The Relationship Between Economic and Political Development Via International Trade Policies

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Abstract

In the development literature, the emphasis is always on the international trade policies. In the global experience, a group of middle-income developing countries are successful in the world trade, and larger number of developing countries have been excluded. This paper uses the simultaneous equation system to examine the relationship between economic and political development with international trade policies during the period 2006_2014 in two groups of selected developing and developed countries. The results of this research show a direct and positive impact of political development on the international trade liberalization policies and the effect of this this policy on economic development. Therefore, based on the present evidence, sustainable development can be created by establishing appropriate platforms and solidarity between political and economic development with international trade.

Keywords: economic development, political development, trade policies, system of simultaneous equations

1. Introduction

The emergence of modern governments outside of the European continent that were created after decolonization, was followed by a disruption to the habits of international relations and shook the traditional analyes of European social and political background. In this context, the question was raised as to which political response is appropriate for the requirements of economic modernization, so that a society that is still considered as a farming society in terms of population, techniques and values can be transformed into an urban and industrial one. Given the special concentration of developing countries on increasing trade volumes in recent decades, the relation between the trade and the development has become more important. Obviously, the relationship between trade and development is a complex one in which the international trade with high productivity and the international division of labor through the diffusion of the benefits of technology leads to an economic growth, which should lead to the economic and political development and eradication of the poverty. In short, the business leads to growth, and the growth leads to the development and this is an automated circle. Of course, it should be noted that the growth alone cannot bring sustainable development. Given that the growth is a single-variable concept based solely on GDP[1], in this paper we study the development, which is a multivariate concept and refers to the achievement of quality of life for the citizens.

Many empirical evidence suggests that the integration of developing countries into the global economy has significant benefits. It is argued, of course, that the trade liberalization has the same benefits for all countries. But what we actually see empirically is that a group of developing middle-income countries succeeds in promoting global trade, being left a larger number of countries in the developing world out of global trade. There are different reasons for this, most notably the policies of successful countries, and the distinction between these and failed countries. A successful approach to development requires the calculation of a wide range of organizational, social and structural needs of a society. One developing country's policies may harm its globalization interests, and this, of course, does not mean that it should be abandoned, but it creates the requirement that the further access to the products of the developing country having a comparative advantage should become possible. International trade is necessary for development, although it is not enough. Trade liberalization, although necessary, its results are not necessary to enhance the ability of developing countries to trade, and this undoubtedly calls for the enthusiasm of developing countries.

Since the second industrial revolution that began in the second half of the nineteenth century, the systematic application of modern scientific systems was oriented to the technology and, more generally, the scarce issues. Revision of economic structures involves understanding the requirements for the professionalization of the world and the division of labor. This means that, in the real world, the bargaining power has an effect on the efficacy of the consequences, since the exchange transaction costs are positive. This means that the economic and political institutions have an effect on the process of reducing exchange costs and increasing international trade, and this shows, in turn, the effect of the development of economic and Political institutions on trade.

The main subject that we are examining in this study is a circle between economic development and political development called the trade policy. First, we examine the effect of the political development on the selection of trade policies and the extent to which improves the exchange conditions. In the following, we will examine how the trade policies affect the indices of economic development. Although much studies have not been conducted on the economic-political development associated with the international trade, especially since this relationship has been studied with both development literature, there are various empirical studies in relation to the research for example, Milner (1999) states that the rise of democracy is associated with free trade policies. Changes in the regulation of trade policies among the domestic politicians in developing countries were more effective than changes in political leaders and political

