

form of exceptionalism in terms of the application of standard GATT disciplines (referred to as 'special and differential treatment' - SDT). In 1955, Article XVIII of the GATT was extensively revised so as to permit developing countries to

- maintain a flexible tariff structure to promote a particular industry, even where previous tariff bindings had been entered into;
- limit imports by quantitative restrictions to address balance of payments problems; and
- impose tariff and quantitative restrictions to promote the establishment of a particular industry with a view to raising the general standard of living.

These extensive dispensations from GATT disciplines (that can be com- pendiously characterized as infant industry or import substitution ration- ales for protectionism) were justified on various grounds. First, it was widely argued by many developing countries - and indeed by many mainstream development economists in developed countries and interna- tional agencies at that time - that developing countries had often inherited truncated economies from their colonial overseers, where they had been largely restricted economically to the role of hewers of wood and drawers of water, leaving them with large, traditional and inefficient agricultural sectors where the marginal product of labour was often thought to be negligible or even zero. As with most developed countries earlier in their histories a major transformation in developing country economies was called for in reallocating resources from traditional agricultural sectors to more productive industrial or manufacturing sectors. To facilitate and encourage this, it was argued that at least temporary protectionism was required for these fledgling manufacturing industries in order to enable them to achieve minimum efficient scale and become competitive in both domestic and export markets.

Second, it was widely argued that infant industry protectionism had been aggressively pursued by many developed countries early in the process of their economic development including the United States, Canada, Germany and many other currently developed countries - and that developing countries which found themselves at similar stages of development in their early post-independence histories should not be denied similar policy flexibility. Third, it was often argued that adjustment costs faced by many developing countries in moving to a fully open inter- national trading regime were likely to prove far more severe than those facing developed countries embarking upon a similar strategy of trade liberalization, because of low levels of education, poor physical infrastruc-

ture, inadequately developed financial, credit and insurance markets, and inadequate or non-existent social safety nets. Fourth, it was also argued that, at least for smaller and poorer developing countries, their share of world trade, and in particular imports, was typically so small that protec- tionist policies on their part were likely to have negligible adverse impacts on world prices in the commodities affected by these policies, and thus any terms of trade externalities from the pursuit of such policies were likely to be small to non-existent.

Despite these arguments for infant industry protection or import sub- stitution policies, it was also widely recognized in the early years of the GATT that increasing export earnings was also an important impetus to economic development, which would be facilitated by enhanced access to developed countries' markets for exports of both primary and manu- factured products from developing countries. Therefore, in 1965, Part IV (Articles XXXVI to XXXVIII) was added to GATT. These provisions called on developed countries to provide favourable market access to products of export interest to developing countries on a non-reciprocal basis. Following the adoption of Part IV, in 1968 the United Nations Conference on Trade and Development (UNCTAD) established a gener- alized system of preferences (GSP), by which developed countries could, on a voluntary basis, provide non-reciprocal preferential tariff reduc- tions for products of export interest to developing countries. Since such preferential tariff reductions violated the most favoured nation (MFN) provisions of the GATT, a waiver from MFN obligations was provided by the GATT in 1971, initially for ten years and, in 1979, was extended permanently by the so-called Enabling Clause which permits - and indeed encourages - the extension of 'generalized, non-reciprocal and non- discriminatory preferences' to developing countries. Pursuant to the initial GATT waiver and subsequently to the Enabling Clause, many developed countries have extended preferential treatment to many exports from developing countries.

In the course of the Uruguay Round of multilateral negotiations (from 1986 to 1993), the general orientation of negotiations was to integrate developing countries more fully into the world trading system.¹³ This was pursued in a number of ways:

- (a) by insisting on the developing countries binding and at least mod- estly reducing most of their typically very high tariff rates;
- (b) by narrowing the scope of the balance of payments exception;

¹³ See Trebilcock and Howse, *ibid.*, Chapter 15.

(c) by treating almost all of the Uruguay Round agreements¹⁴ as a single undertaking to which all members of the GATT (now the WTO) would be required to commit themselves, albeit – in the case of developing countries – typically with longer implementation periods and promises of technical assistance in meeting their compliance obligations.

The so-called 'Grand Bargain' reflected in the Uruguay Round agreements was that developing countries would commit to additional responsibilities in the areas noted above, in return for

- continuing the liberalization of tariffs on industrial exports to developed countries;
- more stringent safeguards regimes;
- a significant start on liberalizing international trade in agricultural products, including some constraints on export subsidies, domestic measures of support, and some reduction in tariffs; and
- the gradual liberalization and elimination of the Multi-Fibre Arrangement (MFA).

