

Trade Politics: A Brief Survey of International Political Economy

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[Abstract]

International political economy has already been shown to be powerful to explain the global trade growth. In this paper we offer a brief survey of international political economy of trade policy. In addition to this, we also try to address three questions: (1) how does electoral competition affect trade policy? Suppose two parties compete for the power over trade policy, would the two parties choose the same tariff? (2) We observe that the US tariffs decline over time, so do the declining U.S. tariffs lead to the fall of the Democratic vote share in the election? (3) What is the relationship between trade globalization and political liberalization? Put it another way, how does trade affect democracy? And conversely, how does democracy affect trade?

Keywords: Tariffs, Political Competition, Democracy, the Gravity Equation

Classification: J13, J14

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The superiority of free trade is one of the profession's most cherished beliefs, yet international trade is rarely free. In order to explain this gap, economists appeal to political intervention. In this paper we offer a brief survey and introduce recent development on international political economy of trade policy.

We proceed as follows. Section I is a brief literature review on international political economy of trade policy. Section II introduces a related framework to answer how electoral competition affects trade policy. Based on this, we introduce an empirical investigation on the relationship between electoral competition and US tariffs in section III. Section IV extends the research into the global level. Section V concludes the paper.

I. Related Literature

Why is trade not free? Perhaps this is the most intriguing questions faced by trade economists given that free trade is one of their most cherished beliefs. Among many pioneering works, the paper "Protection for Sale" by Grossman-Helpman (1994) is one of the most important milestones to explain this puzzle.

In their model, a home government not only maximizes its national welfare but also is concerned about the contribution from each lobby. Interest groups make contributions only to the incumbent government in order to influence its trade policy. Based on such assumptions, they obtain an explicit inverse Ramsey rule for the optimal trade policy. Their model is widely accepted now partly because it allows the endogenous choice of policy in a general framework and partly because of the acceptable result that optimum tariffs are only determined by aggregate variables and the characteristics of the specific sector.

However, they, themselves, recognize that the lack of political competition in their

model is a potential deficiency. Hence, we feel interested in how political competition between parties affects trade policies for a country. It is well known that, according to the median voter theorem, the collective choice will follow the median voter's preference given a continuum of voters. Whether this classical result can still hold when restricted our scope to the competition between two political parties without incumbent advantage becomes an interesting question.

Beyond a doubt, a lot of literatures have investigated the relationship between political competition and the parties' platforms. These began from Downs (1957) and include, more recently, Wittman (1983), Austen-Smith (1987), Baron (1994), Grossman-Helpman (1996) and Roemer (1994, 2003).

Downs (1957) is the first economist who models political competition formally based on the model of spatial equilibrium of Hotelling (1929). Downs' model portrays a competition between two parties whose sole motivation for engaging in politics is to enjoy the power and perquisites of office holding. Each party is assumed to be able to commit to carrying out their promise if elected. He showed that the median voter theorem still holds when two parties compete for office over a unidimensional policy issue. Namely, each party will announce a platform that is the favorite of the median voter in the unique Nash equilibrium given voters have single-peaked utility functions.

Different from the Downsian model, still restricting the scope into two political candidates, Wittman (1983) proposed the first theoretical model of political competition in which parties are ideological in the sense of possessing policy preference over a multi-dimensional space. In his model, the political candidates have policy preferences as well as an interest in winning per se. Hence, each party will maximize its expected utility.

Given this setup, he showed that the unique political equilibrium is still the median voter's ideal point.

Based on the ideological assumption introduced by Wittman, Roemer (1994) explored a case in which each candidate holds some prior belief about the median voter's bliss point but does not know where this point is for sure. He developed Wittman's model and showed that the campaign platform of both parties will diverge when the utility component in their welfare function from holding office is not too large.

More recent studies on electoral competition focus on the effects of campaign contributions from special interest groups. For example, Austen-Smith (1987), Baron (1994), and Grossman-Helpman (1996) explore the relationship between campaign contribution and vote share of candidates with different approaches. Austen-Smith (1987) assumed that the parties use campaign contributions to alleviate risk-averse voters' uncertainty about candidates' policy platforms. Baron (1994) presented an elegant model in which candidates raise campaign contributions by choosing policies that benefit special interest groups and then use those contributions to influence voters who are uninformed about the policies. Informed voters, however, vote based on those policies. When the unidimensional policy is set to generate funds to attract the uninformed voters, the equilibrium policies of the candidates are separated. And the degree of separation is a monotonic function of the proportion of uninformed voters to informed voters.

