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**UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT**  
**GENEVA**

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# **TRADE AND DEVELOPMENT REPORT, 2006**

## *Chapter VI*

### **INSTITUTIONAL AND GOVERNANCE ARRANGEMENTS SUPPORTIVE OF ECONOMIC DEVELOPMENT**

**UNITED NATIONS**  
New York and Geneva, 2006



## **INSTITUTIONAL AND GOVERNANCE ARRANGEMENTS SUPPORTIVE OF ECONOMIC DEVELOPMENT**

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### **A. Introduction**

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In the preceding chapter it has been argued that economic policies in support of industrialization and technological upgrading need to aim not just at efficiency gains, but also, primarily, at strengthening the creative forces of markets to induce capital accumulation and promote innovation and productivity. The present chapter examines institutional and governance structures at both the national and international levels that are best suited to complement these policies.

There is an increasing consensus among economists and policymakers that national institutions are a critical determinant of the pace of per capita income growth. But there is much less agreement as to what their role should be in helping to achieve sustained economic growth and development and, by implication, what types of institutional arrangements are appropriate to achieve these objectives.

Conventional wisdom envisages the main role of institutions as being one of reducing transaction costs so as to create missing markets and make existing markets function more efficiently.

According to this view, the main objective of economic policies is to ensure an efficient allocation of resources in the context of competitive equilibrium, supported by universally applicable forms of institutions, particularly for granting and protecting property rights. This goal is to be achieved by identifying “global best practices” derived from the current institutional set-up in developed countries and transplanting them to developing countries.

Another view, which emphasizes the need for developing countries to achieve economic catch-up through industrialization and structural change, envisages an additional role for institutions, which supports and accelerates the dynamic transformation of developing economies. From this perspective, their crucial role is to provide mechanisms for the effective implementation of policies designed to achieve high rates of investment and encourage the adoption of new technologies. Moreover, the dynamic evolution of economies is determined much less by efficiency criteria than is assumed by the conventional view. Thus, the guiding principle of institutional change should not be to use institutions to reduce departures from

the competitive equilibrium ideal of neoclassical economics, but instead to address the information and coordination failures that undermine decision-making and improve checks and balances on the use of government discretion. While such institutional arrangements have to fulfil similar functions in different countries, the form of institutions will vary from country to country, as well as within the same country over time.

The need for proactive trade and industrial policies to support and accelerate capital accumulation and structural change has long been recognized in development economics, as discussed in the previous chapter, and a large number of developing countries pursued such policies until the beginning of the 1980s. However, at the time, it was not well recognized that the successful implementation of such strategies requires a complementary set of institutional and administrative capabilities.<sup>1</sup> It was only when the successful experiences of the late industrializers, particularly in East Asia, had been properly assessed that the importance of

supportive institutional arrangements came to be more widely acknowledged (see, for example, Amsden, 1989, 2001; Wade, 1990; *TDR 1994, 1996*; Evans, 1995; Chang, 1996).<sup>2</sup> A key finding of these studies is that coherence between policies and institutional arrangements is of crucial importance for successful economic development.

Section B of this chapter addresses these issues in relation to national institutions, and section C discusses institutional and governance arrangements at the international level. Polanyi (1944) was among the first to highlight the governance problems that arise when the regulatory reach of a country's economic, political and administrative institutions is confined to its national borders, while forces unleashed by globalization and growing integration into world markets increasingly constrain countries in enabling their citizens to realize their goals. Section C substantiates the argument that only well-structured and appropriately functioning multilateral governance arrangements can resolve this problem.

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**Coherence between policies and institutional arrangements is of crucial importance for successful economic development.**

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## B. National institutional and governance structures in support of sustained economic growth

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### 1. Institutions and governance

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Conceptually, no clear distinction can be made between institutions and governance. Governance refers to the exercise of political, economic and administrative authority in managing a country's affairs at all levels. It comprises a complex set of mechanisms, processes, relationships and institutions through which citizens and groups articulate their interests, exercise their rights and obligations and mediate their differences.<sup>3</sup> Thus institutions are one part of governance structures, but they have a wider reach than governance structures. They encompass both formal and informal social structures and mechanisms, including rules and regulations that affect the behaviour of individuals and the functions of the State.

Institutions have often been defined as the rules of the game, or a set of humanly devised formal and informal constraints on political, economic and social interactions (North, 1990). This definition, which has been a hallmark of "new institutional economics", sees human actors as making rational choices in market transactions that, under given and unchanging preferences, maximize their utility. The function of institutions is to give individuals the opportunities and incentives to engage in profitable market activity by transmitting information, enforcing property rights and contracts, and managing the degree of competition.

By contrast, the approach of what is sometimes called "old institutional economics" advocates a

broader view of institutions (Hodgson, 2004). It argues that a country's historical and cultural context is, through its impact on habits, a crucial determinant of the country's institutions and of the activities and behaviour of its citizens, an important aspect of which includes non-selfish values (Hodgson, 1998). From this perspective, institutions not only *constrain* the behaviour of individuals, they also *enable* the achievement of goals requiring supra-individual coordination, and are *constitutive* in shaping the ways that groups and individuals use to define their preferences (Chang and Evans, 2005: 100).

The differing views on what shapes preferences and behaviour, and what should be the role of institutions in this connection, also imply diverging opinions about the role of the State and the scope for discretionary, as opposed to rules-based, policies. Much of neoclassical economics, which is complemented by the new institutional economics, views economic policies as being adopted and implemented by self-seeking politicians and bureaucrats who have limited ability to collect information and implement policies and who are subject to pressure from interest groups. This, the argument goes, often results in government failure in the form of regulatory capture, rent-seeking, and corruption, which distort the supposed rationality of the market system. According to this view, the functions of the State need to be restricted through deregulation and privatisation, and the scope for policy discretion needs to be reduced by strengthening rules of conduct or setting up politically independent agencies involved in policy-

making (e.g. independent central banks) bound by strict rules.

By contrast, from the perspective of old institutional economics, it is erroneous to assume that individuals have preconceived and unchanging selfish preferences. Rather, there is an interrelationship between institutions and the preferences and behaviour of individuals (Hodgson, 2005). This interrelationship means, first, that institutions can be seen as the cumulative outcome of past behaviour of individuals and past policy actions. In this sense, institutions are the path-dependent outcome of a society's preferences, behavioural patterns and policies. As emphasized by Rodrik, Subramanian and Trebbi (2004), the legitimacy and desirability of institutional arrangements have a large element of context specificity, stemming from differences in countries' cultural and historical trajectories, other initial conditions, and the political economy of decision-making processes.

Second, as argued by Chang and Evans (2005), who emphasize the constitutive role of institutions, this interrelationship implies that both formal rules and informal norms influence human preferences, as well as individuals' views on legitimate targets of policy and legitimate actions needed to achieve those targets. To the extent that institutions emphasize non-selfish values, individuals can internalize many such values. In this sense, policy-making is a process whereby individuals with different views on the legitimacy and contestability of existing targets and instruments compete with each other. Thus appropriate institutions can ensure that interest groups attempting to alter the "rational" order of markets according to their own specific interests do not dominate the policy-making process.

Third, the interrelationship between institutions and the preferences and behaviour of individuals also implies that desirable outcomes of

institutional arrangements can be achieved by a variety of context-specific designs. Thus, for example, Chang (1998) and Rodrik (2005) emphasize the need to distinguish the *functions* that institutions have to fulfil in order to promote economic development from the *forms* of institutions that serve those functions best. For instance, the function of institutional arrangements to secure property rights – much emphasized by institutional reform agendas – can be achieved through different forms of legislation and different degrees of independence of the judiciary system and contract en-

forcement arrangements. A frequently cited example in this context refers to the fact that in a country with no formal definition of property rights (such as China), those rights may in reality be more secure<sup>4</sup> than in some of the countries where property rights are formally defined and protected and where a formally independent judiciary system exists (see, for example, Rodrik, Subramanian and Trebbi, 2004). Another example relates to the vast differences between Japan, the United States and Europe (as well as within Europe) in institutional set-ups to protect property rights, regulate markets and address social protection. Both these examples indicate that institutional outcomes are more directly related to the effectiveness with which institutions perform their functions, and only indirectly to the forms that such institutions take.

As emphasized by Rodrik, Subramanian and Trebbi (2004), recognizing the difference between institutional functions and their forms means that economic policy targets (such as the protection of property

rights, macroeconomic stability, or industrial restructuring) can be achieved through a variety of institutional forms. It does not imply that economic principles work differently in different places, but rather that transferring specific forms of institutions from developed to developing economies is not a sufficient condition for good economic performance.