[1] Gross domestic product

preferences, and some large-scale changes in the political institutions, especially democracy, were needed in some less developed countries. He concludes that for more developed countries, the democracy has more likely led to more trade liberalization and growth cycle. Anderson and Marcouiller (2002) examine the effect of institutions on trade using the demand model of imports in the unsafe world in different countries. Their estimates indicate that the increased transparency and impartiality of imports will increase the import volumes and significantly reduce corruption and the implementation of trade-violating contracts. They conclude that insecurity in the trade acts as a hidden tax. De Groot et al. (2004) show that the development of political and economic institutions will increase trade by 30-44%, and in countries with similar institutions, the volume of trade will increase by 13%. For this reason, the capitalist countries are creating a disproportionate trade with high institutional development, and the poor countries are deprived of the trade cycle due to the high insecurity. Milner and Kubota (2005) state that as the movement towards free trade proceeded, the democratization occurred and they show that these two subjects are related to each other. Democratization of the political system reduces the government's ability to use trade barriers as political structures. They conclude that an increase in democracy leads to a decline in tariff rates and increases the likelihood of trade openness. Baliamoune-Lutz and Ndikumana (2007) call institutions' quality as a lost link between trade and growth. They show that the effects of institutions are non-uniform and U-shaped, and at low levels of degree of trade freedom, the joint effect of institutions and trade liberalization on the growth is negative. At higher levels of trade freedom, the institutions can improve the growth, and other factors, such as instability, can affect the trade through reducing domestic and foreign investment in business and reduce growth. Abeliansky and Krenz (2015) state that is no relationship between democracy and trade in a stable and absolute way, which do econometric estimates. In the countries with less trade volume, the impact of democracy on trade is more important. Democracy is not the same for all countries. Active economies in the international trade are not necessarily the most democratic countries in the world, so the relationship between democracy and trade is not a clear relationship. To understand more, first part, the theoretical foundations are presented in the second part. In the third part, the relationship between economic development and political development on the one hand and the trade policies on the other is estimated by the system of simultaneous equations and the article is summarized at the end.

2. The Role of Trade Policies in Economic Development

Theories of trade and development have evolved over time, and it has been noted that the trade policies have been the key to achieving economic development policies. The first theory is as followed: trade policies should be based on import substitution; there was a general consensus that the domestic goods should be able to compete with the imported goods in order to meet the needs of the domestic market. In order to achieve this, it was necessary to provide incentives for the domestic producers by supporting domestic production against imports or even imposing import prohibitions; that is, it was thought that the replacement of imports in plant industries is synonymous with industrialization, the key of developments. We review theories of trade and development policies. When the developing countries achieved their independence from the colonial sovereignty and domination, the leaders of these countries considered themselves responsible for the policies that led their country to a higher standard of living and higher economic growth rate. Non-developed countries were specialized in the production and export of raw materials, and imported most of the industrial goods needed from abroad (Krueger, 2004).

Earlier trade and development perspectives and its policy permissions were formed on the basis of well-known statements and facts about undeveloped countries. The first fact is that the production structure of developing economies is heavily dependent on the production and export of primary goods. The reliance on the foreign trade sector was highly believed, almost no production capacity was observed for producing industrial goods, except for a few high-consumption goods in the form of the Factory industries. Many of the evidence indicating the low standard of life in the developing countries is due to the export and import of primary goods. The second fact was that if the developing countries opt for open-door policies, their relative advantage in the production of primary goods would be declining. Therefore, the result was that the process of development or industrialization is impossible through the selection of free trade policies. The third fact is related to the export pessimism, so that in the world the price and the income for the raw materials are very low. Therefore, if growth is to be expected for exports, the lack of rapid growth in export revenues is predicted. The fourth fact is the labor force: the labor force of the developing countries is often employed in the agricultural sector, so their final production is negligible, zero or even negative (Lewis, 1954). At the moment, the fact that the workforce in the developing countries suffers from excess supply or unemployment is fully accepted. The fifth fact is that, for achieving the economic growth, the capital compression is necessary and at an early stage of development, this is possible only through the importation of capital goods. As the demand for capital goods as well as other unused goods is expected in the process of producing goods, while the foreign exchange gains do not increase significantly, it becomes clear that the growth can occur when the domestic production of imported competing goods (substitute to imports) is sharply increasing. Finally, the sixth fact is that in developing countries, the reaction to prices is weak. Based on these facts, the development in the specific sense is the same as industrialization, which basically means the concentration of capital and investment in the Factory industries and its related structures (Chenery, 1955).

Political recommendations are derived from the revealed statements and facts. Given that the industrialization was thought to be necessary for development, and that the free trade was the only way to sustain the export of countries that were specialized in the production of primary products, the result was that these countries should invest in the new Factory industries where their products are replaced by imported goods. Of course, it was believed that the products of poor countries were not able to compete with the developed ones. Therefore, these industries should be protected at the early stages. As a result, the import substitution policies supported the trade strategy for development. These policies form the central axis of the extroverted introspective view, and the import substitution policies form an extreme (intrinsic) view of introverted introspective attitude (Krueger, 2004).