Unlike Austen-Smith and Baron, Grossman-Helpman (1996) didn't restrict the objective of the campaign contribution from special interest groups to the electoral outcome; they also afford the special interest groups an opportunity to influence the parties' platform also. They showed that each party is induced to behave as if it were

maximizing a weighted sum of the aggregate welfares of informed voters and members of special interest groups. The party that is expected to win a majority of seats caters more to the special interests.

However, as we mentioned above, there is still one potential drawback for most of the existing works. Some of the researches don't consider how the political competition affects trade policy. More severely, most of the works always assume that political parties' behaviors are exogenous given. In other words, political parties are labeled as pro-labor or pro-capital arbitrarily. Hence, this raises one question: is it possible to model parties' optimal choices as endogenous? Yu (2005a) provides a related work to address this question.

II. Trade Politics: A Heckscher-Ohlin-Downs Framework

As Yu (2005a) pointed out, in the 2004 U.S. presidential elections, the dispute on foreign trade policy was one of the important issues between the Democratic and the Republican Party. Mr. John Kerry, the candidate from the Democratic Party preferred the "freer trade." He emphasized that the U.S. government should link multinational trade agreements to labor and environmental issues, saying "new trade agreements must protect internationally recognized workers' rights and environmental standards as vigorously as they now protect commercial concerns."² Conversely, George W. Bush, the candidate from the Republican Party who won the said election, advocates "free trade," saying that the case for it is "not just monetary but moral." Thus, he pledged to make the expansion of trade a consistent priority. Specifically, he strongly supports the expansion of NAFTA throughout the Americas.

² The 2004's Democratic Platform of America, page 20-21.

Although the election outcome is already known, one question still remains: *Why does the Democratic Party prefer protectionism, whereas the Republican Party prefers more pro-trade?*

Previous works on election and trade provide no explicit answer to this question. Most of the works instead assume that homogeneous trade platforms are exogenous. They label the Democratic Party as the “Protectionist” whereas the Republican Party is plainly the “Republican”. Although this major simplification is appropriate in some cases, it is not quite consistent with U.S. trade politics.

The history of U.S. tariff legislation in the 20th century suggests that the Democratic Party does not always aim for protectionism and that the Republican Party does not always advocate pro-trade. In the early 20th century, Democratic presidents favored freer trade, whereas Republicans advocated greater protection. As examined by Ferguson (1984) and Baldwin (1986), recent Democratic presidents (such as Kennedy, Johnson, and Carter) were less protectionists than Republicans (such as Eisenhower, Nixon, and Reagan).

The case in the Congress is different from that in the presidency. Evidence from Baldwin (1986) shows that the House of Representatives is generally more of a protectionist than the Senate or the President. Within the House, the Democrats favor protection, whereas the Republicans are relatively pro-trade. In a nutshell, the two parties, the Democratic Party and the Republican Party, always switch their trade position over time. Hence, heterogeneous trade platforms between parties cannot be explained exogenously.

Thus Yu (2005a) presents a straightforward model to explain the *endogenous*

heterogeneous trade platforms between the two parties. This is a model of two-party electoral competition with a continuum of voters. It recognizes the fact that political parties are mostly Downsian, which means that they are purely office motivated and have a unique policy (trade) platform. It is understood that in the standard unidimensional policy of the Downsian model, equilibrium platforms in a two-party system are both located at the ideal bliss point of the median voter. To investigate whether the convergence property holds under the Heckscher-Ohlin framework, he therefore considers two cases: a benchmark case and a more realistic one.

In the benchmark case, he considers a standard Heckscher-Ohlin setup in which voters have the same labor endowment but different capital endowments. They consume one export good and one import good in the economy. Simultaneously, the two political parties propose tariff platforms. During Election Day, they cast their ballots to their preferred party, which could give them higher utility, based on the party's preferred trade platform. He then shows that the two parties will propose the same tariff platform at the Nash equilibrium, which is identical to the median voter's bliss point. Clearly, this finding coincides with the prediction of Downs (1957).