Since the close of the Uruguay Round, many developing countries have become disenchanted with the so-called 'Grand Bargain'. They point out that they still face disproportionately high tariffs on their industrial exports, increasingly frequent invocation of contingent protection mechanisms (anti-dumping, safeguards and countervailing duties), still numerous barriers in exporting their agricultural products to developed countries – including high tariffs, substantial subsidies, escalating tariffs on processed agricultural products, and onerous technical standards.

In the case of the MFA, while quotas have been reduced or eliminated in stages, high tariffs still often remain; moreover, since the expiration of the MFA, major importers such as the United States and the European Union have imposed safeguards or negotiated new limits on imports of textiles and clothing from major developing country exporters, in particular China. In turn, developing countries argue that the new responsibilities that they have assumed in areas such as TRIPS have imposed unforesee-

¹⁴ The Uruguay Round agreements included the Trade-Related Intellectual Property Rights Agreement (TRIPS), the Trade-Related Investment Measures Agreement (TRIMS), the Subsidies and Countervailing Measures Agreement (SCM), the General Agreement on Trade and Services (GATS), the Sanitary and Phyto-Sanitary Standards Agreement (SPS Agreement) and the Technical Barriers to Trade Agreement (the TBT).

ably burdensome compliance requirements on them in setting up sophisticated western-style intellectual property regimes, but have produced negligible benefits, and indeed in many cases adverse impacts on them in terms, for example, of access to essential medicines.

The Doha Multilateral Round of trade negotiations that was launched in 2001 was intended in part to provide a forum for addressing these concerns. Indeed, at its launch the Doha Round was officially characterized as the Doha Development Round. In the course of negotiations during this Round, the future status of SDT for developing countries on both the import side and the export side has emerged as a major fault-line between developing and developed countries, and along with other and often related issues (such as agricultural liberalization) has brought negotiations to the brink of collapse. In this Round – unlike earlier Rounds where developing countries were largely marginalized from being significant participants in the negotiations – developing countries (especially larger states such as China, India, Brazil and Mexico) have formed loose negotiating coalitions.

At the Cancun Ministerial of the WTO in November 2003, a group of 20 developing countries articulated extensive demands for major revisions of the multilateral trading architecture, including special and differential treatment, which many developed countries equally strenuously resisted, leading to the collapse of the Ministerial. Progress on many of these issues has since then been extremely modest.

B. Special and Differential Treatment: An Assessment¹⁵

The two limbs of special and differential treatment (SDT) referred to above need to be seen as inherently interrelated. The much greater policy flexibility extended to developing countries on the import side necessarily implies that, in securing better access to developed countries' markets for

¹⁵ For excellent reviews of special and differential treatment see Bernard Hoekman, Constantine Michalopoulos and L. Alan Winters, 'Special and differential treatment of developing countries in the WTO: moving forward after Cancun' (2004) 27 *The World Economy* 481; M. Pangestu, 'Special and differential treatment: special for whom and how different?' (2000) 23 *The World Economy* 1285; T.N. Srinivasin, 'Developing countries in the world trading system: from GATT 1947 to the Third Ministerial Meeting of WTO' (1999) 22 *The World Economy*; M. Hart and B. Dymond, 'Special and differential treatment and the Doha "Development" Round' (2003) 37 *Journal of World Trade* 395; and J. Michael Finger and L. Alan Winters, 'What can the WTO do for developing countries?', in Anne O. Krueger (ed.), *The WTO as an International Organization* (Chicago: University of Chicago Press, 1998).

their exports, they cannot be expected to offer reciprocal trade concessions (without undermining their policy flexibility on the import side). Hence the second limb of SDT contemplates non-reciprocal and preferential treatment of exports from developing countries by developed countries. While it was assumed that this combination of policies would substantially enhance the economic prospects of developing countries, this assumption has come under increasingly searching scrutiny in academic research.

On the import side, much research beginning in the 1960s and increasing through the 1970s found that import substitution policies were not achieving their goals and were actually hindering the growth of developing countries.¹⁶ For example, research by Balassa found that protectionist policies had hurt developing countries by encouraging industrialization at the expense of agriculture, worsened income distribution, reduced domestic savings, increased unemployment, and led to a very low rate of capital utilization. Little et al. demonstrated the high and indiscriminate levels of protectionism in many developing countries, and research by Krueger revealed the rise of rent-seeking behaviour and corruption that accompanied highly discretionary protectionist trade policies and related policies such as foreign exchange controls. More recent literature has provided further evidence of the positive relationship between trade openness and growth, stemming from gains from improved resource allocation, greater