An industry, even if economically viable, would not necessarily be built by the private sector; this idea had since been accepted by the economists as an exception to free trade and the lack of production of those goods internally. Because the cost of foreign producers was low, and the newcomers in the developing countries faced a lot of costs at the start of their work, and a lot of time was spent on the competitiveness of these goods. Under these conditions, the expansion of the newborn industries through temporary government intervention is necessary in such a way as to ensure continued profitability, provided that in the long run, the industry grows and its costs are reduced to less than the cost of the foreign producer, in order to maximize economic returns, and also have a social justification for the support. Although in the developed countries, the support of the newborn industries is considered to be a subsidy for production, but in the developing countries, this idea was introduced as a substitute for imports. These topics were so accepted that even in various cases, the GATT[2] provided exceptions for the developing countries (Dam, 1970). Another aspect of the supportive policies was that they were applied in a high and non-discriminatory way in all qualified units; these ambitious projects would stimulate higher inflation and more foreign exchange demand, while most of them took the fixed-exchange rate system. This affected the nominal agricultural exchange rates. In other words, they fixed the exchange rates, since it was believed that by doing so, the imports of capital goods would become cheaper and as a, result increased the investments (Prebish, 1984). With the growth of demand for foreign currency and the drop in its supply, the emergence of foreign exchange problems was inevitable. The fall in the prices of the fundamental goods in the early 1950s exacerbated these phenomena. The initial response of policy makers was to apply rationing for the rare foreign exchange of imports, and this system had little potential to encourage small industries. Although initially allocating quotas for import was often fixed and inclusive, over the next two decades, this control became harder and more complex. In the course of the decade, following the overvaluation of the exchange rate and the increase in debt and the failure of the growth of export revenues, a periodic crisis of the balance of payments emerged (Bhagwati, 1978). International Monetary Fund's (IMF) economic stabilization program was used to simplify and rationalize import bans. More concerted efforts were made to rationalize trade bans and find ways to earn more foreign exchange earnings in order to finance import of major items needed to meet additional import substitution investments. These fast and loose playing policies made the development trend to be fluctuated (Weintraub & Cline, 1981).

While the theories of import substitution for economic development were established, the countries such as Taiwan and then, East Asian countries, which contradicted the policies of import substitution policies, was developing. In Taiwan, according to Tsiang and Wu (1985), there was a need for increased export capacity along with the industrialization. Korea, which had similar conditions to Taiwan, imitated Taiwan. Based on the political reforms, all exporters were confident that a real exchange rate change would not cause them a loss. These reforms included less support for domestic rival producers, allowing exporters to import their intermediary and raw materials without taxes. A set of policies is often referred to as introverted

[2] The General Agreement on Tariffs and Trade

extraversion and, in a more restrictive way, the extroverted extraversion, where the trade with open doors is based on relative advantage. East Asian economies were improved with the double-digit growth rates and improved people's standard of life. Hong Kong and Singapore were among the countries that reached the high growth rate with the export encouragement policies (Chenery & Strout, 1968).

Replacing export development policies against import substitution in order to smooth the incentives for exporters, if not enough, is certainly a necessary condition. East Asian experiences were contrary to the neoclassical view that the benefits of the free and dynamic trade are more than the static one. The new trade theories are based on how we can identify and measure the benefits of dynamic trade. Washington consensus has a great deal of difference with the political consensus of the 1950s and 1960s, which has led to the import substitution policies. In this change of views, there were two key issues: First, despite the reasonability of relative theory, the supportive policies were introduced. Secondly, on the role of trade policies in economic development, we should note that the revealed facts have been widely adopted and it has been assumed that the individuals do not react to motives. Presumably export revenues were assumed to be predetermined, and in the best case, to have a slight increase; the supply was also poorly responsive. These types of revealed facts, which are very simple at many times wrong, allow economists to conclude that the economic structure of developing countries is different and that the strategies and patterns for them are also different (Barhedan, 1996).

