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Politics, Policy, and Institutions as drivers of trade openness: A theoretical inquiry

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Abstract. This article aims to deepen our understanding of the determinants of trade openness by developing a hierarchical theoretical framework that explains it as a multidimensional outcome shaped by an integrated causal chain of institutional, political, and policy factors, moving beyond the predominant focus on economic variables in existing literature. The framework conceptualizes trade openness hierarchically, where institutions form the foundational layer structuring political behavior, enforcing rules, and ensuring policy credibility. These institutions shape political dynamics, including regime type, interest group power, and stability, which in turn endogenously determine trade policy choices. Trade policy serves as the direct determinant, translating political choices into measurable trade outcomes. The original contribution of this framework lies in its integration of institutional, political, and policy dimensions into a single coherent causal architecture, offering a more complete and theoretically rigorous explanation of trade openness than either purely economic models or partial political-economy accounts provide. By establishing that a country's outward orientation cannot be fully understood without analyzing the governance structures that condition whether economic potential is realized, this framework bridges gaps across the institutional economics, comparative politics, and international trade literatures, and provides researchers and policymakers with a comprehensive analytical tool for diagnosing the deep determinants of trade performance.

Keywords: *Trade openness; Trade policy; Politics; Institutions; New Institutional Economics.*

1. Introduction

Trade openness is often perceived as a direct outcome of economic and structural variables such as GDP, industrial capacity, and investment levels. Classical and neoclassical trade theories emphasize comparative advantage, factor endowments, and efficiency gains as the primary determinants of a country's engagement in international markets. However, a growing body of theoretical reasoning suggests that trade openness cannot be fully understood through economic indicators alone. Economic potential may establish the capacity for trade, but it is institutions, political dynamics, and policy choices that determine whether this potential is realized in practice.

This article develops a theoretical framework that explains this realization through a clear causal hierarchy. Trade policy, which refers to the set of instruments through which a government's stance on trade is enacted, serves as the most direct determinant. Policies, including tariffs, non-tariff barriers, and trade agreements, directly facilitate or constrain international exchange, forming the immediate link between state action and trade outcomes.

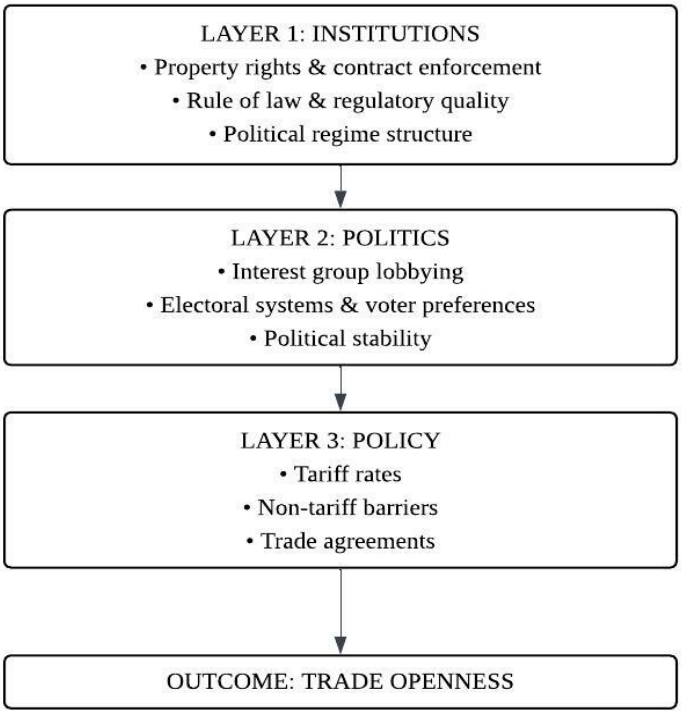
However, these policy choices are not made in an economic vacuum. They are, instead, an endogenous product of political economy. Political regimes, the influence of interest groups, and the distribution of power determine the design and implementation of trade instruments.

The structure of political competition, whether in democracies susceptible to voter and labor demands or autocracies responsive to elite interests, is at the root of every tariff and regulation. Furthermore, political stability creates a predictable environment for trade, while instability acts as a hidden barrier.

Underpinning both the political process and the policies it produces is the foundational role of institutions. Strong institutions, impartial legal systems, transparent regulatory frameworks, and effective enforcement mechanisms, structure political behavior, constrain opportunistic policy shifts, and enforce accountability. They ultimately determine the credibility and sustainability of trade policy. Weak institutions, conversely, exacerbate political risk and raise the transaction costs that suppress trade, directly addressing the "missing trade" puzzle.

By situating trade openness within this integrated lens, the article challenges deterministic economic views. It argues that trade outcomes emerge from a system where institutions structure politics, politics directs policy, and policy directly shapes trade openness. To unpack this dynamic, the paper is structured in three parts. It first examines trade policy as a direct determinant of openness, then traces the political economy of trade policy formation, and finally investigates the institutional foundations upon which both politics and policy ultimately rest. This three-layer hierarchy of trade openness determinants is illustrated in Figure 1.

Figure 1. Three-layer hierarchy of trade openness determinants



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This hierarchy captures the causal sequence: institutions structure the political process by defining who has influence and how stable the system is. Politics then determines which policies emerge through lobbying, voting, and negotiation. Finally, these policies directly shape trade flows through tariffs, barriers, and agreements.

This article makes three contributions to the literature. First, it offers a theoretically integrated framework that bridges institutional economics, comparative politics, and international trade theory, fields that have largely addressed trade openness in isolation. Second, it establishes a

clear causal hierarchy distinguishing between proximate determinants (trade policy), intermediate determinants (political dynamics), and foundational determinants (institutions), providing analytical clarity that partial models lack. Third, by positioning institutions as the ultimate structural layer conditioning both political behavior and policy credibility, the framework offers a more complete explanation of cross-national variation in trade openness than conventional economic or political-economy accounts.