Now let us move to a more interesting case. In reality, some voters do not care about the trade policy, provided that they just spend small amounts of money on import goods. Hence, they do not have favorite parties and could be labeled as "uninformed" voters. Their counterparts, the informed voters, are identical to the voters in the benchmark case.

We also observed that some informed voters would make financial contributions to their preferred party. The intuition here is that some voters have strong preference on a party before the election is held. For example, blue-collar workers prefer high tariffs on

garments; as a consequence, they have the tendency to vote for the labor-friendly Democratic Party. Hence, such voters would like to make financial contributions in order to help their preferred party win the election. In reality, both the Democratic and Republican Parties collect a huge amount of campaign contributions for the election. For example, in the 2004 Presidential Elections, the two major party nominees each received \$74.6 million from public funds to conduct their general election campaigns, and raised an additional \$21 million for legal and accounting costs associated with the general election race³.

Both parties maximize their vote share in the election, since they are purely office motivated. They spend money to sway the uninformed voters via various media using the funds collected from their supporting informed voters. Intuitively, uninformed voters would like to be “addressed” by advertisement due to a social norm, an action that a consumer undertakes for the good of the community (Grossman-Helpman, 2001). Notably, in this one-shot game, the parties will not propose the same tariff platform. Specifically, one party would prefer a high tariff, whereas the other would propose a low one. Hence, the heterogeneous tariff platforms in a two-party system are endogenously determined.

Yu (2005a)’s model joins a few literatures on election and trade policy. The finding on separating tariff platforms makes his model different from the classical Downsian model. Yu (2005a) shares the same result as Baron (1994), though the setups are different. Compared to Wittman (1983) and Roemer (1994), he did not consider ideology. Furthermore, the crucial difference between our model and the model by Grossman-

³ See the documented “2004 Presidential Campaign Financial Activity Summarized” by the Federal Election Committees.

Helpman (1996) is the lack of special interest groups in our framework. On the contrary, each informed voter was viewed as a potential contributor, sharing a common idea with Roemer (2003). Finally, he did not consider legislative bargaining in our model, making it different from the model by Snyder-Ting-Ansolabehere (2002).

III. Do declining US tariffs lead to a fall in the Democratic vote share?

After many rounds of trade negotiations raised by the GATT-WTO agreement, numerous countries have successfully reduced their tariff barriers. Tariffs have fallen over the last 20 years in the U.S. Figure 1 shows the decrease in the U.S. average tariff rates from 4.33% in 1982 to around 1.36% in 2000. Coincidentally, the Democratic Party's average vote share in the election to the House of Representatives has also dropped during these years. For example, the average vote share of the Democratic Party in year 1982 was 57.8%; it diminished to 54.7% in year 2000. This raises an interesting question: can trade policy affect the electoral outcome?⁴ More specifically, can the declining level of tariffs translate into a falling vote share for the Democratic Party?

[Insert Figure 1 Here]

The existing works provide no clear evidence to the question of whether or not trade policy affects vote pattern. Instead, many empirical papers merely analyze what determines congressional roll-call vote patterns on American trade policy. These works include those of Baldwin (1985), Irwin (1996) and Beaulieu (2002). The Stolper-Samuelson theorem (1941) implied that trade policy is independent of industry and

⁴Notice that the U.S. trade policy is determined by the House of Representatives and Senates, as stated in article 1, section 8 of the US Constitution “the Congress shall have the power ... to regulate commerce with foreign nations ...”

depends only on the type of factor ownership. Based on this prediction, Baldwin (1985) published the pioneering work that examined the determinants of congressional vote patterns on trade legislation for the Tokyo Round of GATT. Shortly thereafter, Irwin (1996) investigated this issue using election data from early twentieth century English countries where trade policy was the primary election issue. Both papers suggested that greater labor union is likely to result in higher protection level.

Yu (2005b) has explored the impact of trade policy on vote outcome. The empirical work of this paper was based on an amended Mayer-Heckscher-Ohlin model with parties: Democrats and Republicans. The Democratic Party is assumed to be a protectionist party and has traditionally shown preference on higher tariffs. Campaign contributions are collected from informed voters. Such funding influences the vote of a group of uninformed voters. The Democratic Party maximizes its vote share in the election by choosing the trade policy platform. Accordingly, in the U.S., a more protectionist trade policy platform of Democrats implies more contributions to the Democratic candidates and, therefore, could lead to a larger vote share.