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Institutions influence the preferences of individuals and their views on legitimate policy targets and actions.

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The *functions* that institutions have to fulfil must be distinguished from the *forms* of institutions that serve those functions best.

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## 2. Institutions and market efficiency

Much of the current debate on the role of institutions in economic development emphasizes their function in reducing uncertainty and promoting market efficiency. Some see their role as being to ensure that markets function as closely as possible to the ideal of neoclassical economics, which is that competitive markets result in the efficient allocation of resources (see, for example, World Bank, 2001). According to this view, implementation of economic policies associated with the “Washington Consensus” has failed to bring about good economic results because of the absence of supporting institutions in most developing countries. As a result, multilateral lending institutions and many donor governments have increasingly attached governance-related conditionality – often referred to as second-generation reforms – to their loans and grants.

From this perspective, transaction costs are considered the main reason why the functioning of actual markets deviates from its theoretical ideal.<sup>5</sup> Transaction costs arise from contested or unclear property rights, incomplete or asymmetric information and related external effects, as well as inefficient and costly contract enforcement and dispute resolution. Corruption may further increase transaction costs, and can even disrupt contract enforcement and property rights protection. It is therefore suggested that transaction costs can be minimized by restricting the activities of the State to the creation and enforcement of property rights and the rule of law, the provision of public goods (such as physical infrastructure, education and health) and regulation in favour of creating missing markets and enhancing the efficiency of existing ones. Under these conditions, private investors pursuing their individual profit maximization objective would drive economic development and maximize the economic welfare of the economy as a whole.

Proponents of this approach point to empirical evidence from cross-country regressions, in which the level or the growth rate of per capita income is regressed on specific institution-related measures. These analyses typically find a posi-

tive correlation between the quality of institutions and economic growth to argue that an improvement in market-enhancing institutional conditions (such as the protection of property rights, the rule of law and anti-corruption policies) will promote growth and accelerate convergence with advanced countries.

The methodology of these econometric studies has been criticized for three main reasons. First, these studies generally use institution-related indicators that are highly subjective. The complex nature of institutional structures makes it difficult to find quantifiable objective indicators of the quality of these structures. As a result, the studies employ institution-related indicators based on interpretation by researchers of data from risk-

or credit-rating agencies or by respondents to local survey questionnaires. According to Kaufmann, Kraay and Mastruzzi (2005), the major advantage of employing such subjective measures is that they encompass all the formal as well as informal elements of institutions. However, a major problem of any

subjective institution-related measure is that the perceived quality of a country’s institutions is strongly influenced by its current economic performance.

Moreover, this approach does not enable any conclusions to be made about operational policy. An analysis based on the perceived impact of a country’s institutional arrangements on its economic performance cannot determine which specific forms of arrangements lead to the perceived outcome. Any institutional outcome, such as secure property rights, may be induced by alternative institutional forms. Thus, assessing “how well the rules of the game with regard to property rights are perceived to operate, and not what those rules are” (Rodrik, 2004: 12) does not give any practical indication as to the institutional design required to obtain such an outcome.

Second, virtually all empirical studies have found that developed countries generally rank higher in measures of institutional quality than developing economies, no matter what measure is used (see also fig. 6.1). But it is less clear whether

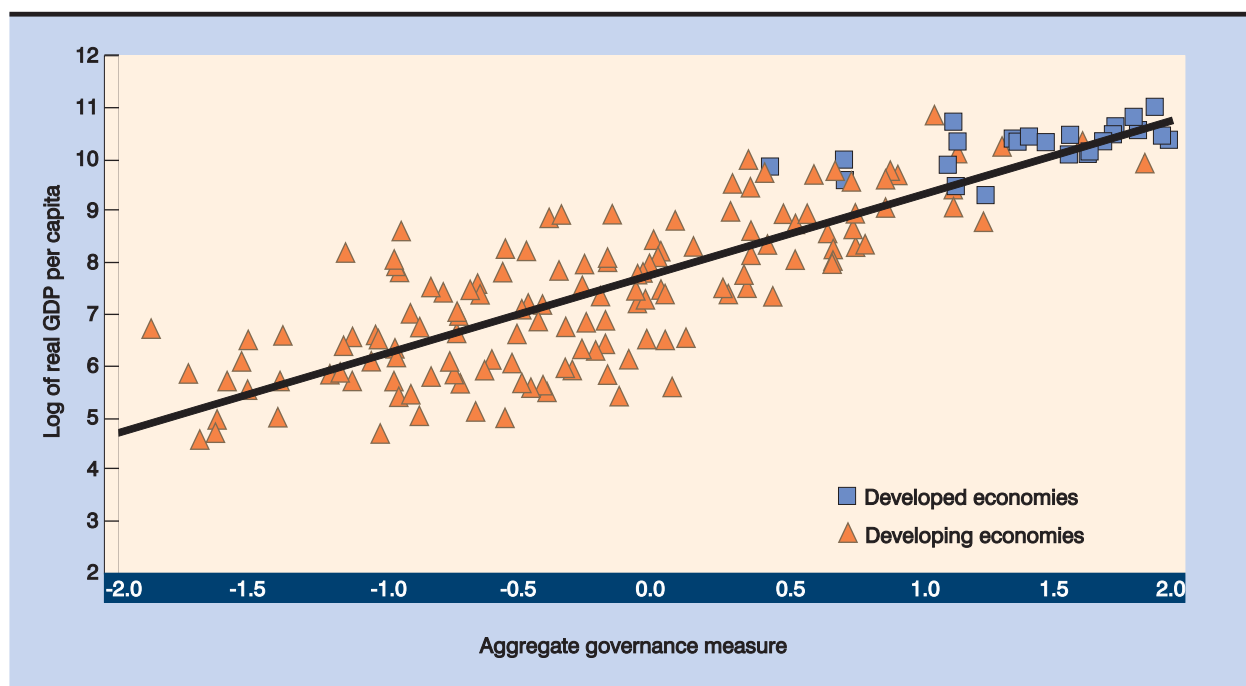
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**Good institutions and good economic performance are interrelated.**

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Figure 6.1

## CORRELATION BETWEEN INSTITUTIONAL QUALITY AND PER CAPITA INCOME, 2004



**Source:** UNCTAD secretariat calculations, based on data from Kaufmann, Kraay and Mastruzzi, 2005; and UNCTAD *Handbook of Statistics*, various issues.

**Note:** The aggregate governance measure is the unweighted average of the six measures provided by Kaufmann, Kraay and Mastruzzi, 2005.

this can be taken to imply a causal effect of institutional quality on economic performance. This is because these cross-country regression analyses are subject to serious econometric identification problems, in particular those related to omitted variable bias and reverse causality. Institutions and economic performance will differ among countries for a variety of reasons. However, given that the quality of institutions is a complex phenomenon that is not directly observable, and that it is therefore impossible to take account of all these differences in econometric estimations, the effects of omitted variables may be ascribed to institutional differences, thereby greatly exaggerating the effects of institutions on economic performance. The problem with reverse causality is that in this context good institutions and good economic performance are likely to influence each other, and are thus interrelated. For example, the impact of good economic performance on good institutions may

be due to the fact that economically well performing countries have the fiscal resources to construct and effectively implement an institutional structure that can ensure low transaction costs for all market participants.<sup>6</sup>

As proposed by Khan (2004), the test required to establish a causal relationship between an improvement in institutional quality in terms of the above measures and income convergence with developed countries is to see if developing countries that rank higher in such measures at the beginning of a period of time actually experience income convergence during that period. Such a test provides only weak support to the hypothesis that an improvement in institutions designed to create missing markets and make existing markets more efficient will promote growth and accelerate convergence with developed countries, as illustrated in table 6.1 and figure 6.2.



Table 6.1

## GOVERNANCE INDICATORS AND PER CAPITA INCOME GROWTH, 1995–2005

	<i>Developed countries</i>	<i>Converging developing countries</i>	<i>Diverging developing countries</i>	<i>Memo item: Countries of Central and Eastern Europe</i>
Number of countries	27	45	88	26
Median of aggregate governance measure	1.62	-0.19	-0.26	-0.27
Range of aggregate governance measure	0.64–1.93	-2.12–1.82	-2.08–1.33	-1.75–0.89
Median rate of real per capita income growth	2.48	3.90	0.95	5.19

**Source:** See figure 6.1.

**Note:** Data refer to 1995 for the aggregate governance measure, and to 1995–2005 averages for real per capita income growth in dollars.