The remainder of this paper is structured as follows. Section 1 presents the methodological approach underlying the construction of the analytical framework. Section 2 develops the theoretical framework through three successive layers of analysis: trade policy, political and political-economy dynamics, and finally institutional foundations. The conclusion synthesizes the framework's key arguments, discusses its theoretical and policy implications, and identifies avenues for future research.

2. Methodology

This study employs a theoretically driven integrative review (Torraco, 2005) to develop a hierarchical framework explaining trade openness. The literature search was conducted primarily through Google Scholar, using search terms including "determinants of trade openness," "trade policy," "political economy of trade," "endogenous trade policy," "New Institutional Economics," and related combinations. Inclusion was guided by theoretical relevance to the research question, studies were retained based on their contribution to one or more of the three analytical layers (i.e. policy, politics, or institutions) and their capacity to illuminate causal mechanisms rather than solely empirical associations. No date restriction was applied, as foundational theoretical contributions span several decades.

The analytical framework was built through progressive theoretical synthesis across five intellectual traditions: classical and neoclassical trade theory, New Institutional Economics, transaction cost theory, endogenous policy theory, and political economy. We first establish trade policy instruments as proximate determinants of openness, drawing on formal economic models. We then trace the political origins of policy through interest group theory, median voter models, and IR frameworks. Finally, we integrate NIE perspectives on transaction costs, contract enforcement, and property rights to establish the institutional foundations of the framework. The result is a three-layer causal hierarchy illustrated in Figure 1, in which institutions structure political processes, politics determines policy choices, and policy directly shapes trade outcomes.

3. Discussion

a. Policy as a direct determinant of trade openness

The free trade doctrine was propounded by classical theorists (Smith, 1776; Ricardo, 1817; Heckscher, 1919; Ohlin, 1933). These classical perspectives, rooted in comparative advantage theory, suggest that dismantling protectionist measures encourages specialization, raises efficiency, and expands both exports and imports. Smith (1776) argued that trade expands markets, enabling more efficient resource allocation through specialization. Building on this, Ricardo (1817) showed that trade allows countries to focus on goods in which they have a comparative advantage, further increasing efficiency and expanding consumption possibilities. Heckscher and Ohlin (1933) emphasized that trade enables countries to exploit their resource endowments, generating additional efficiency gains and overall welfare improvements. New trade theories reinforce this rationale by highlighting economies of scale and market expansion (Krugman, 1980). By relaxing trade restrictions, countries allow firms to access larger markets, achieve scale economies, and enhance international competitiveness.

Despite classical theory's endorsement of free trade, liberalization was largely considered a strategy suited to developed economies with robust industrial bases. In contrast, developing countries initially pursued inward-looking development strategies in the 1950s, promoting import substitution to foster domestic industrialization behind high protective barriers (Irwin, 2021). The infant-industry argument justified temporary protection for sectors expected to develop long-term comparative advantages.

The consensus began to shift after World War II, with the establishment of the General Agreement on Tariffs and Trade (GATT) in 1947 and later its successor, the World Trade Organization (WTO) in 1995, both aimed at promoting trade liberalization. From the 1970s onward, evidence accumulated showing that import substitution often hindered growth and investment incentives. By the late 1970s, developing countries increasingly adopted trade liberalization as a policy goal, though implementation remained complex particularly because trade and tariff revenues constituted a major source of public finance (Geourjon, 2003). The debt crisis of the 1980s created both political motivation and external pressure, through structural adjustment programs (SAPs) by the World Bank and IMF, to liberalize trade. By the mid-1980s, nearly 70% of World Bank adjustment programs included trade policy reforms (Geourjon, 2003). All of these changes led to a far-reaching wave of trade liberalization across the globe (WTO, 1996).

Trade liberalization is generally defined as reducing or eliminating tariffs, quotas, and non-tariff barriers to facilitate freer exchange of goods and services across countries (Acharya, 2015). The World Bank (2002) further specifies that it involves removing trade practices that hinder free flows, dismantling tariff and non-tariff barriers, eliminating government restrictions, and moving toward a more neutral trade regime. In his 1995 paper "Growing World Trade: Causes and Consequences," Paul Krugman identified the decline in trade barriers, such as policy-led trade liberalization, as the main reason for the growth of international trade. Ratnayake (2009) further emphasizes that tariffs, non-tariff barriers, transport costs, and multinational activities exert stronger effects on trade flows than factor endowments. Baier and Bergstrand (2001) show that tariff reductions in OECD countries from the late 1950s to the 1980s had roughly triple the impact on trade growth compared to transport costs, highlighting the central role of policy. Similarly, according to Ibragimova (2020) trade barriers contribute to the reduction of the volume of international trade. Adjustments in these barriers are therefore imperatively correlated with changes in trade. In this light, liberalization represents a deliberate reorientation of trade policy, away from protectionism and toward integration into global markets, an outcome otherwise specified as increased trade openness (Cantah *et al*., 2018).

Trade policy refers to the framework of laws, regulations, and instruments through which a country manages its trade with other nations (Krugman *et al*., 1998), encompassing tariffs, quotas, subsidies, export restraints, price controls, trade agreements, and inspection regulations, all of which shape domestic prices and the flow of goods and services. At its core, trade policy establishes the general rules aimed at protecting domestic economic activities, regulating market access, ensuring product quality, and advancing national economic interests (Velut, 2015; Geourjon, 2003) and reflects a country's degree of integration into, or isolation from, the global economy (Velut, 2015).

Tariffs are the oldest form of trade policy. Adjustments in tariffs directly affect trade flows: increases in tariff barriers depress both imports and exports, while their removal stimulates trade (Faini, 2004). Protectionist policies and tariff barriers can limit international trade growth by increasing import costs, reducing product competitiveness in global markets, and narrowing access to goods and services from other countries (van Aaken and Kurtz, 2019). A tariff creates a price differential between the domestic and foreign markets, leading to higher domestic prices

and reduced demand for imports. By raising the internal relative price of import-competing goods, tariffs reduce consumption of importables and shift domestic expenditure toward locally produced goods (Mankiw, 2018).

