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BLOCKING PROGRESS

The damaging side effects of economic sanctions

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Executive summary

- During the twentieth century, economic sanctions became more prevalent. In the twenty-first century they have become a frequently used tool for governments seeking to change the behaviour of other countries.

- An extensive research literature exists on the effectiveness of sanctions. Overall the research shows that sanctions very rarely achieve foreign policy goals. At the same time, sanctions create negative externalities.

- Sanctions limit the economic well-being of people in targeted countries, in some cases leading to malnourishment or even starvation. They also undermine economic and civil liberties, instead encouraging centralised state control.

- While sanctions are often aimed at destabilising governments, people in sanctioned countries often turn to their government when the country is isolated from the global marketplace. The sanctions on Russia in early 2014 coincided with Vladimir Putin's popularity rising from an all-time low to an all-time high point.

- The sanctions against Russia have led to a trade loss estimated at US$114 billion, with US$44 billion borne by the sanctioning Western countries. In percentage terms, Germany bears almost 40 per cent of the Western trade loss, compared with just 0.6 per cent incurred by the United States.

- Two wealthy countries that are neutral in sanctions against Russia – Israel and Switzerland – have experienced a trade loss of 25 per cent between 2014 and 2016. This is nearly as high as the 30 per cent trade loss of the largest four sanctioning economies. Since sanctions undermine global value chains, neutral third-party countries are also hurt.

- Fostering global value chains is a better strategy for promoting security, since economic interdependency makes peace a more attractive alternative than conflict. Market exchange is typically a better option than sanctions if the objective is a free, peaceful and prosperous world.

Introduction

Economic sanctions have become an increasingly popular tool in foreign affairs since the end of the Cold War. The concept of economic sanctions is not new. In fact, 2,400 years ago Athens declared a trade embargo on the neighbouring city state of Megara, strangling the city's trade. Powers with naval dominance, such as the British Empire, used trade blockades during times of war. However, while sanctions were a known policy tool, they were seldom systematically used until modern times (Cashen 2017). During the twentieth century sanctions become more prevalent, and in the twenty-first century their position as a popular foreign policy tool has solidified.

This paper argues that this reliance on sanctions is a mistake. Sanctions generally do not achieve the underlying objectives, while they create substantial costs for the world economy. In addition, sanctions reduce economic and civil liberties, and by disrupting global value chains undermine peaceful relations.

Economic sanctions usually aim at either signalling dissatisfaction with particular policies, constraining the sanctioned nation or its leaders from further action, or to act as a coercive measure towards a government in an attempt to reverse its actions. Sanctions can severely undermine prosperity in countries when the 'international community' joins together in isolating them. In 1966, the United Nations for the first time introduced comprehensive sanctions against Rhodesia. Eleven years later similar measures were enforced against South Africa. These policies were directed at undermining white supremacy rule, an aim which seems to have been accomplished. These sanctions policies were successful due to the context in which they were introduced. Rhodesia and South Africa were countries governed by apartheid rule, and the large majority of the population were discriminated against due to the colour of their skin. Many whites also strongly objected to apartheid. A similarity can be drawn to Ronald Reagan's escalation of the Cold War, which arguably accelerated the fall of the Soviet Union. In both cases, pressure was put on systems already on the brink of collapse.

During the Cold War period, sanctions were still relatively uncommon. If the West isolated a nation economically, it ran the risk of turning that nation over to the Soviet bloc. Rhodesia and South Africa were obviously the exception, since they were rejected by both blocs due to their racist policies. When the Cold War ended, Western powers gained both military and economic dominance and hence could apply sanctions policies more frequently without as many geopolitical risks. However, contrary to the early experience with apartheid states, sanctions overall proved to be less than effective.

Sanctions rarely achieve their goals

Extensive research has been carried out on the outcome and impact of economic sanctions, with different claims over their results. The Oxford Reference overview article on economic sanctions states that ‘There is considerable disagreement over their effectiveness. Critics point out that they are easily evaded and often inflict more pain on those they are designed to help than on the governments they are meant to influence’[1]. The first major wave of research on the effects of economic sanctions was published during the 1960s and 1970s. The consensus of these papers, as summarised by Baldwin (1985: 373), was that sanctions were not as effective as military force.

