Trade Policy Reform as Institutional Reform[1]

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August 2000

Economists are trained to think about trade policy reform in terms of changes in the levels of tariffs (t) and quantitative restrictions ($\bar{q}$), and the shifts in relative prices brought about by these alterations. They use economic models, supplemented by quantitative estimates of elasticities, to analyze the implications of changes in t and $\bar{q}$ for production, consumption, and trade. By tweaking their models sufficiently, they can also predict the likely impacts on employment, poverty and distribution, macroeconomic balances, and the government budget. If they are ambitious (reckless?), they will also pass judgement on dynamic efficiency, technological progress, and long-run economic growth.

Policy makers often have a different perspective on trade reform. For them, the actual changes in tariff schedules are typically only a small part of the process. What is at stake is a deeper transformation of the patterns of behavior within the public sector, and of the government's relationship with the private sector and the rest of the world. The reform goes beyond particular levels of t and $\bar{q}$; it sets new rules and expectations regarding <u>how</u> these policy choices are made and implemented, establishes new constraints and opportunities for economic policy more broadly, creates a new set of stakeholders while disenfranchising the previous ones, and gives rise to a new philosophy (alongside a new rhetoric) on what development policy is all about. Hence, trade reform ends up being much more than a change in relative prices: it results in institutional reform of a major kind.

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[1] This paper has been prepared for a Handbook on "Developing Countries and the Next Round of WTO Negotiations," edited by Bernard Hoekman and dedicated to Mike Finger. It draws heavily on several earlier papers,

In the language of economics, institutional reform changes not only policy parameters, but also behavioral relationships. Correspondingly, the resource-allocation and dynamic consequences of trade reform become harder to discern with the type of analysis that is the applied economists' stock in trade. Household behavior and investment decisions get altered in a way that is difficult to track in the absence of knowledge about the "deep parameters" of the economy. When the reform is well-designed and consistent with the institutional needs of the economy, it can spur unexpected levels of entrepreneurial dynamism and economic growth. When it is not, it can result in a stagnation that will appear surprising.

Viewing trade reform as institutional reform helps clarify the criterion with which trade reform should be evaluated. My main argument in this chapter is that the relevant criterion is neither openness to trade nor consistency with existing WTO rules.[2] The yardstick that matters is the degree to which trade reform contributes to the construction of a high-quality institutional environment at home. My working hypothesis, supported by empirical evidence to which I will refer below, is that a high-quality institutional environment has greater economic payoffs than a liberal trade regime or adherence to WTO rules.

In practice, there may be some important spillovers among these objectives. To cite an important illustration, a free-trade regime is likely to reduce the corruption and rent-seeking associated with trade interventions. Similarly, tariff bindings under the WTO may generate greater predictability in incentives and solidify property rights, two important attributes of a high-quality institutional framework. But while free trade and/or WTO rules can contribute to

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in particular Rodrik (1999a, 1999b, and 2000).

[2] It should go without saying that openness to trade and adherence to WTO rules are not the same thing. A country can follow free trade policies without being a member of the WTO, and many WTO rules are at variance with free trade (as in the case of anti-dumping, safeguards, and regional agreements).

the emergence of high-quality institutions, these are not one and the same. Institutional development takes time, and often requires unorthodox and divergent choices. Some of the most spectacular cases of development in the postwar period have been the product of gradualist, two-track modes of institutional reform (Rodrik 1999a). The type of investments in institution-building required for full adherence to WTO agreements on, say, customs valuation or IPRs, may not be the first order of business for low income countries with more urgent needs (Finger and Schuler 1999). Since human resources, administrative capacity, and political capital are scarce, especially in developing countries, policy makers need to have a good sense of the priorities.

An implication of this line of reasoning is that we should think of the trade regime and WTO rules as being at the service of developing countries' institutional needs, and not vice versa. Governments that understand this are the ones that are likely to make the most out of trade reform.

