the second hypothesis, they find that on average a one standard deviation increase in hazard leads to a rising FTA import share of about 1.3 percentage points. The authors point out that only full-scope FTAs lead to these results while the effect of partial FTAs on democratic stability is insignificant. This supports their argument that the channel through which FTAs work is the destruction of future protectionist rents because partial-scope agreements most often exclude the domestic sectors that benefit from trade barriers.

On the benefitting sector

According to the Stolper-Samuelson theorem, in open trade countries will export the factor which they possess in abundance. Traditionally the distinct factors are capital and labor. Extending this on the political sphere, the Stolper-Samuelson theorem also implies that power accumulates where rents from trade occur (Acemoglu & Robinson, 2006). In labor-intensive economies, workers profit from increasing trade whereas in capital-intensive economies, most of the time, profits and thus power concentrate in the hands of the owners of capital. Looking at resource-rich countries, these capital-owners tend to be politically strong oligarchs who disfavor democracy to ensure their protectionist rents and influence. The papers featured in this round-up all recur to this theorem in some way.

Liu & Ornelas (2014) show that controlling for resource abundance increases the effect of FTAs on democratic stability. This indicates that resource-rich democracies are weaker on average, probably due to higher capital rents. Yu (2010) also finds that democratization mainly benefits labor-intensive exports from less developed countries compared to capital-intensive goods. For the sake of completeness, it has to be said that López-Cordova & Meissner (2008) cannot find evidence in support of the Stolper-Samuelson theorem. But adding to the criticism already described above, they also use a poor proxy for capital abundance, i.e., land-to-population ratio. Further they do not account for endogeneity.

Table 1: Overview of empirical strategies

Paper	Dependent variable	Independent variable	Instrumental variable
López-Cordova & Meissner (2008)	Democracy score	Trade openness (import + export)	Gravity equation (size and vicinity)
Yu (2010)	Bilateral trade flows	Gravity equation incl. democracy score	Infant mortality
Milner & Kubota (2005)	Trade policy	Democracy score	Age of the party system Level of secondary school completion
Liu & Ornelas (2014)	Dummy indicating end of democracy	FTA import share	FTA contagion
	Δ FTA import share	Calculated hazard of democracy ending from 1 st regression	

Coming back full circle, this might explain to some extent why extensive trade with Russia has not led to more democracy, given the resource wealth of the nation which also makes up a large part of its exports. However, it must be stated again that, in general, no causality of trade leading autocracies to become democracies can be found.

Conclusion and outlook

It cannot be said without doubts that trade in and of itself leads to democracy except for free trade agreements. Those also do not incur democracy themselves, but only serve to consolidate unstable democracies. But could less trade or the threat of it lead countries to change? The European Commission (EC) thinks so. Since 2008 the EU has included so-called Trade and Sustainable Development (TSD) chapters in all of its free trade agreements ([European Commission, 2021](#)). In these, the EC requires its trading partners to adhere to fundamental conventions and agreements that had been ratified by the partners already. This includes International Labor Organization (ILO) conventions and the Paris Agreement on Climate Change. In its TSD review in 2022, the EC includes the possibility of trade sanctions as “last resort [...] for material breaches of the Paris Climate Agreement and the ILO fundamental labour principles” ([European Commission, 2022](#)). Whether this can work will need to be assessed empirically in the future. But even though accusations of (regulatory) imperialism are being raised already, this is a step back towards the more successful Neue Ostpolitik where trade alone was not seen as a sure-fire success to achieve change, but was combined with political demands.

Furthermore, there are other paths through which “change through rapprochement” works. Amongst others, migration stands out as a channel through which trade relations are developed and strengthened, and which also functions as substitute for democratic education in rural areas of less-developed countries and post-Soviet states ([Barsbai et al., 2017](#); [Chauvet & Mercier, 2014](#); [Genç, 2014](#); [Gori Maia & Lu, 2021](#); [Gould, 1994](#); [Parsons & Vézina, 2018](#)).

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DIW Berlin – Deutsches Institut
für Wirtschaftsforschung
Mohrenstraße 58, 10117 Berlin

Tel. +49 (30) 897 89-0
Fax +49 (30) 897 89-200
<http://www.diw.de>

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