The debate is not one-sided, as for some time there was academic enthusiasm about sanctions. According to Rogers (1996: 72), ‘Economic sanctions are more effective than most analysts suggest. Their efficacy is underrated in part because unlike other foreign policy instruments sanctions have no natural advocate or constituency’. An influential study by Hufbauer, Schott and Elliot (1990) was for some time seen as proof that sanctions were an effective tool to achieve policy change in foreign countries. The researchers examined 115 identified cases of sanctions between 1914 and 1990, and concluded that sanctions achieved their foreign policy goals in 40 of them.

In a widely cited study, Pape (1997) examined these 40 cases and concluded that only five of them involved a success for sanctions policy. Thus, four per cent rather than 35 per cent of the cases examined were a success for sanctions policy. Of the remainder, eighteen were determined by force (military defeats, governments being overthrown, etc.) rather than sanctions, eight were failures in which the target state did not concede to the coercer´s demands, six were trade disputes, and three remained undetermined.

For example, the sanctions against Germany during World War I and against Germany and Japan during World War II had been counted as having achieved their goals in the Hufbauer et al. study. However, Pape

[1] http://www.oxfordreference.com/view/10.1093/oi/authority.20110803095741439

argues that both cases were won by military force. During World War I, for example, the food shortage linked to the British blockade led to the starvation of around 500,000 Germans. But the country continued to fight until militarily defeated. Another example is Rafael Trujillo, the president of the Dominican Republic, who was a protégé of the United States. His regime was seen as an embarrassment due to its repressive actions, and the US acted to remove him from power. As part of this policy, tariffs were imposed on Dominican sugar, while oil, trucks and military spare parts were embargoed. Pape challenges the conclusion of Hufbauer et al. that this was a successful case for sanctions, since the issue was resolved when the president was assassinated and his family driven out of the country. Pape concedes that sanctions in themselves have occasionally achieved foreign policy goals, such as when India imposed sanctions on Nepal in 1989 and when the US imposed sanctions against Poland in 1981. However, these are rare cases.

Although rare, the successes of sanctions policies are worth exploring. In 1989, India imposed a trade blockade on Nepal over a dispute about transit treaties and uneasiness over Nepal's increased closeness with China. Since Nepal is a landlocked nation, it imports all of its petroleum supplies from India. The urgent fuel crisis brought on by the sanctions forced Nepal to introduce the policy changes desired by India. In 2015 Nepal accused India of having imposed a new undeclared blockade, which cut off fuel supplies and thus caused an economic and humanitarian crisis. The blockade forced Nepal to introduce constitutional amendments relating to the minority community of Indian origin in the country. Thus, it seems that India has achieved its aims through sanctions more than once. This is not surprising since the conditions and aims of the sanctions were similar in both cases.

Another case is the sanctions that the US and other Western countries imposed on Poland in 1981, in order to push for political change. Specifically, the sanctions were imposed after the martial-law crackdown of the Polish state on the Solidarity trade union. The sanctions had a major effect on Poland's economy and seem to have influenced politics. The Solidarity movement was ultimately successful in helping to transform Poland from Marxism to democracy and a market economy.

There are also some new studies in favour of sanctions, though the consensus is still against them. Marinov (2005: 564) concludes that: 'There is much pessimism on whether [sanctions] ever work. This article shows that economic pressure works in at least one respect: it destabilizes the leaders it targets'. In an empirical analysis, Dashti-Gibson, Davis and Radcliff (1997) reach a similar conclusion. According to this study, sanctions are able to destabilise countries, and financial sanctions in particular may achieve other goals. However, even with this form of more successful sanctions policy, the authors find a modest downward trend over time in the relative effectiveness. Drezner (2003) notes that most scholars consider sanctions an ineffective tool of statecraft. By taking into account unrealised threats of sanctions, Drezner shows that the bulk of successful economic coercion episodes are those in which the threat of sanctions leads to a policy change.