Institutional Prerequisites for Development[3]

Price reforms--in external trade, in product and labor markets, in finance, and in taxation--were the rallying cry of the reformers of the 1980s, along with macroeconomic stability and privatization. By the 1990s, it became clear that incentives would not work or generate perverse results in the absence of adequate institutions. Three sets of disparate developments conspired to put institutions squarely on the agenda of reformers. One of these was the dismal failure in Russia of price reform and privatization in the absence of a supportive legal, regulatory, and political apparatus. A second is the lingering dissatisfaction with market-oriented reforms in Latin America and the growing realization that these reforms have paid too little attention to

[3] This section relies heavily on Rodrik (1999a).

mechanisms of social insurance and to safety nets. The third and most recent is the Asian financial crisis which has shown that allowing financial liberalization to run ahead of financial regulation is an invitation to disaster. A number of recent empirical studies have highlighted the importance of high-quality institutions in shaping economic performance (see especially Haufmann, Kraay, and Zoido-Lobaton [1999], and Acemoglu, Johnson, and Robinson [2000]).

Following Lin and Nugent (1995, 2306-2307), it is useful to think of institutions broadly as "a set of humanly devised behavioral rules that govern and shape the interactions of human beings, in part by helping them to form expectations of what other people will do." All well functioning market economies are "embedded" in a set of non-market institutions, without which markets cannot perform adequately. I will highlight below five types of market-supporting institutions in particular: property rights; regulatory institutions; institutions for macroeconomic stabilization; institutions for social insurance; and institutions of conflict management. I emphasize as well the variety of institutional setups that is compatible with superior economic performance.

Property rights. As North and Thomas (1973) and North and Weingast (1989), among many others have argued, the establishment of secure and stable property rights have been a key element in the rise of the West and the onset of modern economic growth. It stands to reason that an entrepreneur would not have the incentive to accumulate and innovate unless s/he has adequate control over the return to the assets that are thereby produced or improved. Note that the key word is "control" rather than "ownership." Formal property rights do not count for much if they do not confer control rights. By the same token, sufficiently strong control rights may do the trick even in the absence of formal property rights. Russia today represents a case where shareholders have property rights but often lack effective control over enterprises. Township and village enterprises (TVEs) in China are an example where control rights have spurred entrepreneurial activity despite the absence of clearly defined property rights.

As these instances illustrate, establishing "property rights" is rarely a matter of just passing a piece of legislation. Legislation in itself is neither necessary nor sufficient for the provision of the secure control rights. In practice, control rights are upheld by a combination of legislation, private enforcement, and custom and tradition. They may be distributed more narrowly or more diffusely than property rights. Moreover, property rights are rarely absolute, even when set formally in the law. Each society decides for itself the scope of allowable property rights and the acceptable restrictions on their exercise. Intellectual property rights are protected assiduously in the United States and most advanced societies, but not in many developing countries. On the other hand, zoning and environmental legislation restricts the ability of households and enterprises in the rich countries to do as they please with their "property" to a much greater extent than is the case in developing countries. All societies recognize that private property rights can be curbed if doing so serves a greater public purpose. It is the definition of what constitutes "greater public purpose" that varies.

Regulatory institutions. Markets fail when participants engage in fraudulent or anti-competitive behavior. They fail when transaction costs prevent the internalizing of technological and other non-pecuniary externalities. And they fail when incomplete information results in moral hazard and adverse selection. Economists recognize these failures and have developed the analytical tools required to think systematically about their consequences and possible remedies. Theories of the second best, imperfect competition, agency, mechanism design, and many others offer an almost embarrassing choice of regulatory instruments to counter market failures.

Theories of political economy and public choice offer cautions against unqualified reliance on these instruments.

In practice, every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in goods, services, labor, asset, and financial markets. A few acronyms form the U.S. will suffice to give a sense of the range of institutions involved: FTC, FDIC, FCC, FAA, OSHA, SEC, EPA, and so on. In fact, the freer are the markets, the greater is the burden on the regulatory institutions. It is not a coincidence that the United States has the world's freest markets as well its toughest anti-trust enforcement. The lesson that market freedom requires regulatory vigilance has been driven home recently by the experience in East Asia. In South Korea and Thailand, as in so many other developing countries, financial liberalization and capital-account opening led to financial crisis precisely because of inadequate prudential regulation and supervision.