The methodology Yu (2005b) used in his paper was the fixed effects estimation given the data set consisting of a panel of each congressional district from the years 1982 to 2000. The estimation findings suggested that a one percent decrease of tariffs led to a 0.93 percentage points decrease in the Democratic vote share in the election to the House. We don't introduce the detailed technique here to save space. Interested readers please refer to Yu (2005b) for details.

Then it is very natural to ask: besides of the United States, what happens at the global level? What is the relationship between global trade liberalization and world

democratization? This is the issue we will cover in the next section.

IV. Trade Globalization and Political Liberalization: A Gravity Approach

One of the important components of globalization is the rising trade flow. In the last several decades, international trade has grown tremendously and trade liberalization has become an irresistible trend. At the same time, the average democracy level throughout the whole world has improved significantly as shown in Figure 2. The average log real export level increased from 14.02 in 1962 to 16.52 in 1998 and simultaneously, the average democracy level in 157 countries increased from 2.37 in 1962 to 5.41 in 1998⁵. Does this mean trade could foster democracy? Or does democracy increase trade? This paper addresses these questions and discusses the relationship between trade and democracy.

[Insert Figure 2 Here]

To investigate whether or not trade affect democracy and vice versa, Yu (2005c) introduced a two-way causality between democracy and trade globalization is considered. Economic theory does not tell us anything about the signs of these effects but intuition dictates that democracy could help foster trade, in particular, for developing countries. Political liberalization restricts the ability of a government to use strategic trade policies, such as a variety of trade barriers to earn political support. As such, politicians in labor abundant countries could foster trade policy liberalization as democracy increases (Milner, 2005). Trade policy liberalization may be viewed as synonymous to trade volume globalization. In this sense, political liberalization could increase trade.

However, there is also a possibility for democracy to discourage trade. In particular,

⁵ Data on measuring trade and democracy are from Feenstra (2005) and Marshall-Jaggers (2004)

the lengthy debates in the U.S. Congress deter the progress of trade liberalization. One good example was whether the U.S. should grant China, one of its biggest trading partners in the world, permanent normal trade relations in the year 2000. Although the U.S. Congress eventually passed the bill, the issue involved a lot of time and money, gave rise to arguments, and actually created tension that could have led to a “trade war” between the two countries.

Similarly, trade could foster democracy. Trade does not only change the consumption possibility set in trading countries but also creates an important channel for people to communicate ideas. As Lipset (1960) argues, growing communication makes people more aware of different ways of living. As a consequence, the ideas that are dominant in industrialized countries with a higher democracy level could be transmitted to other countries.

However, it is also possible for trade to have a negative impact on democracy. For example, in a labor abundant country with a dictatorial government, workers may be required to work more without extra pay to increase production of trade-related labor-intensive products. As a consequence, the growing GDP will provide an opportunity for the government to maintain and strengthen its political power. In a nutshell, the question as to whether trade fosters democracy and *vice versa* still remains empirical.

Previous studies have mixed findings on how trade affects democracy. For example, Rigobon and Rodrik (2004) found that the trade-GDP ratio has a negative effect on democracy, using a new identification through heteroskedasticity. In contrast, Lopez, Cordova, and Meissner (2005) found a positive impact of trade on democracy from year 1895 onwards, by adopting a powerful series of instrumental variables introduced by

Frankel and Romer (1999) and also Rose (2004).

In sum, very few works have considered the application of reverse causality. This is not a big surprise since researchers face an immediate difficulty in finding good instruments for democracy. Many economic variables affect not only democracy but also trade. Hence, they do not qualify as instrumental variables. It is difficult to find a variable that affects democracy alone and not trade. One exception is the study by Acemoglu, Johnson, and Robinson (2001). They estimated the impact of institution on incomes, using as instruments the morality rates of bishops, soldiers, and sailors during the time of the early European colonists. However, the instruments used in that paper are good for identifying the effect of “protection against expropriation risk” on GDP, but they are not necessarily an ideal proxy to identify the effect of democracy on trade. Milner (2005) considered how democracy affects trade policy in developing countries. She used a percentage of competing secondary schools as one of the instruments of democracy by showing that the correlation between trade policy and the competing secondary schools is low. However, if we use trade volume as a proxy for globalization, a percentage of competing schools may be inappropriate as an instrument. Although education level is an important indicator of skilled labor, previous studies have already found evidence that trade also has a strong relationship with skilled labor (Feenstra and Hanson, 1996). Hence, another contribution of this paper is to introduce new valid instruments to estimate the effect of democracy on trade.