Sanctions limit economic and social liberty, instead encouraging state control

On the other hand, one must also consider that sanctions not only limit the economic well-being of people in the targeted country (in some cases leading to malnourishment or even starvation), but may also reduce economic and civil liberties. By doing so, they undermine the free exchange which breeds global prosperity and peaceful relations.

Peksen and Drury (2010) used a time-series cross-national dataset of sanctions over the period 1972 to 2000 to study the effectiveness of sanctions in reaching their goals. The authors concluded that ‘both the immediate and longer-term effects of economic sanctions significantly reduce the level of democratic freedoms in the target’ (ibid: 240). This occurs through reduced political rights as well as reduced civil liberties in the sanctioned state.

One illustrative example is the sanctions policy imposed on North Korea. World powers have relied on economic and financial sanctions to isolate the North Korean regime and force it into denuclearisation discussions. However, as the Council on Foreign Relations explains, it is doubtful if sanctions have reached their goals and if they ever will (Albert 2018). In fact, these policies have pushed North Korea to stick to a centrally planned command economy. Fortunately, there have been some openings for North Korea to trade with China and to a limited degree also South Korea. Gradually the North Korean state has incorporated some elements of free markets into its economic model, a change which has brought about a quiet social revolution (Kranz 2017). North Korea is still an authoritarian and brutal state, but the shift towards a market economy is nonetheless positive – it has for example reduced starvation. Recently, North and South Korea signed the Panmunjom Declaration for Peace, Prosperity and Unification of the Korean Peninsula. This historic document represents a move towards peace in one of the longest global conflicts; a conflict which could result in nuclear war. An important part of the deal between the two Korean states is about fostering trade links. A question worth asking is: what if North Korea had not been exposed to international sanctions? It is likely that the state would have pushed for market integration at an earlier stage and also to a greater extent. It is also likely that the leadership of the country would have been less rather than more hostile towards the rest of the world.

Sometimes sanctions achieve certain goals, for example undermining the finances of a regime, while also creating massive unintended effects. A famous example is the economic sanctions directed against Saddam Hussein's Baathist regime in Iraq. A near-total trade and financial embargo was imposed by the UN Security Council four days after Iraq's invasion of neighbouring Kuwait. There is a general consensus that the sanctions achieved their goal of limiting the military development of Iraq, but also that the sanctions created poverty and malnutrition among the civilian population. According to UNICEF, per capita income in Iraq dropped from $3510 in 1989 to $450 in 1996 (Sen 2003). People's living standards collapsed.

Free exchange fosters peace

Some 4,000 years ago, the first tamkarum entrepreneurs of the world emerged in Iraq and neighbouring Syria. During the early middle ages, the free-market renaissance of the Islamic Golden Age was focused on Baghdad. In part, this tradition of enterprise lived on even during modern times. Before the UN sanctions were introduced, Iraq still had elements of a developed economy and a well-educated middle class. The country could have built upon this, and its entrepreneurial culture, to become more prosperous. Instead, due to global isolation the country's economy collapsed. Educated people left Iraq as job opportunities became scarce. So, the sanctions did not topple Saddam Hussein, but did significantly limit the ability of people to benefit from market forces.

Iran also has a millennia long story of enterprise. The first known account of specialisation in a marketplace was given by Xenophon two thousand years before Adam Smith, and was based on the accounts of the marketplace of ancient Persia. In the sixteenth century, a Portuguese account describes the impressive amount of sophisticated agricultural and industrial goods for sale at the port of Hormuz, described as a free marketplace. Iran, Iraq and Syria all have deep traditions of enterprise and global exchange that could be tapped, but for this to happen trade routes must be open.