The price effect of a tariff can be expressed formally as:

$$P_d = P_w (1 + \tau)$$

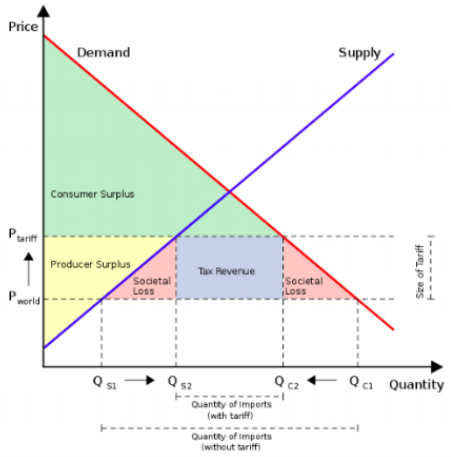
Where P_d is the domestic price, P_w is the world price, and τ is the ad valorem tariff rate. This price wedge directly reduces import demand, and diminishes overall trade and trade openness.

The resulting change in import volume follows:

$$\Delta M = -\varepsilon_M * (\tau / (1 + \tau)) * M_0$$

Where ε_M represents import demand elasticity and M_0 is initial import volume. This shows that import reduction depends on both demand responsiveness and the tariff rate. Tariffs directly affect trade openness by mechanically altering relative prices and suppressing import volumes. Figure 2 illustrates these effects: the tariff raises domestic price from P_{world} to P_{tariff}, generating deadweight losses and shrinking import volume from (Q_{C2} - Q_{S2}) to (Q_{C1} - Q_{S1}). While government collects tariff revenue, this transfer from consumers does not offset efficiency losses. The net effect is reduced trade volume and welfare loss.

Figure 2. Price and quantity effects of a tariff



Source: The Woodward Post

Although tariffs are imposed primarily on imports, they often generate negative repercussions for exports through several channels. First, they invite retaliatory measures from trading partners, who may impose tariffs on the country's exports, limiting access to foreign markets. Second, tariffs raise the cost of imported intermediate goods and raw materials, increasing production costs for exporters and reducing competitiveness abroad. Finally, higher tariffs alter market incentives by encouraging firms to focus on domestic markets rather than exports. Altogether, these mechanisms show how protectionist policies intended to shield domestic industries can unintentionally undermine export performance (Krugman *et al.*, 1998; Faini, 2004). In sum, the main effect of a tariff is to reduce trade volumes and, consequently, the trade openness ratio (Ostry and Rose, 1992; Faini, 2004).

Despite their documented impact, the importance of tariffs has declined in modern times, as governments increasingly use non-tariff barriers (NTBs), such as import quotas, rules of origin,

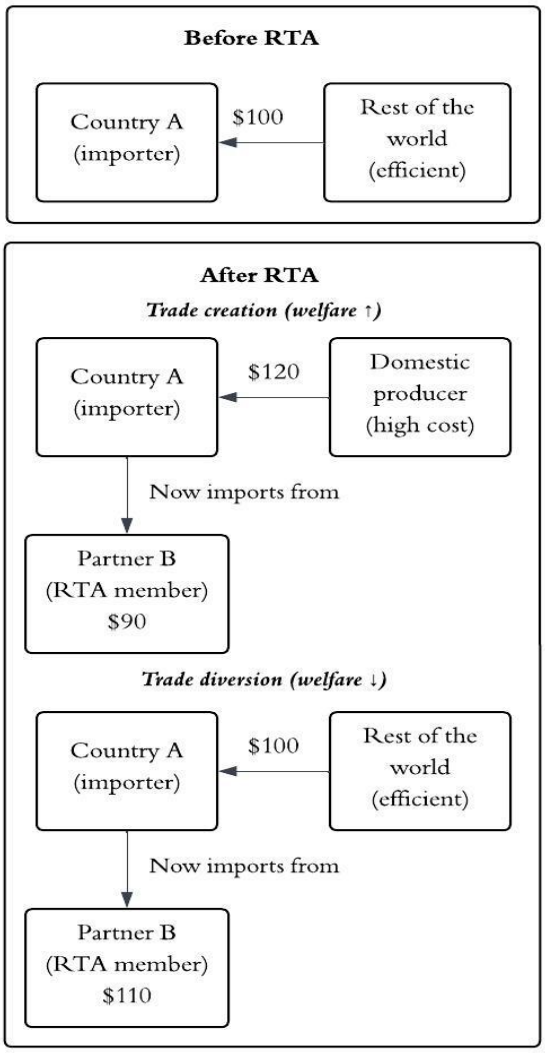
quality standards, technical barriers and export restraints (Ibragimova, 2020). Unlike tariffs, which operate strictly through the price mechanism, NTBs often work through direct physical controls. For example, import quotas impose ceilings on how much can legally enter a country, directly restricting trade volume. Similar to tariffs, quotas also raise domestic prices by limiting supply. In essence, quotas have effects similar to tariffs: they reduce trade volumes and thus trade openness (Krugman *et al*., 1998), an argument corroborated by several empirical findings (Table 1).

The decline in tariffs, as well as NTMs in some cases, is largely a feature of regionalism. The slow progress of trade liberalization under the multilateral system, due to the involvement of multiple actors, complex negotiations, and conflicting interests, has made trade agreements into one of the most widely used policy tools, one that merits distinct analysis due to its political foundations (Mayer, 1981). Their proliferation is evident in WTO data, which reports about 375 agreements in force today compared to only 20 in 1990 (Dhingra *et al*., 2023). These agreements have attracted extensive theoretical and empirical attention (Krugman, 1993; Bhagwati and Panagariya, 1996; Baldwin, 1997; Krishna, 1998; Baier and Bergstrand, 2007). They dismantle trade barriers and establish harmonized frameworks that support liberal measures, including tariff reductions and the removal of non-tariff barriers, with the primary goal of enhancing trade among participants by lowering costs and easing market access (Rodrik, 2018; Baier and Bergstrand, 2007).