The 186 economies for which the commonly used institutional and governance data provided by Kaufmann, Kraay and Mastruzzi (2005)<sup>7</sup> are available may be grouped as follows: 27 developed countries, 26 Central and Eastern European countries,<sup>8</sup> and 133 developing economies, which can be separated into 88 diverging and 45 converging developing economies depending on whether or not their average rate of real per capita growth during the period 1995–2005 exceeded the median rate of growth in developed countries during that period.

Table 6.1 shows that the median of the quality of governance index for converging developing economies is only moderately better than that for diverging developing economies. It also shows a large overlap in the range of variation of this measure for these two groups of economies. This raises some doubts as to whether an improvement in institutional quality as measured by this index actually causes income convergence of developing economies with developed countries.

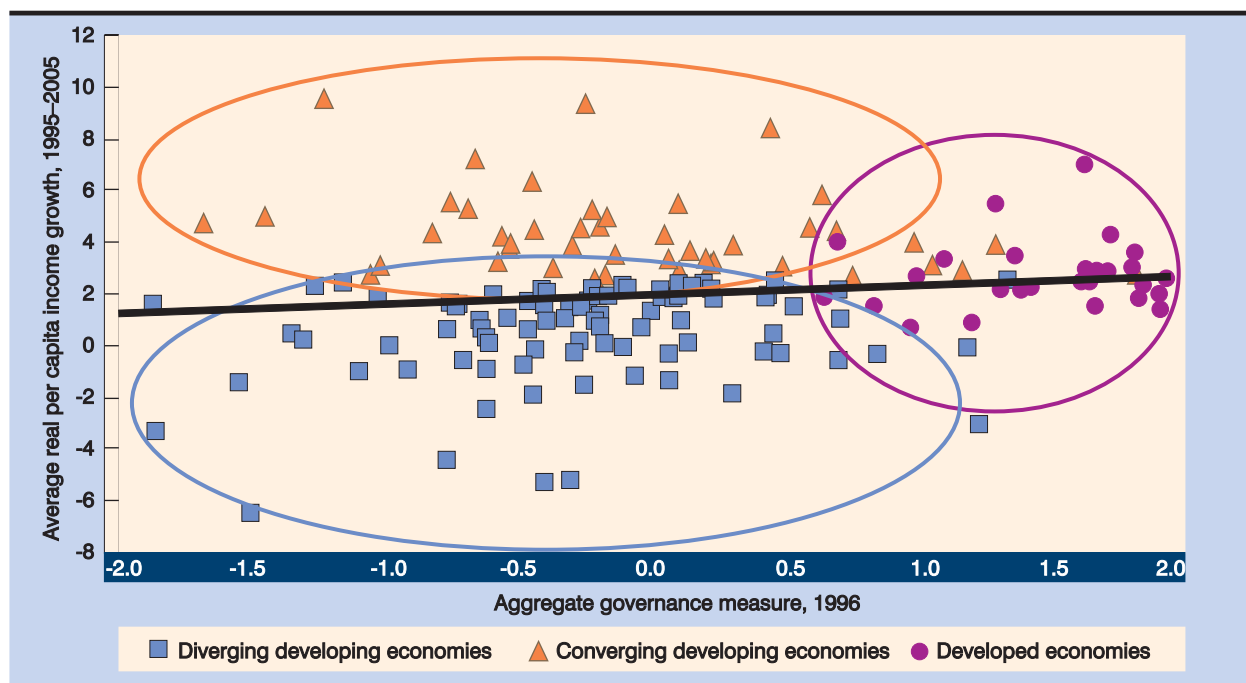
Figure 6.2 shows that for the pool of developed and developing countries there is a very weak positive relationship between the score on the quality of governance index in 1995 and real per capita income growth during the period 1995–2005, as indicated by the trendline. It also shows that this positive relationship is largely due to the

fact that developed countries score high in terms of both institutional quality and per capita income growth, and that the vast majority of developing economies score low on both these measures. However, as discussed above, the subjective nature of the governance measure makes it likely that scores on the basis of that measure may well increase with a country's good economic performance, making it difficult to determine the direction of causality. The location in the figure of the group of converging developing economies is critical for establishing the direction of causality. However, as already indicated in table 6.1, these economies do not generally have better governance scores than the diverging developing economies.

In sum, this evidence indicates that diverging as well as converging developing economies score relatively low in terms of the quality of the governance measure. This suggests that aiming at large-scale institutional reform in the short run is seldom necessary to accelerate growth. While achieving sustained economic convergence will eventually require constructing those institutions that are similar to those in today's developed countries, the initial move of developing countries onto a path of income convergence can be achieved with minimal changes in that direction. In order to explain institution-related differences between developing countries in terms of their growth performance, an examination of other dimensions of

Figure 6.2

**GOVERNANCE AND PER CAPITA INCOME GROWTH,  
SELECTED GROUPS OF ECONOMIES, 1995–2005**



**Source:** See figure 6.1.

**Note:** See figure 6.1.

institutional capabilities is required (see section 3 below).

Third, while so called “instrumental variable estimations” can be used to clarify the identification problems mentioned above, the resulting findings do not provide useful conclusions for policy-making. Indeed, finding suitable instrumental variables (i.e. indicators that are exogenous determinants of institutional quality) has proven to be a formidable task. Those studies that have used such exogenous instruments have often given rise to disagreement about the role and relative importance of institutions, on the one hand, and the instrumental variables themselves, on the other. In particular, there has been a debate as to whether geography has an impact on economic development beyond its effects on institutions.

For example, Hall and Jones (1999) use a country’s distance from the equator and the pro-

portion of its population that speaks English as instruments to measure the quality of institutions (which they call “social infrastructure”). They argue that these variables proxy for the adoption of institutions that protect property rights and, more generally, for the strength of the supposedly “good British influence” on a country’s institutions. Acemoglu, Johnson and Robinson (2001) argue that the mortality rates among early European settlers in a colony determined whether those settlers would stay in the more hospitable places and build European-style institutions, including those protecting property rights, or simply install resource-extractive or resource-plundering institutions.

Others (e.g. Gallup, Sachs and Mellinger, 1999; Sachs, 2003) argue that geographical and ecological variables (such as climate zone, disease ecology and distance from the coast) have a significant direct impact on economic performance. They sug-

gest that institutional choices in the past were influenced by the direct effects of geography on production systems, human health and environmental sustainability.<sup>9</sup> Engerman and Sokoloff (2002) point out that climate and factor-endowment conditions in the Caribbean and Brazil were well suited to growing crops like sugar, which at the time were of high value on the world market, and gave rise to significantly different institutions from those that were established later in the temperate zones of North America. Rodrik, Subramanian and Trebbi (2004) emphasize that the mortality rates of European settlers in the study by Acemoglu, Johnson and Robinson (2001) may be a useful instrument for the immediate statistical purpose of avoiding identification problems, but that it is nonetheless doubtful whether this approach captures the major historical forces that shaped institutional arrangements in former colonies and whether it explains economic divergence.<sup>10</sup> Indeed, income divergence in the past two or three centuries of countries that were never colonized (Afghanistan, Ethiopia, Japan, Thailand and Turkey) has been as great as among formerly colonized countries (Rodrik, Subramanian and Trebbi, 2004).<sup>11</sup>

The institutions discussed so far mainly concern the establishment of secure and stable property rights as an important element in incentives for entrepreneurs to invest and innovate. The presence of a stable and investment-friendly macroeconomic environment is another crucial determinant of such incentive. The inherent instability of financial markets, in particular, can have adverse effects on investment. Institutional solutions to this problem have concentrated on the implementation of procedural devices and regulatory frameworks. These attempts have focused on the role of institutions in facilitating individual decision-making by increasing the predictability of what other market participants will do in a particular context.

In the policy area, attempts to increase the certainty of individual decision-making have often addressed the question of political factors, such as election campaigns, to influence fiscal and

monetary policy. With regard to monetary policy, a widely employed institutional solution to this problem has been the delegation of monetary authority to an independent central bank that follows a clearly determined and pre-announced monetary policy rule,<sup>12</sup> and/or, according to Rogoff (1985), the appointment of a conservative central banker.<sup>13</sup> Particularly in situations of hyperinflation, some countries have used a fixed nominal exchange rate or a currency board as an anchor for monetary policy. Institutional measures such as an exchange-rate anchor may be necessary in the initial stages of a price stabilization strategy. However, in practice, such strategies often lack a credible exit option. As a result, their prolonged use has contributed to substantial capital inflows, which in turn have initially led to an overvaluation of the real exchange rate that has eventually been corrected through a reversal of capital inflows. The resulting gyrations in the real exchange rate have made it difficult for entrepreneurs to make long-term plans and impaired investment.<sup>14</sup>

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Large-scale institutional reform in the short run is seldom necessary to accelerate growth.