Regarding the recent literature, we find, the use of the relative advantage theory has not merely been a simple goal of a permanent assignment in the production of basic goods, which has enabled policy makers to pursue other goals, including changes in trade strategy. In the import substitution theories, the economic rent is not negligible. The experience of East Asia has proven that no policy is constructive as the dynamic trade policies. The experience of East Asian exporters shows that a developing country can succeed in industrialization, while accepting import substitution policies. Recently research’s goal is to investigate that to what extent the trade liberalization policies and the supportive policies (import substitution) are conducive to the economic development.

3. The Role of Political Development in Trade Policies

First time, Lipset (1959) has tried to prove that the political play is only considered to be competitive or democratic when it relies on a degree of economic development. Using a solidarity model, he proved that there is a correlation between political development and economic and social factors. Russett (1965) established some reciprocal relations between several economic, social or cultural indices (per capita income, urbanization, literacy, number of radios, beds of hospitals and so on.) and fewer political indices, such as participation rate of election, government contributions to gross National income and so forth. These relationships naturally confirm the development attitude on the basis of the interaction between economic and political efficiency. He shows, achieving each stage of economic development leads to an increase in the number of participations in elections. Shils (1962) states that all the progressive governments have a common goal and that it is modernization or dynamism, democracy, and egalitarianism. The set of these demands leads the new governments to a pattern of modernity that is nothing but Western democracy, except that minor amendments occur so that it can be adapted to the alien geographic environment. What constitutes a barrier to this prosperity in Third World societies is the collection of undesirable data for democracy. Almond and Coleman (2015) consider the political development as a process in which non-Western traditional systems receive the characteristics of more developed societies, and these characteristics are generally the broad participation of members of society in political and non-political activities. According to their, the political development is the result of events that are rooted in the international environment, the domestic environment or the political elites within the political system. If a political system in the present situation is not able to cope with progressive challenges and problems, then it can be considered to be developed when it has the capabilities needed to successfully deal with such challenges. Otherwise, the result will be backward or negative development. Pye (1967) describes some elements of the new method of political development in the following triangle: enhancing equity, improving political efficiency, and the structural differentiation. Of course, Pye's theoretical foundation is how each society gets to know these signs and how they act against their emergence, and of course, such an encounter would not be without tension and rupture. This is the key to the crisis's vision, and systems must overcome it to ensure the progress of their political development. Huntington answers the above requirements with the notion of institutionalization as a common feature of all political development trends. According to Huntington's classification, the target societies are politically advanced if they are able to respond to the institutionalization, otherwise the modernization will be at the expense of political degeneration (Huntington, 2006). Apter (1965), like Huntington, takes a decisive distinction between development and modernization, but this distinction is made in order to prioritize a renewal analysis. Development is a universal and general process that includes all the changes that lead to the improvement of social classifications or the new division of social roles. Development is no longer considered as a continuous process, but it may also be accompanied by reactions and degenerations. In this way, this theory diverges from the simplistic conception of linear development, which is specific to the classical theories of development.

A country's constitution is an example of a political institution in which the overall structure of political institutions is defined; for example, it describes how politicians are elected and the transfer of power to them, in such a way that it may give power to a democratically elected president, or a dictator. Therefore, the political institutions include the type of government, the assigned power and the limits imposed on policymakers and political elites. Political institutions have an important impact on the trade policies. Here's proposed a model that's basically a model of pressure groups. For example, a group believes that the US Congress, prior to 1934, set the trade policies exclusively to protect interested groups (Destler, 1976).

Trade Liberalization Theory argues that trade liberalization will result in growth and, ultimately, long-term development. Standard theory shows that the trade liberalization will increase trade opportunities and improve resource allocation and accelerate technological development, especially through the liberalization of imports. The experience of development in different countries suggests that the economic and political development and the trade openness have existed in a certain period of time, and their relation is important, but this complex relationship, and at different times and spatially different levels, results in different outcomes; of course, these results are distinguishable regarding institutional development. What is well seen is that the developed countries are less inclined to trade barriers than developing countries (Magee et al., 1989 ; Rodrik, 1995). One of the reasons for this can be the weak income tax system in the developing countries. These countries, by creating trade barriers, actually aim at obtaining revenue from import taxes. Therefore, a change in the political institutions can make a fundamental difference in trade policies.