The theoretical debate on Regional Trade Agreements (RTAs) originates in Viner's customs union theory (1950), which identifies two channels through which regional integration affects trade: trade creation and trade diversion. Trade creation enhances welfare by allowing countries to specialize according to comparative advantage, reallocating production toward more efficient producers, and lowering relative prices for consumers. Trade diversion, in contrast, obstructs this process, as imports shift from the most efficient global producers to less efficient partners due to discriminatory tariffs, reducing efficiency and global welfare.

Viner's (1950) framework identifies two channels through which RTAs affect trade volumes. Trade creation occurs when production shifts from high-cost domestic producers to low-cost partner producers following tariff elimination. Conversely, trade diversion occurs when imports shift from the most efficient global producers to less efficient RTA partners due to discriminatory tariff preferences. Figure 3 visualizes these two channels. In trade creation, imports shift from high-cost domestic producers to more efficient RTA partners, representing a movement toward comparative advantage. In trade diversion, imports shift from the most efficient global suppliers to less efficient RTA members due to preferential tariff treatment. Crucially, both channels increase measured trade flows among RTA members, even though their welfare implications differ. This explains why RTAs consistently show positive effects on trade openness regardless of whether creation or diversion dominates.

Figure 3. Trade creation and trade diversion effects



Source: Authors' elaboration

Beyond these static effects, integration can generate dynamic gains. Larger markets allow firms to expand output, exploit economies of scale, and innovate under stronger competition, benefits highlighted by new trade theory and especially valuable for smaller economies, which gain access to broader markets and greater efficiency. Under Viner's framework, even if trade diversion occurs, trade agreements still stimulate trade by redirecting flows rather than eliminating them. Meade (1955) extended Viner's analysis, showing that tariff reductions within a customs union lower import price, encouraging greater intra-union consumption. If demand is elastic, this increases trade among members, potentially at the expense of third-party suppliers.

Proponents of regionalism argue that RTAs, by reducing or eliminating trade barriers, enhance trade openness and act as building blocks toward multilateral liberalization (Ethier, 1998). They dismantle trade barriers and establish harmonized frameworks that support liberal measures, including tariff reductions and the removal of non-tariff barriers, with the primary goal of enhancing trade among participants by lowering costs and easing market access (Rodrik, 2018; Baier and Bergstrand, 2007). By expanding market opportunities, trade agreements allow firms to exploit economies of scale, a central insight of new trade theories, while lowering consumer prices, increasing purchasing power, and stimulating demand for tradable goods. Their impact

manifests both on the intensive margin, enhancing pre-existing trade flows, and the extensive margin, creating new trade relationships (Bureau and Jean, 2013).

Opponents, however, contend that TAs may substitute for full WTO implementation or cause trade diversion rather than trade creation, potentially interfering with multilateral trade effects. Concerns include trade diversion driven by special interests, stalled external liberalization, and the undermining of multilateralism (Srinivasan, 1998). Additionally, the proliferation of RTAs can create a complex, costly "hub-and-spoke" or spaghetti bowl structure.

Additionally, the trade-promoting outcomes of RTAs vary by agreement type, region, and implementation policies. In Latin America, regional integration positively affected trade openness between 2000 and 2020 (Santamaría *et al*., 2025), while in Africa, RTAs enhanced bilateral trade flows but overlapping memberships in multiple trade blocs complicated policy coherence (Ngepah and Udeagha, 2018). East Asian studies highlight that the ASEAN Free Trade Area (AFTA) promotes intra-member trade and facilitates trade with major partners (i.e. China, Japan, Korea, Australia, New Zealand, and India) while imposing minimal negative effects on non-members (Dianzah, 2022). Similarly, ex-post analyses of eighteen plurilateral RTAs from 1960 to 2014 show that trade creation dominates among members, while trade diversion is concentrated in American and African RTAs, with European and Asian RTAs showing stronger patterns of intra-bloc trade creation (Nguyen, 2019).

Table 1: Quantitative estimates of the impact of trade policy instruments on trade

Source	Policy instrument	Effect size
Baier & Bergstrand (2001)	10% Tariff Increase	-10% to -30% imports
Kinzius *et al*. (2019)	10% NTB Increase	-1.7% trade volume
Baier & Bergstrand (2007)	RTA Membership	+50% to +100% bilateral trade
Bureau & Jean (2013)	Preferential Margin (5-10%)	+2% per 1% margin
Walkenhorst and Yasui (2005)	1% Trade transactions costs decrease	+ USD 40 billion global welfare gains
Wilson, Mann and Otsuki (2005)	Trade facilitation measures	+ USD 377 billion merchandise trade, +9.7% total trade
Hoekman & Nicita (2011)	10% increase in NTBs	-1.7% trade
Ghodsi *et al*. (2017)	Various NTB measures	-5% and -30% trade

Source: Authors' elaboration

Against this background, the theoretical link between trade policy and openness is rather intuitive. The removal of trade barriers, whether tariffs or non-tariffs, and whether undertaken unilaterally, bilaterally, or multilaterally, directly affects trade flows through both imports and exports. The empirical case is just as clear: trade policy with all its instruments directly shapes the volume and patterns of international trade, and thus the level of trade openness. However, these policy choices are not made in a vacuum. They are the product of domestic political

contests, which make a country's stance towards trade fundamentally political (Fernández-Albertos and Manzano, 2010). This forms the next layer of our analysis.

b. The political economy of trade policy

If trade policy is the direct determinant of openness, as established in the previous section, a critical question remains: what determines the policy itself? Economic theory often prescribes liberalization as a path to aggregate welfare gains, yet the real world is replete with protectionism, targeted subsidies, and complex trade agreements that defy purely economic logic. This gap between theory and practice is the central domain of political economy.