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### 3. *Institutions and structural transformation*

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To the extent that economic restructuring, technological upgrading and productivity growth depend on better resource allocation, improving market efficiency is clearly desirable. But the preceding chapter has argued that economic catch-up largely depends on industrialization and technological upgrading, and that to this end proactive trade and industrial policies need to reinforce the creative functions of markets that drive the dynamic transformation of developing economies. An important element of this policy strategy is the creation of “rents” that boost corporate profits above their free-market levels. Thus institutional arrangements that successfully manage economic rents must complement proactive support policies.

As with the discussion of principles and types of policies in the preceding chapter, it is possible

to identify a number of generally desirable functions of institutions that must complement proactive trade and industrial policies. As already mentioned, the specific institutional forms of these functions are largely context specific. Each country needs to discover which specific form will provide the appropriate incentives to achieve the desired institutional outcome, based on its particular circumstances.

One such function concerns strategic collaboration between the government, business organizations and institutions of learning and innovation. Such collaboration aims at: (i) coordinating investment activities with scale economies, where the interdependence of individual investment decisions makes the investments and profits of one entrepreneur partly dependent on the investment decisions of others,<sup>15</sup> and (ii) exchanging information on the government's vision of development strategies, the entrepreneurs' views on business opportunities and investment constraints, particularly those related to the production of new products and the use of new modes of production, and on research institutions' assessments of national and international technology developments. Such arrangements help the government to design, implement and coordinate policy measures, because they allow the gathering of information on investment ideas and an assessment of the technology requirements needed to make such investments profitable. In addition, they allow identification of areas that require better coordination among State agencies and where changes in legislation and regulation could eliminate unnecessary transaction costs or other impediments to investment. This would also help to assign responsibilities for solving identified impediments and, more generally, to indicate which individual/agency should be approached to find a solution to a specific problem. Furthermore, such institutionalized forms of government-business collaboration allow the soliciting of subsidies and financial backing for new activities when needed, encourage cooperation among private firms, and between them and research institutes, and enable a bundling of all the different elements of support to new investment.

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**Institutional arrangements to manage economic rents must complement proactive support policies.**

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Another function is the imposition and enforcement of performance criteria on the recipients of the rents, in particular by using the disciplines of the international market in order to prevent rents from becoming permanent. The absence of such criteria, or failure to enforce them, would run the risk of causing unproductive rent-seeking, which would eventually weaken entrepreneurship and hamper productivity growth. Linking support to performance requirements ensures that the initial rents are essentially part of a nurturing exercise and that the rents will eventually be withdrawn as the supported activity matures. Moreover, such a link lends transparency and accountability to policy support, because it forces decision-makers to clarify and justify their actions. It also provides a yardstick for the evaluation of outcomes.

Thus, clear quantitative criteria for success or failure need to be formulated. Given the objective to support and accelerate productivity growth, success criteria should be related to productivity. Moreover, they should include a sunset clause to prevent open-ended support. This institutional function of identifying and disciplining under-performing firms ("losers") is often overlooked in conventional assessments of industrial policies, which tend to equate industrial policy with "picking winners". In a sense, it represents the "stick" that is a necessary complement to the "carrot" provided by the creation of temporary rents from subsidies or protection.<sup>16</sup>

A third function of institutional arrangements is the provision of institutions that facilitate the incorporation of increasingly more advanced technology into production processes. The protection of clearly defined property rights is an important incentive to generate and absorb new technologies. However, as already mentioned, this protection can take many forms. Detailed codification of private ownership rights is not the only institutional form for providing innovative entrepreneurs with the possibility to appropriate at least a substantial part of the innovation rent. What matters more is that property rights are acknowledged *de facto*, as the experience of China between 1979 and 1993 indicates (see, for example, Qian, 2003).

Given that the availability of a well-skilled labour force is a key element of an economy's ability to innovate, adapt existing technologies and achieve learning-by-doing externalities in the production process, the existence of appropriate educational institutions (particularly for science and technology as well as vocational training) is clearly important for an economy's technological development. The same is true for the promotion of domestic knowledge generation in research institutes and universities. But the effectiveness of the output of these institutions depends largely on their links with corporate research and on the institutional structure of the corporate sector itself. Chang (1998), for example, points out that large enterprises may have the organizational structure and financial ability to conduct their own R&D, while an industry structure with a large proportion of small firms will require more government involvement in R&D.

The institutional structure of the financial system influences the scope of domestic investment financing beyond retained corporate profits. Compared to a capital-market-based system, a bank-based financial system may be better equipped to overcome the information and coordination problems in capital markets that pose a major obstacle to rapid investment and innovation. It facilitates the financing of productive investment from money and credit creation rather than from a pool of savings, and can thereby provide decisive stimuli for capital accumulation and growth. It also facilitates the allocation of credit from private sector financial institutions under government guidance, and from State-owned banks to finance investment in innovative activities (*TDR 1996*: 129). Moreover, bank-based financial systems are usually considered to be better at creating a corporate governance culture that emphasizes long-term development goals rather than short-term profits.

Fourth, the design and successful implementation of support policies require a strong and com-

petent meritocratic civil service<sup>17</sup> that is not unduly burdened with immediate political concerns. The relationship between the State bureaucracy and the private sector should be one of "embedded autonomy" (Evans, 1995). The State bureaucracy should be closely connected to the business community through the State-business links discussed above. This fosters its responsiveness to required changes in policy design and implementation, and reduces the risk of its becoming a power unto itself and pursuing its own objectives. But the State bureaucracy should nonetheless retain a degree of autonomy that is essential for long-term policy-making, rather than being unduly subject to day-to-day politics and risk becoming overburdened with multiple objectives, many of which may be short-term in nature.

Civil service activities will be more effective if they provide support to economic activities that are national priorities and are supported at the highest political levels. Moreover, the strength of the civil service also depends on the coherence of support policies. Thus, State agencies that design and implement policies need to have coherent goals. Relatively greater homogeneity in values, preferences and political objectives across a country's political landscape will make it easier to formulate and implement a coherent policy strategy. It will also make it easier to enforce performance requirements as non-performing beneficiaries of policy support will not be able to play different political factions off against each other.

Finally, institutional arrangements must address distributional conflicts and promote social coherence.<sup>18</sup> This function of institutions is an important complement to proactive support policies, in particular because the creation of rents is not a harmonious process. Rather, it can give rise to distributional conflicts that can quickly cause deviation from a sustainable growth path and undermine the perceived legitimacy of the policy strategy adopted to spur development. While rela-

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Linking support to performance requirements ensures that the initial rents are part of a nurturing exercise ...

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... and that the rents will be withdrawn as the supported activity matures.

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tively equitable income distribution fosters social cohesion, taking into account the preferences of large segments of the population for the formation of new institutions and the reform of existing ones also plays a role in this context.

As emphasized by Evans (2005), wide participation by a country's citizenry in the setting of policy priorities along with institutional change will allow the country to discover what institutional forms are best suited to its specific circumstances. Although there is considerable scope to learn from experience elsewhere, eliciting and aggregating local knowledge provides better ideas of how to build effective organizations and institutions, particularly administrative norms, legal rules and other governance mechanisms, rather than technocratically imposing institutional blueprints. Participatory processes are also likely to better define the most appropriate legitimate goals of development. Moreover, they will increase the sentiment among citizens of ownership of the government's policy strategy.

#### 4. Conclusions

Institutional arrangements are an important determinant of the effectiveness of domestic policy instruments in influencing national target variables. The presence of institutions to support the efficiency of existing markets and the creation of missing ones appears to be necessary, particularly in advanced stages of economic catch-up. However, the statistical correlation between per capita income levels and indicators of "good governance" does not point to the need to adopt the long list of institutional and governance reforms prescribed by the conventional reform agenda as a necessary condition for the initiation of a successful catch-up process.

By contrast, putting in place institutional arrangements that successfully manage economic rents associated with proactive trade and industrial policies in support of structural transformation is of particular importance in initiating and supporting a process of sustained growth and structural change. Once an economy is on a path of sustained catch-up growth, the government's capacity to sup-

port the creation of high-quality institutions through increasing public expenditure will also rise. Improved economic performance and strengthened public sector support for institution-building will enhance the process of institutional transformation, which will feed back into the growth process by enhancing the effectiveness of public policies.