In developing countries, with pervasive market failures, regulatory institutions may need to extend beyond the standard list covering anti-trust, financial supervision, securities regulation, and the like. Recent models of coordination failure and capital market imperfections[4] make it clear that strategic government interventions may often be required to get out of low-level traps and elicit desirable private investment responses. The experience of South Korea and Taiwan in the 1960s and 1970s can be interpreted in that light. The extensive subsidization and government-led coordination of private investment in these two economies played a crucial role in setting the stage for self-sustaining growth. It is clear that many other countries have tried and failed to replicate these institutional arrangements. And even South Korea may have taken a good thing too far by maintaining the cozy institutional linkages between the government and

[4] See Hoff and Stiglitz (1999) for a useful survey and discussion.

chaebols well into the 1990s, at which point these may have become dysfunctional. Once again, the lesson is that desirable institutional arrangements vary, and that they vary not only across countries but also within countries over time.

Institutions for macroeconomic stabilization. Markets are not necessarily self-stabilizing. Keynes and his followers worried about shortfalls in aggregate demand and the resulting unemployment. More recent views of macroeconomic instability stress the inherent instability of financial markets and its transmission to the real economy. All advanced economies have come to acquire fiscal and monetary institutions that perform stabilizing functions, having learned the hard way about the consequences of not having them. Probably most important among these institutions is a lender of last resort--typically the central bank--which guards against self-fulfilling banking crises.

There is a strong current within macroeconomics thought that disputes the possibility or effectiveness of stabilizing the macroeconomy through monetary and fiscal policies. There is also a sense in policy circles, particularly in Latin America, that fiscal and monetary institutions--as currently configured--have added to macroeconomic instability, rather than reduced it, by following pro-cyclical rather than anti-cyclical policies. These developments have spurred the trend towards central bank independence, and helped open a new debate on designing more robust fiscal institutions. Some countries (Argentina being the most significant example) have given up on a domestic lender of last resort altogether by replacing their central bank with a currency board. The debate over currency boards and dollarization illustrates the obvious, but occasionally neglected fact that the institutions needed by a country are not independent of that country's history.

Institutions for social insurance. One of the liberating effects of a dynamic market economy is that it frees individuals from their traditional entanglements--the kin group, the church, the village hierarchy. The flip side is that it uproots them from traditional support systems and risk-sharing institutions. Gift exchanges, the fiesta, and kinship ties--to cite just a few of the social arrangements for equalizing the distribution of resources in traditional societies--lose much of their social insurance functions. And the risks that have to be insured against become much less manageable in the traditional manner as markets spread. A modern market economy is one where idiosyncratic (i.e., individual-specific) risk to incomes and employment is pervasive.

The huge expansion of publicly provided social insurance programs during the 20th century is one of the most remarkable features of the evolution of advanced market economies. In the United States, it was the trauma of the Great Depression that paved the way for the major institutional innovations in this area: social security, unemployment compensation, public works, public ownership, deposit insurance, and legislation favoring unions. In Europe, the roots of the welfare state reached in some cases to the tail end of the 19th century. But the striking expansion of social insurance programs, particularly in the smaller economies most open to foreign trade, was a post-World War II phenomenon. Social insurance need not always take the form of transfer programs paid out of fiscal resources. The East Asian model, represented well by the Japanese case, is one where social insurance is provided through a combination of enterprise practices (such as lifetime employment and enterprise-provided social benefits), sheltered and regulated sectors (mom-and-pop stores), and an incremental approach to liberalization and external opening.

Social insurance legitimizes a market economy because it renders it compatible with social stability and social cohesion. However, the existing welfare states in Western Europe and the United States engender a number of economic and social costs--mounting fiscal outlays, an "entitlement" culture, long-term unemployment--which have become increasingly apparent. Partly because of that, developing countries, such as those in Latin America that adopted the market-oriented model following the debt crisis of the 1980s, have not paid sufficient attention to creating institutions of social insurance. The upshot has been economic insecurity and a backlash against the reforms. How these countries will maintain social cohesion in the face of large inequalities and volatile outcomes, both of which are being aggravated by the growing reliance on market forces, is an important question without an obvious answer.

Institutions of conflict management. Societies differ in their cleavages. Some are made up of an ethnically and linguistically homogenous population marked by a relatively egalitarian distribution of resources. Others are characterized by deep cleavages along ethnic or income lines. These divisions often hamper social cooperation and engender social conflict. Economists have used models of social conflict to shed light on questions such as: why do governments delay stabilizations when delay imposes costs on all groups? why do countries rich in natural resources often do worse than countries that are resource-poor? why do external shocks often lead to protracted economic crises that are out of proportion to the direct costs of the shocks themselves?