Endogenous policy theory starts from the premise that trade policy is not crafted by external economic forces but is instead an endogenous outcome of a political process, shaped by the interaction between governments, interest groups, and citizens (Zusman and Rausser, 1992). While a normative "terms-of-trade" argument might suggest governments act as benevolent social planners who set tariffs to maximize national income, the political economy approach explains why they frequently deviate from this ideal, prioritizing political survival, electoral incentives, and the demands of powerful constituencies. To unpack this process, this section examines the political determinants of trade policy through three interconnected channels: the interests of individuals, the power of organized groups, and the constraints of the international system.

The formation of trade policy begins with individual interests. The foundational assumption of political economy is that individuals support or oppose trade policies based on their perceived impact on personal income (Lake, 2009). This creates a fundamental political problem: while free trade often enhances aggregate national welfare, it creates concentrated winners and losers. The losers, facing significant income threats, typically have a stronger motivation to organize for protection than the winners have to organize for liberalization (Olson, 1965). This dynamic was recognized early on; Adam Smith (1776) himself noted that the national interest in free trade is often subverted by collusion among businessmen.

The distributional consequences of trade are theorized through two primary models. The Heckscher-Ohlin/Stolper-Samuelson (H-O-SS) model posits that gains and losses fall along factor lines (e.g., labor vs. capital). Owners of a country's abundant factor gain from trade and support liberalization, while owners of the scarce factor lose and support protectionism (Rogowski, 1989). In contrast, the Ricardo-Viner (RV) model argues that factors are often sector-specific. Thus, the conflict is between sectors: workers and capital in import-competing industries favor protection, while those in export-oriented industries favor liberalization (Hiscox, 2002).

While societal preferences form the broad backdrop for trade politics, as argued by the median voter model, which argues that trade policy can reflect the preferences of the median voter (Mayer, 1984), the direct influence on policy is mediated through specific actors. Conventional wisdom holds that interest groups (e.g. firms, unions, and business associations) are the primary political actors, as they aggregate individual preferences and lobby on their behalf (Guisinger, 2009).

The structure of these groups is critical. Producers, who are geographically concentrated and have high stakes per capita, are easier to organize than the diffuse mass of consumers who bear the cost of protection. Consequently, producer interests consistently outweigh consumer interests in trade policy formation, a pattern evident in 19th century protectionism across Europe and the United States (Gourevitch, 1977). This collective action logic explains why unilateral liberalization is politically difficult, it mobilizes concentrated opposition from import-

competers while offering only diffuse benefits. Reciprocal liberalization, by contrast, can mobilize a countervailing force of export-oriented interests who lobby for foreign market access (Gilligan, 1997). Formal models capture this interplay between governments and interest groups. Findlay and Wellisz (1982), for instance, model protection levels as the outcome of a lobbying contest between pro- and anti-protection factions.

A key debate concerns the primary motive for contributions: to influence policy directly or to affect electoral outcomes. One perspective, advanced by Magee, Brock, and Young (1989), emphasizes electoral competition. In their model, interest groups contribute to enhance the election prospects of political parties. Parties first commit to their policy platforms, consequently, contributions do not directly alter these pre-selected policies but are intended to help the favored party win. Conversely, a competing and dominant perspective argues that the primary goal is direct policy influence. Grossman and Helpman's (1994) seminal "Protection for Sale" model formalizes this mechanism. The government maximizes:

$$G = \Sigma C_i(p) + a * W(p)$$

Where C_i represents contributions from lobby group i, W(p) is aggregate social welfare, and a captures the government's weight on public welfare relative to contributions. This framework treats trade policy as the outcome of a "menu auction" where organized interest groups offer contribution schedules contingent on policy choices (Bernheim and Whinston, 1986). The equilibrium tariff that emerges is:

$$\tau_i / (1 + \tau_i) = [(I_i - \alpha_L) / (a + \alpha_L)] * (z_i / e_i)$$

Where I_i equals 1 if industry i is organized (0 otherwise), α_L is the share of population in organized lobbies, z_i is the output-import ratio (domestic output relative to imports), and e_i is the absolute import-demand elasticity. This reveals that organized industries systematically receive higher protection, with the magnitude increasing in the output-import ratio and decreasing in the import-demand elasticity and the government's welfare weight a. In this framework, contributions are designed explicitly to sway the policy choices of those already in power.

In relation to this, a significant body of scholarship argues that the preferences of policymakers themselves can be more decisive than the demands of interest groups or voters. Pioneering work by Bauer *et al*. (1972) found that constituents rarely hold strong or communicated preferences on trade policy, concluding that the personal beliefs and ideas of politicians are often the dominant factor. This ideational perspective is further developed by Baldwin (1986) and Goldstein (1988), who contend that the core beliefs of policymakers about trade are paramount, suggesting that ideational factors can outweigh material determinants in shaping policy outcomes. This aligns with Public Choice theory, which posits that political actors, like market participants, act in their self-interest, leading to rent-seeking behavior where groups compete for protectionist policies (Buchanan, 2003).

Nonetheless, the political struggle over trade policy is not confined within national borders. In the international arena, governments face a strategic dilemma. While all countries could benefit from mutual liberalization, each has an individual incentive to protect its own market. This scenario constitutes a Prisoner's Dilemma, where the lack of guarantees about others' behavior leads to a sub-optimally protectionist equilibrium (Fernández-Albertos and Manzano, 2010). Consequently, unilateral liberalization is rare, governments are typically only willing to open their markets if others reciprocate, leading to trade agreements.

International relations theory offers two principal solutions to this problem of cooperation. First, Hegemonic Stability Theory (HST) posits that a dominant power (hegemon) can enforce

a liberal trade order. The hegemon bears the costs of maintaining the system because the benefits it derives from global openness outweigh them, effectively providing a public good (Krasner, 1976; Lake, 1988). This view was however challenged. Conybeare (1984), for instance, argued that large countries tend to favor optimal tariffs rather than free trade, even at the risk of retaliation, while Snidal (1985) suggested that cooperation can be sustained by a small number of powerful states without a single hegemon.