The importance of market commerce for long-term stability is often neglected. Yet, trade and commerce are often the alternative to conflict. Sanctions can break the link of the targeted nation to the global marketplace. Goods that used to be imported are suddenly in short supply, and those who work in exporting firms might lose their jobs. The government therefore intervenes to ensure that the immediate crisis is addressed. The country turns away from market freedom towards state intervention, and the people begin to view the rest of the world with suspicion. In the case of Iraq, the people ultimately turned not only to state reliance but also to tribal society and feuding militias. Sanctions thus induced future instability. If the Iraqis had been able to trade with the world, it is doubtful if groups such as ISIS would have found a breeding ground in the country.

Putin’s popularity increased when Russia was sanctioned

One aim of sanctions is to destabilise governments, inspired by the regime changes in Rhodesia and South Africa. However, these were unusual cases, in which the vast majority of the populations suffered from white supremacy rule and naturally viewed the state with suspicion. In countries where the bond between the ruling classes and the population is stronger, sanctions can have the opposite effect by expanding the rulers’ grip over society.

A topical case is the sanctions introduced against Russia in early 2014, which have since expanded, at least from the US. These sanctions were implemented after Russia intervened in Ukraine. One concern raised in a report from the Centre for European Policy Studies is that the sanctions actually facilitate what they are designed to combat – they make Putin more popular, not less (Dolidze 2015). The mechanism through which this happens is that average Russians deem the sanctions imposed by the rest of the world to be unfair, siding with their own government position. The report states: ‘it seems that the “unfair” western sanctions have had the perverse effect of increasing Putin’s popularity – at the start of the Ukraine crisis in November 2013 to the present, his ratings have risen from an ever-low to an ever-high point’.

In the last Presidential elections, held in March this year, Putin won re-election for his second consecutive term in office with 77 per cent of the vote. Although these numbers are not reliable, and some opposition candidates were blocked, it still seems that Putin currently holds strong approval ratings. The support comes as no surprise. One should remember that people above all else are motivated by self-interest for themselves and their families. If the US imposes sanctions which significantly increase the cost of putting food on the table for your family, you are not likely to hold a positive view of US policies.

The US recently began to target businesspersons as a way of broadening the scope of sanctions. Earlier this year, the US Treasury published a list of 96 businessmen of Russian origin. The unusual element to this was that this list was not focused on political or criminal activity; it was compiled according to wealth, based on the yearly wealth index published by Forbes. The list even includes businesspersons living in exile and in fear of persecution after falling out with the Russian state.

In theory, the sanctions against Russia are targeted on a few sectors and towards the firms owned by the political elite of the country. The reality is, however, far from the intended design of the sanctions. The inherent complexity of a world economy made up of global value chains has resulted in significant unintended consequences, which not only hurt the Russian population, but also European economies, and even those Western economies which have not participated in the sanctions policies.

Trade losses from sanctions against Russia

Crozet and Hinz (2017) analyse the friendly-fire effect of the Russian sanctions and the counter-sanctions imposed by Russia. The authors study monthly trade data from 78 countries, as well as firm-level data, to estimate the actual impact of the sanctions. The authors find that the sanctions have led to a total trade loss of US$114 billion, with US$44 billion borne by sanctioning Western countries. Out of the loss borne by the sanctioning countries, 90 per cent is incurred by EU member states. Germany is particularly badly affected, while the US, which has been the main diplomatic force pushing for the sanctions, only bears a small share of the cost. In percentage terms, Germany bears almost 40 per cent of the Western trade loss, compared with just 0.6 per cent incurred by the US.

In a recent study, Dennis Avorin and I look more closely at the friendly-fire effect of sanctions policy. We focus on the two Western economies that did not participate in the policy to impose sanctions on Russia (Sanandaji and Avorin 2018). One might imagine that the two countries, Switzerland and Israel, would have massively increased their trade with Russia – since the sanctions hinder Russia from trading with other Western economies. The trade data between 2014 and 2016 suggest that the opposite is true. Exports to Russia fell by around 25 per cent in the two non-sanctioning economies. This is nearly as high as the 30 per cent drop in exports experienced on average by the four largest economies engaged in the sanctions (US, Japan, Germany and UK). Between February 2014 and December 2016, we estimate that Israel had a trade loss with Russia amounting to US$680 million, while the loss for Switzerland was US$2.38 billion.