In a nutshell, Yu (2005c) empirically explores the relationship between trade globalization and political liberalization. To investigate trade pattern, he used a revised version of the gravity equation, which means that bilateral trade volume is directly

affected by the countries' GDP levels and also by other factors such as transportation costs, geographic characteristics, and social-economic factors. Recent studies (Rose 2004, Subramanian and Wei, 2003) found mixed evidence on the impact of membership to GATT/WTO on trade. Thus, this paper also intensively investigates the impact of membership to GATT/WTO.

Besides these, environmental regulations may also play an important role in determining trade pattern. Developing countries have loose environmental regulation policies. As a consequence, dirty industries in industrial countries prefer to migrate to developing countries to avoid stricter regulations in their own countries. In other words, different environmental policies among countries generate a "pollution haven" for industrial countries and affect international trade patterns as well. If this hypothesis holds true, one can expect that the worse the environmental quality is, the more trade exists between the country and its trading partners. Therefore, to fully explore the relationship between trade and democracy, environmental quality was also considered in Yu (2005c).

Briefly speaking, based on a revised gravity approach, Yu (2005c) argues that trade globalization could foster democracy whereas democracy does not have a significant effect on trade, controlling for many other factors such as GATT/WTO membership, environmental quality, and many other related socio-economic factors.

Besides this, two other interesting findings are presented in this paper. First, the membership to GATT/WTO could increase trade when democracy and environmental issues are considered. Second, the effect of environmental quality on trade is mixed. In other words, there is no strong evidence to support the "pollution haven hypothesis".

V. Conclusion Remarks

In this paper, we first review the related literature on the international political economy of trade policy, and then introduce three recent works to answer the three interesting questions as follows:

First, how does political competition affects trade? Yu (2005a) shows that the unique Nash equilibrium of a political competition model between two parties in a Heckscher-Ohlin setting entails differentiated trade politics, with one party proposing a high tariff, and the other, a low one. The basic departure from a median voter model is the introduction of campaign contributions which influence the vote of a group of uninformed voters. Parties are Downsian, not ideological, yet campaign contributions create an asymmetry between them. Thus, the heterogeneous trade platforms in a two-party system are endogenous. One party is labeled as a promoter of protectionism, whereas the other is labeled as pro-trade.

Second, can declining US tariffs lead to a fall in the Democratic vote share? Yu (2005b) provides evidence on an amended Mayer-Heckscher-Ohlin model with parties by studying the effects of U.S. tariffs on the Democratic vote share. The effects are estimated with fixed effects and Two-Stage Least Squares based on data from the House of Representatives from the years 1982 to 2000. Weighted trade policy proxy for each congressional district are constructed and shown to be significant. Overall, a one percentage point decrease of weighted tariffs leads to a 0.93 percent point decrease in the Democratic vote share in the election to the House, *ceteris paribus*. Also, the predictions of the model for electoral outcome are consistent with today's U.S. politics.

Finally, what is the relationship between trade globalization and political liberalization at

the global level? Yu (2005c) offers an empirical investigation on the relationship between trade globalization and political liberalization. The sample is based on 157 countries from years 1957-1998, taking into consideration many social, economic, environmental, geographical, and historical factors. From this, an augmented gravity equation is estimated and evidence is found to support the prediction that political liberalization could discourage trade and trade could foster democracy.