Second, international institutions like the GATT/WTO facilitate cooperation by making it more sustainable. They do this by extending the time horizon of interactions and providing mechanisms for monitoring compliance and resolving disputes (Keohane, 1984; Axelrod, 1984; Yarbrough and Yarbrough, 1992). The WTO's design, for instance, helps governments escape the terms-of-trade-driven Prisoner's Dilemma by structuring reciprocal, multilateral negotiations (Bagwell and Staiger, 2002).

The empirical record of the WTO reflects this complex political reality. While its purpose is to promote trade, its effects are uneven and remain debated. Some early studies found limited impacts (Rose, 2004), but subsequent research shows it significantly boosts trade for countries that engage in reciprocal tariff reductions, primarily developed members, while offering more muted benefits for developing countries (Subramanian and Wei, 2007). This is partly attributed to provisions like the Generalized System of Preferences (GSP), which enable developing countries to maintain higher tariffs while securing market access, thereby limiting liberalization incentives (Ozden and Reinhardt, 2003; Subramanian and Wei, 2007).

In light of the above discussion, trade policy can be viewed as a political artifact, shaped by the interplay of individual interests, the power of organized groups, and the strategic constraints of the international system. However, these political dynamics are themselves fundamentally structured, constrained, and enabled by a country's domestic institutional framework. It is to this foundational dimension that we now turn, exploring how institutions ultimately govern the feasibility and sustainability of trade openness.

c. The institutional foundations of trade openness

The central role of institutions in shaping trade outcomes emerged from attempts to explain why global trade volumes consistently fall short of levels predicted by standard models, giving rise to the "missing trade" puzzle (Trefler, 1995). This gap shifted attention to institutional quality as a crucial determinant of trade performance, with Rodrik *et al*. (2004) famously arguing that "institutions rule" in explaining development outcomes.

This inquiry is at the core of New Institutional Economics (NIE) (North, 1990, 1995). This institutional framework operates on two distinct but interconnected levels: economic institutions (the rules governing contracts, property rights, and business transactions) and political institutions (the structures of governance, such as regimes and electoral systems). While the former directly determine the costs and risks of international exchange, the latter fundamentally shape the quality and persistence of those economic institutions.

One of the fundamental branches of NIE, Transaction Cost Theory (Williamson, 1981), provides the crucial mechanism of the institutions-trade link. These transaction costs emerge due to the very nature of international trade, which involves activities such as searching for information, evaluating options, contracting, and coping with bounded knowledge and potential mistakes (North, 1994; Anderson and van Wincoop, 2004). Institutions reduce these costs by stabilizing interactions, creating shared expectations, and enforcing obligations.

In relation to this, Anderson and Marcouiller (2002) formalize how institutions affect trade through transaction costs, an association that can be expressed in an augmented gravity framework:

$$X_{ij} = f(Y_i, Y_j, D_{ij}, T_{ij}, Q_i, Q_j)$$

Where X_{ij} represents exports from country i to j, Y denotes GDP, D_i captures distance, T_{ij} represents tariffs and trade barriers, and Q measures institutional quality (encompassing contract enforcement and corruption control). This functional specification embeds institutions as a fundamental trade cost alongside traditional geographic and policy barriers.

Den Butter and Mosch (2003) decompose these institutional transaction costs into three stages, a stylized representation can be expressed as follows:

$$TC = TC_{search} + TC_{contract} + TC_{enforcement}$$

Where TC_{search} includes information and partner identification costs, $TC_{contract}$ covers negotiation expenses, and $TC_{enforcement}$ captures the costs of ensuring compliance across jurisdictions. The initial contact stage involves search and information costs, heightened by language barriers and divergent legal systems (Cyrus, 2015; Audu *et al*., 2022). In the contract stage, parties negotiate terms, complicated by international differences in legal and cultural systems. Finally, the control stage requires enforcing the agreement across jurisdictions. From this framework, contract enforcement emerges as a paramount influence on transaction costs (Rodrik, 2004; Anderson and Marcouiller, 2002; Anderson, 2005; Anderson and Young, 2006). Its significance is magnified in international trade, where differing legal systems and high sunk costs create risks, such as hold-up problems. Important to note, when formal institutions are weak, informal mechanisms like trust and ethnic networks can substitute for them by reducing perceived risks (Yu *et al*., 2015; Rauch and Trindade, 2002), though their importance diminishes as formal enforcement improves.

Within the transaction cost framework, corruption functions as an informal cost arising from opportunistic bureaucratic behavior. Bribes for licenses or customs clearance impose expenses that reduce trade efficiency and deter foreign partners who view corrupt countries as unreliable (Irfansyah and Wardaya, 2025). This dynamic is often fueled by restrictive regulations, which create rent-seeking opportunities. Furthermore, corruption indirectly suppresses trade by discouraging foreign direct investment and reducing capital formation, thereby undermining a country's long-term trade capacity (Rodrik, 1995). Nonetheless, while pervasive corruption generally hinders trade, it can paradoxically "grease the wheels" in overregulated economies by helping firms bypass bureaucratic hurdles, creating a perverse positive correlation between corruption and trade in such contexts (Naz *et al*., 2023).

The influence of institutions on trade operates both directly and indirectly. Directly, they shape agents' willingness to engage in cross-border exchange by reducing uncertainty and mitigating risks (Rodrik *et al*., 2004; Anderson and Marcouiller, 2002; François and Manchin, 2013; Wei, 2000). One of the most direct channels is by mitigating insecurity. Anderson and Marcouiller (2005) argue that insecurity can prevent trade despite potential mutual gains, as predation not only directly reduces traded goods but also diverts resources away from productive use toward the defense of property rights. Effective institutions can deter predation and enforce property rights, thereby fostering cross-border exchange. This includes protecting against risks such as expropriation of private property by the government, which creates profound uncertainty among producers, investors, and traders. Furthermore, transparent, impartial, and efficient regulations foster confidence and lower the uncertainty of international exchanges (Jansen and

Nordås, 2004; Anderson, 2005). Conversely, corruption, predation, and bureaucratic inefficiencies raise costs and deter trade (Wei, 2000; Faruq, 2011).