Yet the widespread scepticism about the capacity of the State to create and manage growth-promoting rents cannot be ignored. Part of this scepticism is clearly justified, given the poorly performing institutional set-ups in a large number of developing countries. The restoration of peace and basic social order is a prerequisite for any institutional reform and economic development in countries that have experienced long years of civil strife and external conflicts. Indeed, there can be little doubt that some States will be more effective than others in implementing the institutional arrangements that have a major impact on the effectiveness of proactive trade and industrial policies for achieving their objectives.

Much of this effectiveness depends on the professionalism of the bureaucracy and the efficiency of information exchange between the public and private sectors. But it also depends on the extent to which nationwide State entities wield authority in policy-making and their access to budgetary resources that can be directed to those goals, including through the creation and withdrawal of rents.

In terms of "good governance", the East Asian States often performed rather poorly, but they had a different set of governance capabilities that were growth enhancing. Formal and informal arrangements for collaboration between the government, business organization and institutions for learning and innovation played an important role, as did the existence of reciprocal control mechanisms and the presence of a strong and competent meritocratic civil service.

The precise form of institutional arrangements depends on the specific mechanisms through which the State attempts to accelerate investment and technological upgrading. The diversity of the experience of successful catching up in East Asia indicates the importance of the compatibility of the governance capabilities that States have

and the growth-enhancement strategies they are attempting to implement.<sup>19</sup> Country-specific conditions have clearly helped the development of these institutional arrangements in East Asia. This has sometimes been interpreted as implying that the kind of economic catch-up experienced in East Asia cannot be replicated elsewhere. However, as emphasized by Akyüz, Chang and Kozul-Wright (1998), the important point is not whether these economies' particular set of initial economic and cultural conditions equipped their societies for economic development better than others. All country-specific conditions contain elements which may either hold back or support future development, and the challenge is to explore whether and how pro-development elements can best be promoted.

Moreover, it should not be presumed that institutional arrangements required to successfully manage more orthodox policies are less demanding than those needed to accompany proactive support policies. As emphasized by Chang (2003: 310), "the fact that many developing countries have tried

during the last half-a-century to build institutions that are needed to have a well-functioning market economy, often with little success, is testimony to the difficulties involved in constructing the institutions required for a well-functioning market economy."

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**Institutional arrangements determine the effectiveness of domestic policy instruments in influencing national policy targets.**

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Developing countries may wish initially to pursue a limited number of proactive policies that do not require the management of significant amounts of rents, but can contribute to the accumulation of capabilities and know-how that will prove useful in conducting more sophisticated

support policies later. Designing policies to maximize the gains from hosting TNCs in selected areas may provide a particularly important area for policymakers in early phases of institutionally managed proactive policies. A gradual strategy of this kind would allow a government and its bureaucracy to learn their country's specificities regarding the types of incentives that are effective and for what purpose, and to identify any possible loopholes that might exist in otherwise well-designed policies.

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## C. Multilateral institutions and global economic governance

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### 1. Introduction

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The considerable, and still growing, degree of global interdependence in contemporary world economic relations provides a strong rationale for a well-structured system of global economic governance.<sup>20</sup> Such a system would ensure the provision of global public goods such as international economic and financial stability. It would be represented by coherent multilateral institutional arrangements, created by inter-governmental agreements to voluntarily reduce sovereignty on a reciprocal basis. The guiding principle of these arrangements would be to manage the interface between different national systems, rather than reducing national difference and establishing one omnipotent economic and legal structure. These arrangements would design, implement and enforce multilateral rules and disciplines. Such a

system of global collective action would make a key contribution to minimizing adverse international spillovers and other negative externalities created by national economic policies that focus on maximizing national benefits.

Self-centred national economic policies can generate adverse negative spillover effects beyond a country's borders. The spread of financial crises through contagion, even to countries with sound policies and good fundamentals, is one example. Moreover, global economic interdependence provides an opportunity for policy-makers in influential economies to deliberately use beggar-thy-neighbour types of policies. They may be tempted to employ commercial, macroeconomic, financial or exchange-rate policies in pursuit of certain national economic objectives – such as attaining mercantilist goals or postponing the adjustment of internal or external imbalances – which may harm the economic performance of other countries. In the absence of multilateral disciplines and cooperation, retaliatory action by adversely affected countries could lead to instability and disruptions in international economic relations that might leave all countries worse off.

For global collective action to be acceptable to all parties, it must result from a consultative process based on full, equal and voluntary participation of all the parties concerned. However, there is a natural inclination, particularly by internationally powerful countries, to shape multilateral rules and commitments in a way that gives them the maximum degrees of freedom to pursue their own national economic goals, while restricting the degrees of freedom for others in areas where national interests conflict. Countries that feel disadvantaged by the way multilateral rules and commitments are formulated and implemented can, in principle, stay out of or leave the multilateral arrangements in question and conduct international relations on a bilateral basis. But countries with little power internationally (i.e. the vast majority of developing countries) will rarely follow this route, because coercive action is likely to be even stronger in bilateral relationships with major economic and political powers.

How to determine the right balance between maintaining sovereignty in national economic policy-making and constraining it through multilateral disciplines and collective governance remains a contentious issue. Chang (2006) makes the general argument that a liberal economist who values autonomy and choice for individuals should not try to restrict national autonomy of developing countries, including their right to be wrong.

More directly related to the multilateral trade regime, Kleen and Page (2005: 48–49) argue that flexibilities in disciplines should aim to give developing countries what they want, not what developed countries, or researchers, think is “good for them”. This could be understood as advocating an “everything goes” approach whereby

governments would be allowed to implement any policies they think maximize their country's interests. But these authors clearly recognize that the absence of multilateral disciplines can disrupt international economic relations and/or bias them in favour of those countries that wield substantial economic or political power. Perhaps more importantly, as discussed earlier in this chapter and in the preceding two chapters, economic theory, borne out by history, suggests that there are a number of general principles underlying development-enhancing policies and institutions which can guide policymakers in their development strategies.

On the other hand, the extension of legally binding external constraints on national economic policies, as well as a generally less permissive attitude to the granting of waivers, may be viewed as subscribing to a “one-size-fits-all” approach. However, when there are information asymmetries and unequal capacities among countries to participate in the processes leading to an agreement on multilateral rules and disciplines, or when these rules and disciplines are perceived as unduly impinging on legitimate national development aspirations, they could be called into question and result in a repudiation of the institutions overseeing those disciplines. Hence, determining the right balance between national sovereignty and multilateral disciplines is very much a question of finding the right compromise between a “one-size-fits-all” and an “everything-goes” approach.

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**There is no quantifiable single balance between multilateral disciplines and national policy autonomy that suits all countries.**

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Any perception that multilateral disciplines extend too far and constrain the attainment of legitimate national development goals greatly depends on an individual economy's structural characteristics and its level of development. There is no *quantifiable* single balance between multilateral disciplines and national policy autonomy that suits all countries or applies across all spheres of economic activity. The degree of national policy autonomy needed to promote national economic development differs across countries. For example, the maturity of a country's institutional development and its pattern of domestic production will influence the depth of its integration into international financial markets and its FDI policies. Economic size and natural resource endowments will influence the depth of a country's trade integration, while the pattern of domestic support policies will vary with a country's level of industrial development, as discussed in chapter V. By the same token, at any level of economic development, the optimal degree of openness for benefiting a country is likely to differ across different spheres such as trade, investment, finance, labour and technology. For example, countries would be well-advised to postpone capital market integration until they have successfully integrated into other areas, notably trade (*TDR 2004*, chap. IV). Such differences in the optimal degree of openness may extend beyond narrow economic areas to involve equity considerations or the preservation of national culture and national institutions.

In the Sao Paulo Consensus (paragraph 8) reached at UNCTAD XI in 2004, the international community recognized that "it is particularly important for developing countries, bearing in mind development goals and objectives, that all countries take into account the need for appropriate balance between national policy space and international disciplines and commitments." However, multilateral arrangements do not appear to move in that direction.

The current system of global economic governance does not seem to be entirely satisfactory, largely because of the existence of two overlapping asymmetries. First, contrary to the existing

institutional structure in international trade, current international monetary and financial arrangements are not organized around a multilateral rules-based system that applies a specific set of core principles to all participants. This asymmetry has particularly strong adverse effects on developing countries because self-centred national monetary and financial policies can have much more damaging effects than those caused by trade and trade-related policies. Despite increased international financial instability, and recurrent financial crises in emerging markets – along with their attendant adverse effects for both the economic prospects of many developing countries and the healthy expansion of international trade flows – there has been no attempt to fill the vacuum created by the breakdown of the Bretton Woods arrangements. This asymmetry is a major reason behind the lack of coherence in international policy-making (*TDR 2004*).