Of course, correlation and causation are two different things. It is difficult to separate the effect of reduced trade brought on by sanctions and the effect brought on by the fall in the Ruble (which in turn does reflects sanctions, but also other important economic drivers such as lower oil prices). Yet, the observation that the loss in trade was almost of the same magnitude in sanctioning and non-sanctioning economies is still important, not least because one might have expected Russia to turn to trading with Switzerland and Israel as an alternative to the other Western countries. Third parties are obviously hurt by unintended consequences.

This provides an important lesson. When the global value chains that connect people and businesses together in the modern world economy are disrupted, massive unintended losses are created. Countries that in theory are neutral are also significantly affected. As a tool for foreign policy, sanctions may have their use. But their cost in practice is much higher than was originally intended. As the nineteenth-century economist Otto T. Mallery wrote: ‘If goods don’t cross borders, soldiers will’. This is, of course, even more relevant in the modern global economy in which global value chains create substantial interdependency between nations. Sanctions policies which exclude countries from trade with Western economies through unintended consequences reduce peaceful interdependence and thus undermine long-term global security.

A greater understanding of the history of capitalism as an institution might be useful in this regard. A commonly held view today is that the market economy is a recent invention of the Western world. In fact, for much of the last four millennia, the Middle East has alongside China and India been a free-market centre of the world, with advanced manufacturing, financial institutions and global trade. The periods characterised by market exchange have also been quite peaceful. Peaceful market exchange between the East and the West continued until the beginning of the eighteenth century, when the British Empire introduced sanctions against the industrial goods of Persia, India and China.

The motive was to foster Britain’s own industrial development. Instead of peaceful market exchange, a more aggressive form of colonial capitalism was to dominate. When later the same countries turned towards state planning, this was in large part motivated by the fact that the market economy had become associated with foreign colonialism. These embargoes, associated with the British industrial revolution, moved economic policies in the great eastern civilisations away from the market economy – and thus had a significant effect on world politics. Shutting out countries from the global marketplace is not conducive to free markets or free societies.

Russia, likewise, is today associated in the West with state planning and the Soviet period. Yet, the country has a long history of peaceful trade. The Novgorod Republic, a predecessor to modern Russia, was a merchant republic. Until the communist revolution, Russia had deep trade relations with Europe and even the US. After the fall of communism, the country could have moved towards a market-friendly model. Relatively recently, there was interest in implementing market reforms inspired by Chicago School economists. The personal income tax rate in Russia is a flat 13 per cent, while the top corporate tax rate is 20 per cent. In these regards, at least, the country is quite market-oriented. However, corruption and bad governance hindered moves towards a market economy and an oligarch-dominated economy developed instead. We cannot however disregard the effect of sanctions. When sanctions are imposed on a country, it is likely to turn away from economic freedom and towards central planning. In fact, even the threat of future sanctions will favour central planning. The simple reason is that an economy is in great trouble if it is reliant on foreign goods and sanctions are introduced. Better then to rely on state enterprises or enterprises run by oligarchs with close links to the state leadership.

There is still hope for countries such as Russia. The Index of Economic Freedom finds that Russia is a relatively free-market country when it comes to business freedom, trade freedom, tax burden and fiscal health. The weaknesses of the system are, amongst others, lack of protection for private property and low freedom for investors. The government of Russia would have stronger incentives to improve these weaknesses if the country were more integrated into global trade and investment networks.

A last point about sanctions is that they became popular when the Soviet bloc fell. The western world gained economic dominance and the US in particular started using this dominance to pursue foreign policy goals. Today, however, China, India and other countries are rising as prosperous world economies. If the West pushes countries away through sanctions, they will become more dependent on trade with China and India instead. The West ultimately isolates itself, not only the sanctioned economies. The point is not that sanctions are always the wrong policy, but that they should be used with regard for their considerable friendly-fire effects. In addition, a key aim of foreign policy should be to include more and more countries in free global trade. Linking the world together in advanced global value chains is the best strategy for future peace and prosperity.

[2] https://www.heritage.org/index/

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