Indirectly, institutions affect economic conditions that influence trade decisions. Notably, by influencing production structures, institutions that lower specific transaction costs can change a country's revealed comparative advantage, steering specialization toward sectors supported by institutional conditions rather than those indicated by traditional models (Belloc, 2006). Better contract enforcement and regulatory quality allow countries to specialize in institutionally intensive goods, adopt more sophisticated technologies, and upgrade export structures (Levchenko, 2004, 2007; Acemoglu *et al*., 2005). By contrast, corruption, inefficient bureaucracy, and weak protection of property rights constrain export quality, investment, and innovation, locking countries into low-value-added activities (Méon and Sekkat, 2005; Faruq, 2011). Institutions also shape the broader economic environment by affecting investment, productivity, and competitiveness, which underpin trade conditions (Knack and Keefer, 1995; Olson *et al*., 2000).

Institutional similarity across countries further facilitates trade. Homogeneity in both formal rules and informal norms lowers adjustment costs, increases familiarity, reduces uncertainty and fosters mutual trust, making bilateral trade easier to initiate and sustain (De Groot *et al*., 2004). This homogeneity acts as a facilitator by lowering insecurity and transaction contingencies.

Therefore, the quality of a nation's economic institutions, which govern contract enforceability, property rights, and bureaucratic integrity, emerges as the proximate determinant of its trade performance. However, these institutional arrangements are not self-generating. They are themselves the product of a deeper, prior political process. The structure of a country's political institutions establishes the fundamental incentives for those in power: to create a predictable, pro-trade business environment that fosters long-term growth, or to engage in rent-seeking and predation that stifles exchange. It is to these foundational political structures that we now turn.

A central debate concerns the influence of political regime type, with the "regime type hypothesis" yielding a straightforward expectation: democracies should be more open to trade than autocracies (Henisz and Mansfield, 2006). This hypothesis is derived from the interaction between the Heckscher-Ohlin-Stolper-Samuelson model and the median voter theorem.

The median voter model (Mayer, 1984) provides a foundation for understanding how democratic trade policy is determined. Under majority voting, the equilibrium tariff $\tau*$ maximizes the median voter's utility, which depends on their factor ownership via the Heckscher-Ohlin framework. If the median voter owns the abundant factor, they benefit from trade and prefer free trade; if they own the scarce factor, they prefer protection.

Later literature extends this logic to a regime-type hypothesis. Democracies, by expanding voting power to all citizens and representing broader consumer and factor-owner interests, tend to exhibit systematically lower tariffs than autocracies, where policy is dominated by narrow elite producer groups. They are also facilitated by institutional structures such as checks and balances and veto points that constrain purely protectionist policies (Remmer, 1998; Bearce et al., 2022). This "optimistic" view is corroborated by a considerable body of research indicating that democracies have lower tariffs, cooperate more on trade liberalization, and trade more intensively with one another (Mansfield et al., 2000). Several mechanisms underpin this positive relationship. The stronger rule of law and better protection of property rights typical of democratic regimes create fairer markets and more effective regulations (Barro, 1996; Rigobon and Rodrik, 2004). Democratic institutions also encourage stricter enforcement of intellectual property rights, promoting innovation (Clarke, 2001). Ultimately, these features improve

confidence in exporters, thereby increasing international demand for their products (Levchenko, 2007).

Conversely, a "pessimistic approach" contends that autocratic regimes may be better positioned to implement trade reforms by shielding themselves from protectionist lobbying, while democracies might abandon reforms due to voter backlash (O'Rourke and Taylor, 2006). Verdier (1998) argues that the political conflict engendered by trade can make democracies more protectionist toward each other, except when intra-industry trade dominates. Empirical evidence supporting this view, though limited, shows that democratization can sometimes correlate with lower trade openness (Fankem, 2017).

Beyond regime type, the specific structure of political institutions critically affects policy outcomes by shaping the influence of interest groups and the capacity for decisive action. The concentration of trade policymaking power in the executive branch has been linked to trade liberalization (Haggard and Kaufman, 1995). Analyses of successful reforms show they often involved delegating authority to insulated government units, shielded from bureaucratic inertia and legislative lobbying (Haggard and Webb, 1994). However, the effect of insulation is not deterministic. While Rogowski (1987) argues that policymakers in systems with large electoral districts (e.g., PR) are more insulated and thus less protectionist, Mansfield and Busch (1995) find the opposite. Similarly, Laussel and Riezman (2001) find that delegation can, under certain conditions, lead to more protectionist outcomes. Rodrik (1997) also suggests that less autonomous and more participatory institutions may better manage exogenous shocks. This indicates that the preferences of insulated policymakers are as important as the insulation itself.

The nature of the party system is another key determinant of policy outcomes, acting principally on policy stability. Highly polarized or fragmented multi-party systems often lead to unstable or immobilized governments. Haggard and Kaufman (1995) predict that such systems are unable to initiate economic reforms, including trade liberalization, a perspective that aligns with veto-player theory (Tsebelis, 1995). The structure of government further compounds this; divided government, where different parties control the executive and legislature, is consistently linked to higher protectionism, as it creates veto points that make lowering trade barriers more difficult (Lohmann and O'Halloran, 1994). In sum, systems with "weak executives and fragmented party systems, divided government, and decentralized political structures responded poorly to crises" and were unable to mobilize support for reform (Haggard and Kaufman, 1995).