Healthy societies have a range of institutions that make such colossal coordination failures less likely. The rule of law, a high-quality judiciary, representative political institutions, free elections, independent trade unions, social partnerships, institutionalized representation of minority groups, and social insurance are examples of such institutions. What makes these arrangements function as institutions of conflict management is that they entail a double "commitment technology:" they warn the potential "winners" of social conflict that their gains will be limited, and assure the "losers" that they will not be expropriated. They tend to increase the incentives for social groups to cooperate by reducing the payoff to socially uncooperative strategies.

Trade Policy and Institutional Reform

What is the link between trade policy reform and these institutions?[5] Trade reform often entails the importation of institutions from abroad. Sometimes this is the outcome of deliberate policy actions to “harmonize” a country’s economic and social institutions with those of the trade partners. Membership in the WTO, for example, requires the adoption of a certain set of institutional norms: non-discrimination in trade and industrial policies; transparency in the publication of trade rules; WTO-consistent patent and copyright protection; and so on. Similarly, membership in the European Union requires the adoption of wide-ranging legal and bureaucratic requirements set down in Brussels.

At other times, institutional arbitrage is the result of the working out of market forces. Mobility of employers around the world, for example, makes it harder to tax corporations, and tilts national regimes towards the taxation of “non-traded” goods and factors (such as labor). Financial integration raises the premium for macroeconomic stability and makes central-bank independence look more desirable. Finally, openness can change national institutions by altering the preferences that underlie them. Civil liberties and political freedoms are among the most

[5] The paragraphs that follow are drawn from Rodrik (1999b), chap. 2.

important imported concepts in the developing world; the demands for democracy to which these ideas give rise are a direct product of openness in this broad sense.

Arbitrage in markets for goods and capital, in the absence of second-best complications, is associated with normatively desirable outcomes; arbitrage increases efficiency. One cannot make the same presumption where arbitrage in institutions is concerned. There are no theorems that state that institutional convergence, harmonization, or "deep integration" through trade is inherently desirable. While many of the examples cited above involve outcomes that are desirable (greater democracy for instance), not all possible outcomes are. Think of countries that face the prospect of adopting the EU's Common Agricultural Policy or its anti-dumping regime. It all depends on the circumstances, and how national governments are able use such circumstances.

One way that governments can use institutional arbitrage to good effect is to enhance the credibility of domestic institutions. For example, the new disciplines imposed on developing-country governments by the WTO—in the areas of tariff bindings, quantitative restrictions, services, subsidies, trade-related investment measures (TRIMs), and intellectual property—can be viewed as helping these governments to overcome traditional weaknesses in their style of governance. These disciplines impose a certain degree of predictability, transparency, rule-bound behavior, and non-discrimination in areas of policy often subject to discretion and rent-seeking. In the same vein, perhaps the greatest contribution of NAFTA to the Mexican economy was the element of irreversibility and "cementing" that the agreement has contributed to the country's economic reforms. In Europe, the accession of Greece, Spain and Portugal to the EU has made a return to military dictatorship virtually unthinkable.

However, imported institutions can also turn out to be ill-suited or counter-productive. Many of the labor standards that some labor groups in the North would like developing countries to adopt—such as higher minimum wages or restrictions on some kinds of child labor—fit possibly in this category. The new patent restrictions called for by the IPR agreement of the WTO are at best a mixed blessing for countries like India, for example, which have so far benefited from cheap pharmaceuticals. A similar argument can be made about the tightening of environmental standards in developing countries.

Successful institutional reforms typically combine imported blueprints with local flavor. A good example of this in the area of trade comes from Mauritius, where superior economic performance has been built on a peculiar mix of orthodox and heterodox strategies. This economy's success derives in large part from an export processing zone (EPZ), which operates under free-trade principles. The EPZ has enabled an export boom in garments to European markets and an accompanying investment boom at home. Yet the island's economy has combined the EPZ with a domestic sector that was highly protected until the mid-1980s. The origins of this essentially dual-track strategy (not unlike that followed in China) lay in the social and political make-up of the island, and the decision by policy makers not to disrupt a fragile ethnic situation through an across-the-board liberalization, which would have disadvantaged established import-substituting groups. The EPZ scheme in fact provided a neat way around the political difficulties. The creation of the EPZ generated new opportunities of trade and of employment, without taking protection away from the import-substituting groups and from the male workers who dominated the established industries. The segmentation of labor markets early on between male and female workers--with the latter predominantly employed in the EPZ--was crucial here, as it prevented the expansion of the EPZ from driving wages up in the rest of the economy and hurting import-substituting industries. New profit opportunities were created at the margin, while leaving old opportunities undisturbed.