Some scholars argued that the democratic countries are less engaged in supportive policies. Mansfield et al (2002) show that there are less trade barriers in the democratic countries and are more susceptible to signing trade liberalization agreements. Rodrik (1992) argues that almost all changes in trade policies are due to changes in political regimes, which indicate a profound influence of political development on the rejection of the trade policies option. In the short run, the trade liberalization can have negative effects; in particular, the weakening of domestic production due to the competitive import is one negative effect of this process. Therefore, the positive effects appear to be delayed, and the growth of a j-like curve in response to the opening of trade takes place (Greenaway et al., 2002). Trade liberalization and increased trade volumes, although they have an important impact on the growth of a country, have not always been led to the development, as the experience of the different countries shows, and there are some causes for growth constraints that may be due to the institutional weaknesses. In another case, the benefits of trade liberalization depend on the growth-engine-driven trade combination (Mazumdar, 1996). Countries that import the capital goods and export the consumer goods experience faster growth (Lundberg & Squire, 2003). Therefore, in order to obtain the benefits of liberalization, there should be a sufficient industrial strategy to stimulate economic diversification to prevent to be import-oriented.

4. Research method and findings

We want to examine to what extent the components of political development are effective in choosing between import substitution policies and trade liberalization policies, or, in other words, to what extent the countries with different levels of political development choose the policies of trade liberalization or the policy of support (import substitution). In this research, the model estimation was performed using the simultaneous equation system and the data of 20 developing countrieswith the similar economic and political structures and 20 developed [3] countries[4] with the similar economic and political structure during the years 2006-2014. And the reason for choosing this timeframe is the limitation on the release dates of extracted

[3] Afghanistan, Armenia, Brazil, Central African Republic, Egypt, India, Indonesia, Iran (Islamic Republic of), Iraq, Kenya, Libya, Mali, Pakistan, Sudan, Tajikistan, Thailand, Turkey, Uzbekistan, Venezuela, Zimbabwe

[4] Australia, Austria, Canada, China, Denmark, Finland, France, Germany, Italy, Japan, Korea (Republic of), Malaysia, New Zealand, Norway, Romania, Serbia, Singapore, Switzerland, United Kingdom, United States

attributes from the Bertelsmann Foundation[5], since the first year of publication in 2006 was that we used in the data for all years.

The research pattern for testing the research hypothesis is as follows:

$$GNI_{it} = \alpha_{i1} + \alpha_{i2} PD_{it} + \alpha_{i3} HDI_{it} + \alpha_{i4} TARIFF_{it} + u_1 \quad (1)$$

$$PD_{it} = \beta_{i1} + \beta_{i2} GNI_{it} + \beta_{i3} FP_{it} + \beta_{i4} TLR_{it} + u_2 \quad (2)$$

$$TARIFF_{it} = \gamma_{i1} + \gamma_{i2} PD_{it} + \gamma_{i3} TO_{it} + \gamma_{i4} GNP_{it} + u_3 \quad (3)$$

In the following, the indices will be introduced:

The PD shows the political development indices that include the average data of rule of law and political participation, derived from the Bertelsmann Foundation and the data of political legitimacy (political stability, violence and terrorism), and political accountability extracted from the World Bank (WDI)[6]. The GNI[7] represents the per capita income, GDP represents Growth Gross Domestic Product, and HDI represents Human Development Index, obtained from the geometric mean of per capita income, literacy and life expectancy. The reason for using HDI as an indicator for explaining economic development is the relative importance of this index to explain the welfare of the current countries. In fact, for modeling, there is no comprehensive statistical information. For this reason, we have to use this indicator to explain economic development, which, of course, explains the use of this indicator in economic development research in the research literature. TLR represents Total Literacy Rates, and TO indicate the degree of trade openness. TARIFF represents the applied average tariff rate for all products (in percentages) extracted from the World Bank. The FP[8] data represent political freedom extracted from the Freedom House Foundation, and then, using these observations, the proposed model is estimated. Simultaneous equation system is a suitable model for indicators that have a bilateral relationship. According to the research literature, political and economic indicators establish a bilateral systematic relationship. Thus, for this reason, we use the simultaneous equation model.

In the first step, the static nature of the data is considered. For this purpose, Fisher Phillips-Peron co-integration test has been used. The results of these statistics have been given for the equations in the following table:

Table 1: Results of unit root tests of the model's variables

Variable	Fisher Phillips-Perron test	
	prob	statistic
GNI(-1)	0.00	222.40

[5] https://www.bertelsmann-stiftung.