Further, the design of the electoral system exerts a significant, though contested, influence. A prominent school of thought argues that majoritarian systems are inherently more protectionist. Theoretically, Grossman and Helpman's (2005) model demonstrates a 'protectionist bias,' a finding supported empirically by Mansfield and Busch (1995) and Evans (2009), who showed majoritarian systems maintain higher tariffs than proportional representation (PR) systems. This extends to subsidies, with majoritarian systems spending more (Rickard, 2012). Conversely, an opposing line of research, drawing on the selectorate model and seat-vote elasticity theory, contends that PR systems lead to higher tariffs (Rogowski and Kayser, 2002). Rogowski (1987) adds that large electoral constituencies in PR systems encourage politicians to favor general policies like openness over narrow, locally concentrated interests.

Underpinning all these institutional features is the fundamental role of political stability. Stable political regimes provide the predictable institutional frameworks, fair legal systems, consistent policies, transparent dispute resolution, that reduce uncertainty and are essential for cross-border economic activity (Anderson and Marcouiller, 2002). Instability, in contrast, increases policy uncertainty, weakens law enforcement, exacerbates corruption, and functions as a hidden

trade barrier. Empirical evidence consistently shows that politically stable countries exhibit higher trade volumes, while instability, through unrest, terrorism, or abrupt government changes, reduces trade by raising transaction costs and discouraging investment (Alesina *et al*., 1996). Ultimately, political stability creates a secure environment that facilitates trade, while instability imposes a substantial drag on cross-border commerce.

The combined quality of a nation's economic and political institutions not only determines its domestic trade environment but also its ability to leverage the international trading system. Indeed, institutions interact powerfully with trade policies and agreements. Trade facilitation and liberalization measures yield stronger effects when embedded in solid institutional frameworks (Portugal-Perez and Wilson, 2012; Shepherd, 2016). WTO membership and RTAs enhance trade, but their effectiveness depends on domestic institutional capacity (Rose, 2005).

Ultimately, the journey from a theoretical trade potential to actual trade flows is fundamentally governed by a country's institutional architecture. While international agreements set the stage for exchange, and domestic politics creates the script, it is the underlying quality of economic institutions, themselves a product of the political system, that determines whether actors can perform their roles efficiently. From the micro-level hurdle of a contract enforced in a reliable court to the macro-level credibility offered by a stable democracy, institutions ultimately define the boundary between trade that is merely possible and trade that actually occurs. The "missing trade" is, in the final analysis, trade missing sufficient institutional support.

4. Conclusion

Trade openness is not merely a function of economic capacity or structural factors such as GDP, industrial composition, or investment levels. While these elements establish the potential for international engagement, realizing this potential follows an interdependent causal sequence: institutions structure politics, politics directs policy, and policy determines the degree of trade openness.

Institutions form the foundational layer, setting the "rules of the game" by shaping political behavior, enforcing accountability, and defining the boundaries within which policy operates. Strong legal systems, transparent governance, and effective contract enforcement make trade reforms credible and sustained, addressing the "missing trade" puzzle by lowering transaction costs. Weak institutions, by contrast, undermine policy effectiveness, increase political risk, and hinder the translation of economic potential into actual trade flows. Political dynamics, including regime type, the structure of interest group representation, and political stability, form the intermediate layer that mediates how trade policies are designed and maintained. Democracies can promote liberalization through inclusive decision-making but remain vulnerable to protectionist pressures, whereas autocracies may act decisively but often pursue reforms aligned with elite interests. Political stability, in turn, reduces uncertainty and fosters the trust essential for cross-border exchange, while instability acts as a hidden tariff. Trade policy, enacted through tariffs, non-tariff measures, and trade agreements, is the proximate mechanism through which political choices shape trade outcomes. Its effectiveness, however, is bounded by the institutional and political context in which it operates. The journey from theoretical trade potential to actual trade flows is fundamentally governed by a country's institutional architecture. While international agreements set the stage for exchange, and domestic politics creates the script, it is the underlying quality of economic institutions, themselves a product of the political system, that determines whether actors can perform their roles efficiently. From the micro-level hurdle of a contract enforced in a reliable court to the macro-level credibility offered by a stable democracy, institutions ultimately define the

boundary between trade that is merely possible and trade that actually occurs. The "missing trade" is, in the final analysis, trade missing sufficient institutional support.

The framework developed in this article makes three contributions to the literature. First, it offers a theoretically integrated analytical structure that bridges institutional economics, comparative politics, and international trade theory into a single coherent causal architecture. Second, by distinguishing between proximate determinants, intermediate determinants, and foundational determinants, it provides the kind of analytical layering that partial models lack, allowing researchers to locate specific causal mechanisms rather than treating openness as a monolithic outcome. Third, by positioning institutional quality as the ultimate structural layer that conditions both political behavior and policy credibility, the framework offers a more complete account of cross-national variation in trade openness than conventional economic or political-economy models, and equips policymakers with a diagnostic lens for identifying where in the causal chain barriers to trade performance actually originate.

While this framework establishes a clear causal hierarchy, the real world presents important nuances. Short-term policy volatility can occur even when underlying institutions remain stable, as seen when governments abruptly shift tariff policies in response to electoral pressures or external shocks. Conversely, some countries with weak institutional frameworks maintain relatively high trade openness, particularly when autocratic regimes pursue export-led growth strategies or when economic dependence on trade supersedes domestic institutional constraints. Additionally, institutional change typically unfolds gradually, creating temporal lags where political dynamics and policy choices may outpace or diverge from institutional evolution. These observations do not invalidate the framework but underscore that while institutions provide the foundational architecture for trade outcomes, the relationship between layers is dynamic rather than deterministic, and the relative weight of each layer may vary across contexts and time periods.

Overall, trade openness is a multidimensional outcome shaped as much by governance and political-institutional structures as by economic endowments. Understanding these upstream determinants is essential to explain cross-country variation in trade participation and to design policies that can translate economic potential into sustained trade engagement. Future research should examine how these layers interact dynamically over time, particularly during periods of institutional transition, external shocks, or regime change, to refine our understanding of when and how each determinant exerts its influence on trade outcomes.

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