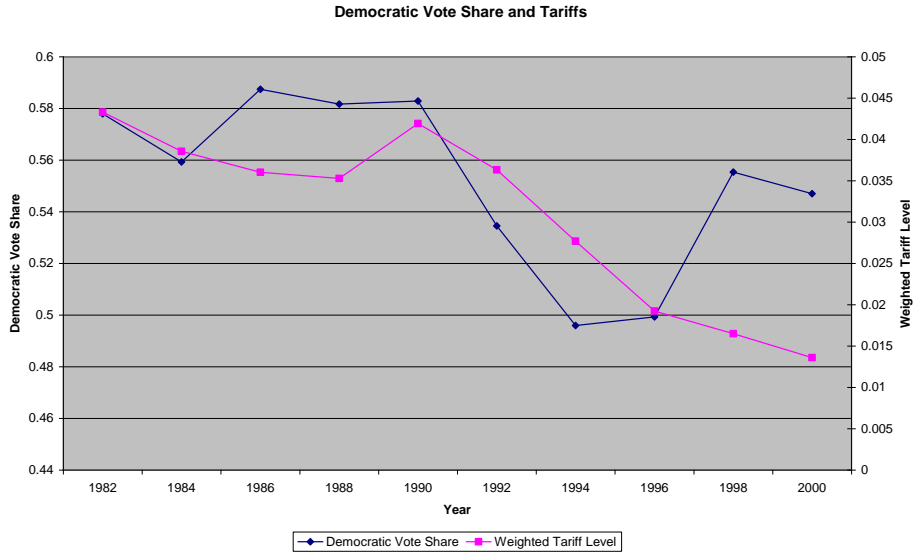
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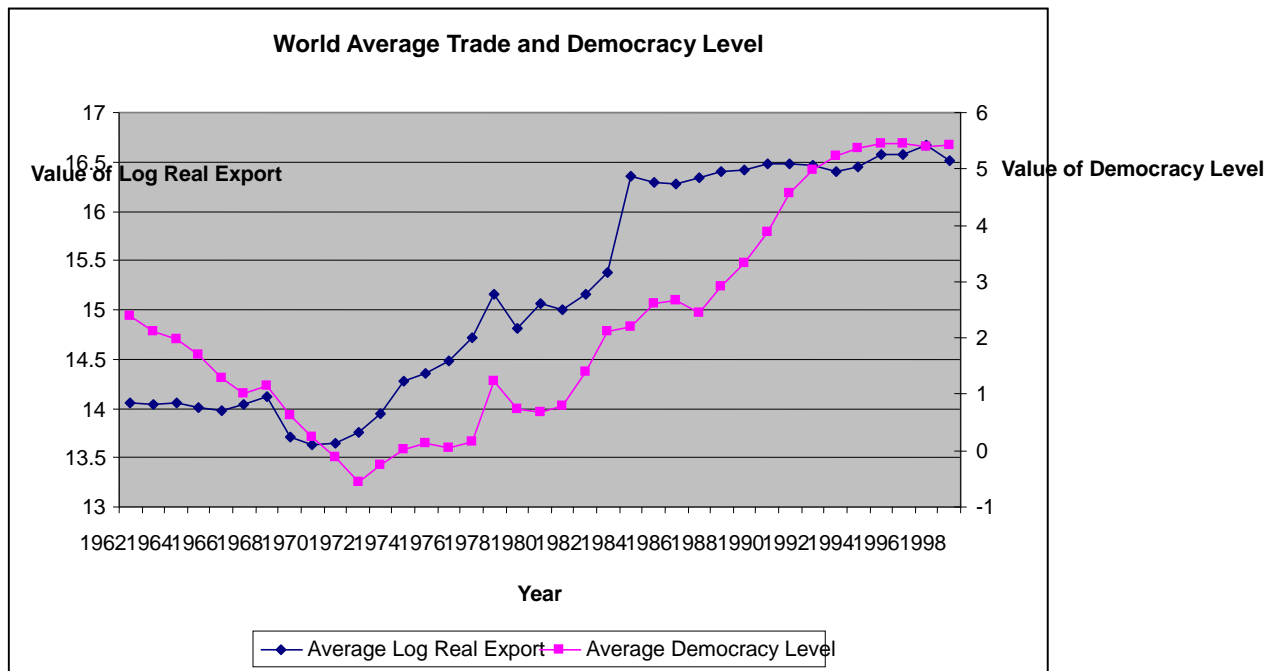
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Figure 1: Tariffs Data and Vote Pattern for the United States



Note: Data of the Democratic vote share are from Federal Elections Committee. Data of tariffs are from Feenstra (2002).

Figure 2: Trends of World Trade Flow and Democracy Level



Notes: Data comes from Robert Feenstra, *et. al.* (2005) and Marshall-Jagers (2004).