One can cite other instances of heterodox trade reforms that proved successful because they were better suited to existing political and institutional realities. South Korea's outward orientation during the 1960s, for example, was achieved not by import liberalization (of which there was little), but by export subsidization (of which there was a lot). This type of reform is now prohibited under existing WTO rules on subsidies. Similarly, China's two-track reform strategy in agriculture, industry, and trade--which maintained non-market institutional forms while aligning incentives correctly at the margin--has been wildly successful. These are cases where imaginative experimentation with institutional reform has had in all likelihood greater payoffs than the wholesale transplantation of institutions from advanced industrial countries would have had.[6]

Integration into the World Economy as a Model of Institutional Reform[7]

WTO membership entails institutional reforms that are not only demanding, but also of a particular kind. One can question, as Michael Finger has done eloquently, the fit between these reforms and the needs of developing countries, particularly of the least-developed among them. Finger has calculated that it would cost a typical developing country $150 million to implement requirements under the WTO agreements on customs valuation, sanitary and phytosanitary measures (SPS), and intellectual property rights (TRIPs)--a sum equal to a year's development budget for many of the least-developed countries. Would this be money well spent? Finger

[6] See Kapur and Webb (2000) and Pistor (2000) for useful discussions of the limits of importing legal and institutional forms from abroad.

[7] This section and the next are adapted from Rodrik (2000).

argues that the answer is no for the vast majority of developing countries. While these countries would benefit from the strengthening of their institutions in the relevant areas, the reality is that "WTO obligations reflect little awareness of development problems." "Other alternatives, e.g., basic education for women and girls, would have much more attractive rate-of-return numbers" (Finger 1999). It is a safe bet that any new trade round will shorten the leash on developing countries further (even if pressure in the controversial areas of environment and labor can be fended off).

Integration into the world economy has other, more subtle institutional requirements as well. Openness implies heightened exposure to external risk, and consequently greater demand for social insurance. Greater provision of social insurance seems to be a key factor behind the empirical regularity that governments tend to be bigger in economies where trade is a higher share of GDP (Rodrik 1998). Openness increases the premium on institutions of conflict management more broadly (Rodrik 1999b).

It is often overlooked that the most successful "globalizers" of an earlier era--the East Asian tigers--had to abide by few international constraints and pay few of the costs of integration during their formative growth experience (the 1960s and 1970s). Global trade rules essentially gave them a free ride, and capital mobility was hardly an issue. This is why these countries can hardly be considered poster children for today's globalization. South Korea, Taiwan, and the other East Asian countries had the freedom to do their own thing, and they used it abundantly. As mentioned above, they combined their reliance on trade with unorthodox policies--export subsidies, domestic-content requirements, import-export linkages, patent and copyright infringements, restrictions on capital flows (including on DFI), directed credit, and so on--that are either precluded by today's rules or highly frowned upon. The environment for today's globalizers is quite different.

None of the institutional reforms needed for insertion in the world economy is bad in and of itself, and in fact, many of them can be independently desirable as I argued above. Some can also have unintended benefits. For example, a government that is forced to protect the rights of foreign investors perhaps becomes more inclined to protect the basic human rights of its own citizens too. This was a potent argument in the recent U.S. debate about China's PNTR status.

But one has to recognize that a strategy of institutional reforms that is based on global integration is a strategy of trickle-down institutional reform. The reforms may or may not trickle down; and even when they do, they will rarely constitute the most effective way of targeting the desired ends (whether those ends are legal reform, improved observance of human rights, or reduced corruption). Institutional change is costly, and requires the expenditure of scarce human resources, administrative capabilities, and political capital. The priorities implied by global insertion will not always coincide with the priorities of a more fully developmental agenda.