Second, the multilateral rules and commitments governing international economic relations are, in legal terms, equally binding for all participants,<sup>21</sup> but in economic terms they are biased towards an accommodation of the requirements of the national development strategies of developed countries. As discussed in chapter V, the measures prohibited under WTO

rules and regulations are of diminishing importance at relatively advanced levels of development, where much of economic advance depends on pushing out the technology frontier. At the same time, they reduce the degree of freedom for national economic policies designed to promote productive capacity at earlier stages of industrialization. By contrast, the measures permitted – or at least not explicitly prohibited – are those that allow developed countries to sponsor technology- and knowledge-intensive industries.

Taken together, these two asymmetries result in multilateral rules and practices that seek to deepen economic integration in a number of areas crucial to the interests and priorities of developed countries, and reduce the degrees of freedom for national economic policies in areas crucial for

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**The scope of multilateral disciplines may be too narrow in international monetary and financial relations, but it may well be too large in the area of international trade.**

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industrialization and economic catch-up. Thus, in *qualitative* terms, and from the perspective of development, the scope of multilateral disciplines in the current pattern of global economic governance would appear to be too narrow in the area of international monetary and financial relations, but may well be too large in the area of international trade. The quality of a global partnership for development can be expressed not only in terms of the existence or absence of multilateral rules and disciplines but also in terms of the context of these rules and the degree to which this context reflects the interests and needs of the different parties in a balanced and equitable manner.

## **2. International monetary and financial rules and disciplines<sup>22</sup>**

The rapid pace of globalisation in monetary and financial relations has not been accompanied by an equally rapid change in multilateral monetary and financial rules and disciplines. The Bretton Woods institutions have progressively assumed different mandates and have extended their functions to areas far from those that they had been given originally (such as structural reforms covering a wide range of economic and social matters in developing countries and in economies in transition). Yet they appear to exercise little control over key international financial problems like exchange-rate volatility, huge and prolonged balance-of-payments imbalances, the dominance of short-term financial flows over long-term ones, and recurrent financial crises. Nor do they seem to possess the appropriate instruments for responding to these problems.

Above all, the existing global economic governance system lacks institutional arrangements that could exercise multilateral discipline on exchange rates. Until the early 1970s, the power of markets to generate unexpected and erratic movements in exchange rates was limited in part by the low value of financial market transactions relative both to trade transactions and to the amount of foreign exchange reserves. The power of markets was also constrained by capital controls and the obligation, under the Bretton Woods system, of central banks to intervene in foreign-exchange

markets in order to maintain exchange-rate stability. The system restricted the kind of short-term capital flows that were motivated by interest arbitrage and that had proven so damaging in the interwar period. By defining narrow exchange-rate bands, the Bretton Woods system also limited the ability of governments to manipulate the exchange rates of their currencies. This was intended to prevent beggar-thy-neighbour policies based on competitive depreciation, the lack of such prevention having been among the most damaging policy failures of the interwar period.

These institutional arrangements allowed the Bretton Woods system to ensure a balance between national policy autonomy on the one hand and multilateral disciplines on the other. Sacrificing formal monetary autonomy was rewarded by stability in the financial markets and better foresight in international trade and in related decisions concerning investment in fixed capital.

However, the Articles of Agreement in the IMF provided for changes in par values “to correct, or prevent the emergence of, a fundamental disequilibrium” (Article IV and Schedule C of the IMF Articles of Agreement). In many cases this adjustment was supported by the provision of financing from IMF resources to enable countries “to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity” (Article I of the IMF Articles of Agreement). At the same time, the conditionalities associated with this financing entailed macroeconomic adjustments in borrowing countries to support the reduction of external imbalances, with the aim of protecting both the financial integrity of the Fund and the revolving nature of its resources.

The balance between financing and adjustment in crisis situations has gradually been lost since the termination of the Bretton Woods exchange-rate system. Instead of providing adequate liquidity to allow countries to weather payments difficulties, the IMF started to impose extensive adjustments in macroeconomic and even in structural policies. Indeed, the Fund sought to impose the kind of policies that the architects of the post-World War II international monetary system had wanted to avoid on countries facing payments difficulties – that is, adjustment through austerity –

irrespective of the causes of the payments difficulties. These difficulties might result from domestic factors such as a loss of the overall competitiveness of the economy, excessive domestic spending or distortions in the price structure; or from external disturbances such as terms-of-trade shocks, hikes in international interest rates, trade and exchange-rate measures introduced by another country, or the volatility of capital flows and international speculation.<sup>23</sup>

Today the IMF may intervene in a country's exchange-rate policy only if that country asks for financial support from the Fund and thus becomes subject to IMF conditionality. Hence the IMF has no grip on possible exchange-rate misalignments in an economy that runs a balance-of-payments surplus, or in deficit countries that still have access to borrowing in international financial markets or issue a currency that other market participants are willing to continue holding in their portfolios, as in the case of the United States. Therefore, negotiations on exchange rates among the most important currencies, when they occur, are held outside the IMF, mainly at the G-7 meetings or in bilateral talks among the most important players.

This highlights a basic asymmetry and shortcoming in the current international financial system: the institution that is in charge of promoting exchange-rate stability and of avoiding excessive and prolonged payments disequilibria is unable to impose meaningful disciplines on the policies of those economies that run the most significant external imbalances and whose exchange-rate volatility has the most significant negative impact on the international economy. The Fund's policy oversight is confined primarily to its poorest members, who need to draw on its resources because of their lack of access to private sources of finance and, occasionally, to emerging-market economies experiencing currency and financial crises. As a result, the bulk of the adjustment burden in case of external imbalances is concentrated in a group of developing and transition economies despite the fact that the source of such imbalances may be found in the developed world.

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The existing global economic governance system lacks institutional arrangements that exercise multilateral discipline on exchange rates.

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In fact, in a financially highly-integrated world the Fund is unable to tackle one of the main sources of current-account imbalances in developing countries, namely, exchange-rate misalignments that are due mainly to volatile, and often speculative, short-term capital flows. As UNCTAD has repeatedly shown (e.g. *TDR 2004*, chap. IV, section C), exchange-rate gyrations are not always driven by policy errors in the receiving countries. Even countries following orthodox monetary policies of price stabilization can be subject to strong overshooting of their exchange rates, leading first to over- and then to undervaluation. Capital flows, which have

come to have a much stronger impact on nominal exchange rates than trade flows, are closely related to short-term financial conditions. For example, speculation that aims at exploiting short-term interest rate differentials for arbitrage profit can eventually lead to pressure on the exchange rate and become destabilising even if the countries involved have only slightly diverging inflation rates.

This behaviour is often at the origin of the boom-and-bust cycles in emerging markets. A more balanced and effective international financial system, one that also takes into account the specific needs of developing countries, should be designed to protect countries against overshooting and undershooting of the exchange rate by discouraging this kind of arbitrage through a truly international exchange-rate management system and/or by controls. In the absence of such a system, due to the unwillingness of the major developed countries to make the necessary multilateral commitments, developing countries must be allowed to manage exchange rates and capital flows at the national or regional levels, as discussed in chapter IV of this *Report*.

The globalized economy requires a new multilateral approach to managing the most important international price, the exchange rate. New or reformed institutions promoting a system of stable exchange rates to ensure a predictable trading environment would need to represent better the interests of countries at different stages of de-

velopment and become more symmetrical in the treatment of the different member States. The main objective of institution building in this context would be the prevention of systemic crises in emerging markets, prevention based on the close monitoring of trade imbalances and global exchange-rate misalignments. Separating surveillance from lending decisions taken by the international financial institutions and assigning such surveillance to an independent authority could improve its quality, legitimacy and impact.

### **3. Rules and commitments in the multilateral trade regime**

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The GATT/WTO provides negotiated, binding and enforceable rules and commitments that constitute the multilateral trade regime. The resultant certainty and predictability of international trade are arguably key benefits of this regime. Moreover, the core principle of non-discrimination, as embodied in the most-favoured nation (MFN) rule, provides that trade concessions given by one member to any other member will be extended to the entire membership. This kind of reciprocity is an essential component of any system of global collective action. The WTO dispute settlement process is intended to protect members from unilaterally imposed restrictive trade policy measures, which is of particular importance for weak countries that otherwise could face undue pressure from economically or politically more powerful countries. To the extent that this regulatory system functions effectively, it is an important tool for development because it minimizes the risk of disruptive changes in trade flows. Moreover, the GATT/WTO rules have granted developing countries important exceptions regarding both the MFN rule, by allowing them to enjoy preferential and more favourable market access, and the reciprocity principle, by allowing them to grant developed countries less than full reciprocity in multilateral trade negotiations.

