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Rule of Law and Trade: The Case of the European Union

Keywords: rule of law, bilateral trade, European Union, investor-state arbitration

Introduction

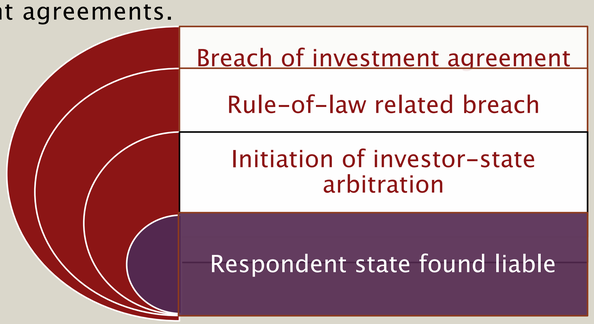
Global decline in the rule of law → **Impact on businesses and the economy** → **Sustainability of illiberal regimes**

Research Question

- Are there significant negative trade outcomes associated with the decline in the rule of law?
- Do "older" and "newer" EU countries have different trade patterns in response to the decline of the rule of law?

Study Design

With an event-based approach, I study the impact of the decline of the rule of law on bilateral trade in the European Union between 2004 and 2019 through investor-state arbitration cases. I focus on cases that found the respondent country liable for rule-of-law related breaches of investment agreements.



#	Respondent state	Case count
1	Czechia	3
2	Estonia	1
3	Hungary	6
4	Italy	3
5	Latvia	1
6	Lithuania	1
7	Poland	7
8	Slovakia	2
9	Spain	25

isolated instances of rule of law-related breaches **vs.** recurrence of rule of law-related breaches across industries

More cases = declining rule of law?

Estimation Method

Advanced gravity estimation with high-dimensional fixed effects on >190,000 observations on 22 European Union member states across 14 impacted industries.

Results

- **On average, ~7%*** decline** in exports by respondent countries in impacted industries, driven by EU member states that joined before 2004 ("older" EU countries).
- **However, >7%** increase** in exports **for repeat offenders** like Czechia, Hungary, and Poland in the impacted industries, with each additional case.

	Value of exports when a case is initiated	Value of exports with each additional case	N
Respondent countries *(vs. other countries)*	1.30%	**-6.96%***	190,142
Cross-industry repeat offenders *(vs. other countries)*	25.06%	**7.36%**	27,268
	Value of imports from *respondent* countries		
"Older" EU countries *(vs. "newer" EU countries)*	.	**-2.68%**	9,865
	Value of imports from *other* countries		
"Older" EU countries	3.46%	**-5.91%***	122,849
"Newer" EU countries	-4.72%	-9.76%	

- On average, "older" EU countries import significantly less from respondent countries compared to imports by "newer" EU countries (by ~3%**) and compared to their imports from other exporters (by ~6%***).

Implications

- Number of rule-of-law related cases matters more for bilateral trade than the recurrence of rule-of-law related breaches across industries that reflects a decline in the rule of law.
- Countries with declining rule of law get away with it from a trade perspective.

→ I find no evidence that bilateral trade incentivizes upholding the rule of law or, thus, that it facilitates a positive relationship between the rule of law and economic growth.

- Need for further research to expand geographical scope and set of economic outcomes.

Tools for Deterrence?

- Temporary export limitations on cross-industry repeat offenders in impacted industries with each additional rule-of-law related breach.
- Progressive penalty regime with each additional rule-of-law relate breach, once arbitral tribunal establishes the respondent country's liability.

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