[6] http://www.worldbank.org

[7] gross national income

[8] https://www.freedomhouse.org

PD	0.00	121.44
HDI	0.00	346.99
TLR	0.00	65.93
FP	0.00	30.30
TO	0.00	116.14
TARIFF	0.00	95.57
GGDP	0.00	134.81

Source: Research findings

As it can be seen from *Table 1*, the results obtained from the unit root test show that the existence of a unit root in the variables rejects the model, and all of the variables are static.

In addition to the unit root test, in the system of equations, the grade and ranking condition should be studied. The results of the evaluation of the grade condition and the matrix indicate that all the equations are Over identified so the method of Three Stage Least Squares (3SLS) is used. According to the literature of research and the algorithm designed in the second chapter, with the entry of the international trade circle in economic development and political development, the results of *Table 2* show there is a significant relationship between the policy of governments and development.

As it can be seen in the Economic Development Equation, the increase in tariff rate in the developed countries does not have a significant effect on economic development, but in the developed countries, there is a positive relationship; this result is correspondent with the theories of the evolution of policies and the control of imports and with the Prebisch’s (1984) research, which stated that the policies of Tariff reduction in these countries should be far from accelerating and taking into account the domestic production conditions. The reason for this difference is an origin in the development nature of countries. According to Mazumdar's (1996) theory, the countries that import capital goods and export the consuming goods will gain more benefits from trade liberalization. According to Lundberg and Squire’s theory (2003), in the developing countries, the quality of export goods is weaker than in the developed countries, so increasing tariff to protect domestic goods will lead to economic development in the country.

In the trade policy equation (tariff), it is observed that in the developed countries, the increase in the political development has a reversed relationship with tariff rate, which means that the countries with higher political development must apply lower and exogenous tariffs, but in the developing countries this relationship is reversed: Increase in the political development did not have a significant effect on tariffs, which is consistent with the study of Abeliansky and Krenz (2015). However, generally, it can be seen in the panel data of both countries that the increased political development has led to the adoption of trade liberalization policies, which is also consistent with the result of Milner's (1999), Anderson and Marcouiller (2002), De Groot et al. (2004).

Table 2 - Model Estimates for 2006-2014

Equations	Model's variables	Developed		Developing		Universal	
		Coefficients	Prob	Coefficients	prob	Coefficients	prob
Economic development	PD	211.77	0.00	48.29	0.00	162.99	0.00
	HDI	1078.49	0.00	316.59	0.00	684.14	0.00
	TARIFF	-454.17	0.22	265.45	0.00	-126.11	0.36
Political development	GNI	0.003	0.00	0.008	0.03	0.003	0.00
	FP	-7.94	0.00	-8.16	0.00	-8.85	0.00
	EDU	1.43	0.00	0.05	0.55	0.10	0.04
Trade policy	PD	-0.06	0.00	0.10	0.75	-0.11	0.00
	TO	0.01	0.56	0.86	0.59	0.19	0.08
	GRW	0.07	0.46	-1.41	0.53	-0.19	0.49

Source: Research findings

5. Discussion and Conclusion

This article examines the relationship between the indices of political development and economic development on the one hand and the international trade policies on the other in selected developing and developed countries of world during the period 2006-2014, using a panel data approach. Initially, this relationship is examined for the developed countries and then for the developing countries, and eventually it is estimated in a model of both countries.

Regarding the results of this research, it can be concluded that the increased trade freedom and the extroverted policies have no significant effect on the economic development of developing countries, but this effect is positive in the developed countries and it increases economic development, because they import capital goods and export consuming goods and gain more benefits from trade liberalization. In the developing countries, the quality of export goods is poorer than the developed countries, so raising tariffs to protect domestic goods will lead to economic development in the country. Countries with higher political development have to apply tariff reduction and exogenous policies, but in the developing countries, this relationship is reversed. Although the increase in the political development has not had a significant effect on tariffs, it should be noted that the effect of democracy on trade in the countries with less volume of the trade is more important, and the relationship between democracy and trade which makes econometric estimates, is not stable and absolute. Democracy is not equally important for all countries, but in general, the increase in political development has led to the selection of trade liberalization policies in the panel data of both countries, and as the democratization has increased, increase in the trade liberalization is seen as well.

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