Thus the multilateral trade regime, in principle, provides a framework for an orderly, rules-based system of international trade, with appropriate checks and balances, arbitration of inter-State disputes and determination of the sanctions to be

applied. However, de facto this regime has been under increasing pressure to expand the number of areas regulated by multilateral disciplines and to move towards the establishment of a homogeneous regulatory framework. However, such a move would not adequately take into account asymmetries existing among the different actors in the world economy.

A variety of factors have contributed to this development. First, many developing countries perceive that the so-called “trade-related” agreements of the Uruguay Round, which were discussed in chapter V, commit them to renouncing the policy autonomy that both the mature and late industrializers had enjoyed during their periods of economic catch-up. They believe such autonomy to be indispensable for maintaining an appropriate degree of flexibility in multilateral commitments that would give them the option to adopt national support policies which other countries have used to accelerate industrial development and technological catch-up, even if they may not currently have the intention or the budgetary and institutional resources to use that option.

Second, developing countries accepted new commitments stemming from these “trade-related” agreements (notably TRIPS) as part of the grand bargain of the Uruguay Round in exchange for improved access to developed-country markets of interest to developing-country exporters, particularly agricultural goods and textiles and clothing. But, as discussed in chapter III, progress in this area (particularly in agriculture) has fallen short of expectations, while new forms of selective protectionism have gained in importance. Imbalances in the outcome of the Uruguay Round Agreements are reflected, *inter alia*, in numerous implementation-related issues and concerns (Finger and Schuler, 2000). From this perspective, the global partnership for development between developed and developing countries has not materialized, and developing countries have expressed concerns about the failure of the Uruguay Round to deliver fully the benefits that had been estimated by various international organizations (OECD, 1993; World Bank and OECD, 1993) before the end of the Round.

Third, the perception of continuing asymmetries biased against developing countries has

been reinforced by the reinterpretation of the principle of “special and differential treatment” (SDT). Prior to the Uruguay Round Agreements, the case for SDT was couched in developmental terms, notably that it would be undesirable for developing countries to pursue policies and subject themselves to disciplines that may be sensible for developed countries owing to differences in their economic structure and levels of development. By contrast, the main concern of SDT since the conclusion of the Uruguay Round appears to have been that of assisting developing countries in implementing the WTO disciplines (Whalley, 1999). Thus developing countries are offered extra time and technical assistance to enhance capacity in order to facilitate their adjustment. As noted by Hoekman (2005: 406), it is now recognized that these provisions are inadequate “as these are arbitrary and are not accompanied by or based on an objective assessment of whether (and when) implementation of a specific set of (proposed) rules will be beneficial to a country.”

Fourth, WTO negotiation procedures have often given the impression of less than full transparency and participation, so that some countries appear to have stronger influence than others. Decisions taken in so-called “green room” meetings or in other gatherings of a limited number of members are often presented to the entire membership as *fait accompli*. These procedures may have resulted from well-intentioned attempts to preserve practicality and efficiency in complex decision-making. However, they have prompted concerns about unequal influence and unequal representation of national priorities in processes the results of which affect all participants. As such, the increasing difficulty in reaching decisions on the basis of equal participation of all members is intimately linked to the growing number of WTO members.

Indeed, the increasing participation of developing countries in the multilateral trade regime, which dates back to the Uruguay Round, has given universality to multilateral rules and regulations in the area of international trade. It has brought together countries that may not necessarily be

“like-minded”, as was the case when the GATT was founded. As noted by Kleen and Page (2005: 48) “if the WTO members now accept that the organisation should aim for universal membership, in order to ensure that the benefits of certainty and predictability apply to all trade by its members, then both the possibility that some countries are permanently ‘different’ and the certainty that some will not share the same approach to all rules imply that the WTO must either limit its rules to those that can benefit and be accepted by all members or allow permanent derogations for countries with different economies or different approaches to economic policy.” The Task Force on Trade (United Nations Millennium Project, 2005: 185) notes that designing generic rules is particularly difficult when it comes to behind-the-border policies, and suggests

that agreements in this area should be flexible and encourage experimentation, learning and competition (similar to the flexibilities envisaged in the GATS architecture).

Hence an inclusive multilateral trade regime must build in flexibility in order to avoid a deadlock in multilateral negotiations with attendant ad-

verse effects on the substantial gains that multilateral disciplines in the area of international trade have achieved. Failure to provide flexibility might lead to increased doubts by influential segments of civil society as to the legitimacy of the multilateral trading rules and disciplines at large.

So how can the multilateral trade regime move forward? Further discussions and negotiations at the multilateral level will need to explore a range of options. As noted, for example, by Rodrik (2001), if the multilateral trade regime is to maximize the development potential of developing countries, the criterion by which rules and commitments governing global trade are judged should be whether they appropriately fit a trade dimension to the development needs and goals of developing countries, rather than whether they maximize market access and international trade per se.<sup>24</sup>

It is likely that this exploration of options will aim at creating a new framework or new guide-

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The increasing participation of developing countries in the multilateral trade regime brings together countries that may not be “like-minded”.

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lines for SDT in the WTO, as noted, for example, by Kleen and Page (2005), Hoekman (2005) and Singh (2005).<sup>25</sup> The Doha Ministerial Declaration (paragraph 44), reaffirming the importance of SDT by stating that “provisions for special and differential treatment are an integral part of the WTO agreements” also called for a review of SDT provisions with the objective of “strengthening them and making them more precise, effective and operational”. Establishing a new framework would probably need to start from the recognition that SDT for developing countries means redressing structural imbalances, rather than giving concessions.

From this perspective, developed countries would need to agree to move to a new framework or new guidelines for SDT without receiving any concessions in return. This could also be considered one of the tasks for developed countries to undertake within the global partnership for development.

There are, in principle, two options to reflect differences among countries in their structural characteristics or approaches to economic policy (see, for example, Kleen and Page, 2005; and Hoekman, 2005). The first option is to adopt a country-specific approach that would allow member countries to selectively opt out of specific rules and commitments, depending on their specific national priorities. Different variants of this option have been proposed, *inter alia*, by Rodrik (2001) and Singh (2005). The basic principle of this option would be to provide flexibility for developing countries to seek some latitude in the application of multilateral disciplines consistent with the pursuit of national development goals. Singh (2005), for example, argues that prior to the single undertaking adopted for the Uruguay Round Agreements, SDT allowed countries to follow different paths towards development as there was no requirement for each country to follow all the rules. He suggests a re-conceptualization of SDT which would allow developing countries to subscribe to certain portions of multilateral agreements as they develop, without the obligation to commit to all portions at once.<sup>26</sup>

This option would ensure that each developing country has the flexibility to determine inde-

pendently the scope of multilateral disciplines which it wishes to implement, and thus avoid threats of retaliation for non-compliance with disciplines that it sees as constraining its development strategy. It would also leave intact the current practice of leaving individual countries to determine whether they should invoke SDT. How-

ever, its major drawback is that it would effectively result in a multi-track multilateral trade regime, thus conflicting with the basic rule of non-discrimination and complicating adherence to the consensus-based norm of the multilateral trade regime. Moreover, it runs the risk of leading to a prolif-

eration of specific agreements, with disciplines that may well go beyond the desired scope of developing countries for many years to come. Thus countries that opt out will not enjoy the benefits of existing multilateral disciplines, and might not be able to renegotiate them once they decide to sign on to a specific agreement.

The second option is to adopt an agreement-specific approach that would set specific criteria for individual agreements to determine whether members could opt out of the application of negotiated disciplines for a limited period of time. A major difficulty of this approach is to determine whether the exemptions from the specific agreements should be defined before discussing which countries would be entitled to them, or the other way round. Regarding country selection, the criteria used could include a variety of economic indicators relating to countries' levels of development. As with the first option, following this second option would also lead to differentiation between developing countries. However, contrary to self-selection, as in the first option, in this case differentiation would be based on objective criteria. As noted by Kleen and Page (2005), determination of the kinds of criteria used and the specific levels chosen would need to be the outcome of negotiations, which would have to strike a balance between a country's needs and the potential damage inflicted on other members by relaxing an agreed rule.

According to Das (2003), the provisions on SDT need to become an integral part of the WTO

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An inclusive multilateral trade regime needs flexibility to avoid a deadlock in negotiations.