Can We Rely on a Growth Payoff from Openness?

Global integration has opportunity costs because of the institutional consequences that such a strategy entails. These costs have to be traded off against the expected benefits.

All economists know that there exist gains from trade. However, the standard gains from trade--the Harberger triangles--tend to be small. The tendency in policy discussions has been to go considerably beyond the standard case for trade and to claim that open trade policies produce significant boosts in economic growth rates. This claim is apparently supported by a large cross-national empirical literature.

Recently, Francisco Rodríguez and I have reviewed the extensive literature on the relationship between trade policy and growth (Rodríguez and Rodrik, forthcoming). We reached the conclusion that there is a significant gap between the message that the consumers of this literature have derived and the "facts" that the literature has actually demonstrated. The gap emerges from a number of factors. In many cases, the indicators of "openness" used by researchers are problematic as measures of trade barriers or are highly correlated with other sources of poor economic performance. In other cases, the empirical strategies used to ascertain the link between trade policy and growth have serious shortcomings, the removal of which results in significantly weaker findings.[8] One common problem has been the misattribution of either macroeconomic phenomena (overvalued currencies or macro instability) or geographic determinants (e.g., location in the tropical zone) to trade policies proper. Once simple corrections are made for such problems, one rarely finds a statistically significant relationship between the level of tariff and non-tariff barriers and economic growth across countries.

There are in fact reasons to be skeptical about the existence of a general, unambiguous relationship between trade openness and growth. The relationship is likely to be a contingent one, dependent on a host of country and external characteristics. The fact that practically all of today's advanced countries embarked on their growth behind tariff barriers, and reduced protection only subsequently, surely offers a clue of sorts. Moreover, the modern theory of endogenous growth yields an ambiguous answer to the question of whether trade liberalization promotes growth. The answer varies depending on whether the forces of comparative advantage push the economy's resources in the direction of activities that generate long-run growth (via externalities in research and development, expanding product variety, upgrading product quality,

[8] Our detailed analysis covers the five papers that are probably the best known in the field: Dollar (1992), Sachs and Warner (1995), Ben-David (1993), Edwards (1998), and Frankel and Romer (1999).

and so on) or divert them from such activities. Finally, as I have stressed throughout, the institutional setting in which trade policy operates is more important for economic performance than the levels at which specific trade barriers are set.

No country has developed successfully by turning its back on international trade and long-term capital flows. Very few countries have grown over long periods of time without experiencing an increase in the share of foreign trade in their national product. In practice, the most compelling mechanism that links trade with growth in developing countries is that imported capital goods are likely to be significantly cheaper than those manufactured at home. Policies that restrict imports of capital equipment, raise the price of capital goods at home, and thereby reduce real investment levels have to be viewed as undesirable prima facie. Exports, in turn, are important since that is what one purchases imported capital equipment with.

But it is equally true that no country has developed simply by opening itself up to foreign trade and investment. The trick in the successful cases has been to combine the opportunities offered by world markets with a domestic investment and institution-building strategy to stimulate the animal spirits of domestic entrepreneurs. Almost all of the outstanding cases--East Asia, China, India since the early 1980s--involve partial and gradual opening up to imports and foreign investment.

The appropriate conclusion to draw from the evidence is not that trade protection should be preferred to trade liberalization as a rule. There is no evidence from the last 50 years that trade protection is systematically associated with <u>higher</u> growth. The point is simply that the benefits of trade openness should not be oversold. When other worthwhile policy objectives compete for scarce administrative resources and political capital, deep trade liberalization often does not deserve the high priority it typically receives in development strategies. This is a lesson that is of particular importance to countries (such as those in Africa) that are in the early stages of reform.

Concluding Remarks

A high quality policy environment is one that sends clear signals to producers and investors, precludes rent-seeking, does not waste economic resources, is consistent with the administrative capabilities of the government, and maintains social peace. Trade policy reform contributes to economic development insofar as it helps build high-quality institutions along these lines. I have argued here that the first question that policy makers contemplating trade reform should ask is not whether the reform will result in higher volumes of trade, render their trade regime more liberal, or increase market access abroad, but whether the reform will improve the quality of institutions at home. The results of trade negotiations--whether they are of a bilateral, regional, or multilateral nature--should be judged by the same yardstick.

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