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rules and disciplines, rather than being treated as exceptions as at present. Das (2003: 186–187) argues that the main goal of the GATT/WTO system is to ensure a fair sharing of the benefits from liberalization of trade in goods of services. Therefore, the protection of intellectual property rights (and, thus, the TRIPS agreement) should be taken out of the WTO system and placed in either the World Intellectual Property Organisation (WIPO) or a separate organisation of its own.<sup>27</sup> Moreover, in order to enhance the impact of developing countries' trade integration on the development of their domestic productive capacity, Das (2003: 190–191) argues that developing countries should be allowed to impose domestic-content requirements on firms, which are now prohibited under the national-treatment principle of the TRIMS agreement and to subsidize selected economic sectors.

With regard to the Agreement on Subsidies and Countervailing Measures, this proposal implies that member States could consider setting aggregate limits to subsidies that WTO member governments can use while allowing them flexibility in the allocation of subsidies to firms and

economic sectors, as proposed by Akyüz (2006). Multilateral trade negotiations could determine the aggregate limit on subsidies, as well as its reduction over time, while maintaining allocative flexibility. Such a scheme would be similar to the provisions on Aggregate Measures of Support (AMS) for agriculture, under which WTO members have set targets for percentage reductions while leaving considerable flexibility to member governments in the allocation of reductions across different agricultural products. It would also allow governments to modulate the sectoral pattern of domestic support policies outlined in figure 5.1 above.

The options suggested here are intended simply to sketch out some possible ways forward. There may well be other options. Moreover, what will eventually be adopted will need to result from multilateral discussions and negotiations. What is important at this point is to recognize that the wide disparity in structural characteristics and approaches to economic policies among the membership of a universal WTO requires greater flexibility. ■

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## Notes

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- 1 While such a complementary set of institutions was not spelt out, early development economists (e.g. Hirschman, 1981), nevertheless, clearly recognized the fundamental difference between the rules and institutions governing developed countries and those existing in developing economies.
- 2 Wade (2005), for example, argues that the difficult task is not defining and adopting proactive trade and industrial policies, but designing a bureaucracy with sufficient motivation, legitimacy and creativeness to be able to choose the right instruments for achieving the intended objectives of those policies.
- 3 This definition of governance has been proposed by the United Nations Development Programme (UNDP), which sees “good” governance as characterized by participation, transparency, accountability, rule of law, effectiveness and equity (see [http://mdg-guide.undp.org/?page=glossary\\_3](http://mdg-guide.undp.org/?page=glossary_3)).
- 4 According to Qian (2003), local communities (townships or villages), rather than individuals or the central government, held the formal ownership rights in township and village enterprises between 1979 and 1993. The efficiency loss stemming from the absence of private property rights was compensated

- by an implicit ownership guarantee from local governments that for fiscal reasons had a strong interest in the prosperity of these enterprises.
- 5 This argumentation is closely related to the so-called “Coase theorem”, according to which the neo-classical ideal of efficient competitive markets is obtained when market transactions are cost-free.
  - 6 Kaufmann and Kraay (2002) and Keefer (2004) find a weak but negative reverse causality, suggesting the absence of a virtuous circle between better governance and better economic outcomes. But Dixit (2006: 7) notes that even negative reverse causality can create an econometric problem requiring instrumental variables. The use of instrumental variables to address the problem of reverse causality is discussed later in this chapter.
  - 7 These data aggregate a large number of indices available from other data sources into six broad governance indicators: voice and accountability (measuring political, civil and human rights), political instability and violence (measuring the likelihood of violent threats to or changes in government, including terrorism), government effectiveness (measuring the competence of the bureaucracy and the quality of public service delivery), regulatory burden (measuring the incidence of market-unfriendly policies), rules of law (measuring the quality of contract enforcement, the police and the courts, as well as the likelihood of crime and violence), and control of corruption (measuring the exercise of public power for private gain, including both petty and grand corruption and State capture).
  - 8 These categories follow those used by the United Nations up to 2004 (i.e. the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia are classified in the category of countries in Central and Eastern Europe, rather than as developed countries).
  - 9 By contrast, Acemoglu, Johnson and Robinson (2002) point to some “geographically handicapped” countries that are now relatively poor but were relatively rich some 500 years ago (e.g. the Aztec and Inca empires) or in early colonial times (e.g. Barbados, Cuba and Haiti), arguing that these “reversals of fortunes” were more related to colonial history, extractive policies and institution-building than to geography.
  - 10 Bockstette, Chanda and Putterman (2002) show that a long history of a territory-wide polity and experience with large-scale administration may make for more effective government and more rapid economic growth. Many colonized countries suffer a relative lack of State antiquity, which stems in part from colonization itself and in part from the artificial regrouping of territories by colonial rulers, who often caused post-colonial States to be incongruent with pre-colonial political structures and boundaries.
  - 11 Moreover, as argued by Dixit (2006: 4), “[t]aken literally, these findings constitute a message of pessimistic determinism: if your country lacks the right prior or starting conditions, its economic future is bleak.” On a humorous note, Dixit (2006: 6) argues that these studies recommend a developing country “to use plate tectonics to move itself to a more favourable location, or to turn the clock back and invite British colonizers, of course cleaning up the local disease environment and getting rid of mineral resources beforehand.”
  - 12 For a critical assessment of this proposition see, for example, Bibow, 2004, and Forder, 2001.
  - 13 Another kind of solution has emphasized reputation-related mechanisms (Barro and Gordon, 1983).
  - 14 See *TDR 2003*, chap. VI, for a detailed discussion of these issues in the context of economic reforms in Latin America.
  - 15 Regarding specific forms of institutional functions, one attempt to address the problem of investment coordination has been the establishment of large industrial conglomerates, such as the *chaebols* in the Republic of Korea. Unifying decision-making on interrelated investment and production processes into one management structure significantly reduces uncertainty in investment decisions about the availability of auxiliary activities that in part determines profits. Another attempt, which has relied on a more decentralized and differentiated market structure with relatively smaller enterprises, has been the creation of institutional coordination mechanisms, such as the deliberation councils in Taiwan Province of China.
  - 16 The East Asian late industrializers successfully used such reciprocal control mechanisms to make the privileges of local entrepreneurs conditional on technological upgrading and international competitiveness, as often measured by export success, rather than allowing such privileges to be taken for granted, as pointed out by Amsden (1989), Wade (1990), and Evans (1995).
  - 17 Rauch and Evans (2000) show that the key ingredients of effective state bureaucracies include competitive salaries, internal promotion and career stability, and recruitment based on merit.
  - 18 Rodrik (1999), for example, emphasizes the need for strong domestic institutions of conflict management to deal with the consequences of external shocks, such as terms-of-trade declines or reversals in capital flows.
  - 19 For detailed accounts of how institutional arrangements complemented proactive trade and industrial policies in East Asia’s late industrialization, see, for example, *TDR 1994* and *1996*; Evans, 1995; Akyüz, Chang and Kozul-Wright, 1998; and Chang, 1998.
  - 20 The following paragraphs in this section partly draw on Akyüz (2006).



- 21 However, SDT is often expressed in terms of best endeavour.
- 22 This section partly draws on Akyüz (2006).
- 23 The only multilateral discipline left in the IMF is “avoidance of restrictions on current payments and discriminatory currency practices”. According to Article VIII of the Articles of Agreement members are obliged to avoid such restrictions and must obtain the approval of the Fund to impose “restrictions on the making of payments and transfers for current account transactions”. This article provides the possibility for countries to impose exchange controls on current transactions in situations where the Fund has formally declared a currency to be “scarce” because the demand for a currency threatens the ability of the Fund to supply that currency (Article VII). In principle, this scarce-currency clause may help put pressure on surplus countries, but it has never been implemented.
- 24 This will imply a major departure by trade negotiators from their past practices which seemed to be based on following mercantilist rules, “in which an increase in exports ... is a victory, and an increase in imports ... is a defeat” (Krugman, 1997: 114).
- 25 For an account of recent negotiations in the area of SDT, see Kleen and Page (2005: 37–43). In what follows, only SDT related to regulatory matters is discussed. For discussions on SDT relating to preferential market access and the provision of technical and financial assistance to help developing countries implement multilateral rules, see, for example, Kleen and Page, 2005, and UN Millennium Project, 2005.
- 26 As noted by Hoekman (2005: 418), plurilateral agreements lead to a similar outcome, with the difference that they do not entail the presumption that a country will eventually join and thus be subject to all the rules and commitments.
- 27 The Task Force on Trade (UN Millennium Development Project, 2005: 215) also concludes that, from an economic point of view, intellectual property rights should probably not have been included in the WTO because they “require a very delicate balance of market forces and public action—a balance unlikely to be the same for countries with wide differences in terms of income and technology, all the more because obligations of the TRIPS Agreement also tend to be ‘one size fits all’, taking no account of levels of development and varying interests and priorities.”

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