¹⁶ See, for example, Ian Little, Tibor Scitovsky and Maurice Scott, *Industry and Trade in Some Developing Countries* (Oxford: Oxford University Press, 1970); Bela Balassa, *The Structure of Protection in Developing Countries* (Baltimore: Johns Hopkins University Press, 1971); Anne O. Krueger, *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences* (Lexington: Ballinger, 1979); and Jagdish Bhagwati, *Foreign Trade Regimes and Economic Development: Anatomy and Consequences of Exchange Control Regimes* (Lexington: Ballinger, 1978). Writing in 2002, Jeffrey Williamson reports that the World Bank has conducted over 41 studies of developing countries and contrasted the performance of relatively open and relatively closed economies, concluding that trade openness and growth are positively correlated: see Jeffrey Williamson, 'Winners and losers over two centuries of globalization' (September 2002) NBER Working Paper No. W9161 at 9. See also Jeffrey Sachs and Andrew Warner, 'Economic reform and the process of global integration' (1995) 1 *Brookings Papers on Economic Activity* 1; David Dollar, 'Outward-oriented developing economies really do grow more rapidly: evidence from 95 LDCs, 1976-1985' (1992) 40 *Economic Development and Cultural Change* 523; Sebastian Edwards, 'Productivity and growth: what do we really know?' (1998) 108 *The Economic Journal* 383; Romain Wacziarg and Karen Horn Welch, 'Trade liberalization and growth: new evidence', Stanford Graduate School of Business Working Paper (2003). For a critique of this literature, see Francisco Rodriguez and Dani Rodrik, 'Trade policy and economic growth: a skeptic's guide to the cross-national evidence' (1999) National Bureau of Economic Research Working Paper 708.

Table 7.1 Trade-policy orientation and growth rates in the Third World, 1963-92

Trade policy orientation	Average annual rates growth of GDP per capita %		
	1963-73	1973-85	1980-92
Strongly open to trade	6.9	5.9	6.4
Moderately open	4.9	1.6	2.3
Moderately anti-trade	4.0	1.7	-0.2
Strongly anti-trade	1.6	-0.1	-0.4

Note: In all periods the three strongly open economies were Hong Kong, South Korea and Singapore. The identities of the strongly anti-trade countries changed over time. In 1963-73 they were Argentina, Bangladesh, Burundi, Chile, Dominican Republic, Ethiopia, Ghana, India, Pakistan, Peru, Sri Lanka, Sudan, Tanzania, Turkey, Uruguay and Zambia. For the two overlapping later periods, the strongly anti-trade countries were the previous 16, plus Bolivia, Madagascar and Nigeria, minus Chile, Pakistan, Sri Lanka, Turkey and Uruguay.

Source: Peter H. Lindert and Jeffrey G. Williamson, 'Does globalization make the world more unequal?' in M. Bordo, A.M. Taylor and J.G. Williamson (eds), *Globalization in Historical Perspective* (Chicago: University of Chicago Press, 2002).

potential to realize economies of scale, improved access to technology, greater domestic competition and increased domestic savings and foreign direct investment. While measuring trade openness is not unproblematic, these findings are reflected in Table 7.1.¹⁷

These findings are often reinforced by reference to the trade policies adopted by the so-called East Asian miracle economies - beginning with Japan in the early post-war years, followed by Hong Kong, Singapore, Taiwan, Korea, Malaysia, Thailand and more recently by Vietnam, China and India, or in Africa countries such as Botswana and Mauritius, or in Latin American countries such as Chile. In one respect or another all these countries have pursued policies of export-led growth (outward rather than inward-looking policies that were adopted in many countries that adopted import substitution policies). It must be acknowledged, however, that there is ongoing and, to some extent, unresolved controversy as to the extent to which this export-led growth has been managed by interventionist trade and related policies designed to protect infant industries in their early stages and to support selectively export-oriented industries (various

versions of so-called 'strategic trade theory'). At the very least, it is true that most of these countries have pursued somewhat idiosyncratic paths to integration with the global economy.¹⁸

As to the second limb of SDT – non-reciprocal trade preferences – much recent research suggests that these preferences have not proved to be as useful to developing countries as they had hoped for the following reasons:

1. The benefits of the preferences seem to be concentrated on the more advanced developing countries, which needed them least. For example, a 1987 study found that four beneficiaries – Brazil, Hong Kong, Korea and Taiwan – derived more than 50 per cent of all GSP benefits.¹⁹
2. GSP market access preferences have tended to become less valuable as margins of preference have been eroded through successive negotiating rounds which have reduced MFN tariff levels.
3. Preferences are also not durable since they have often been tied to the level of a country's economic development; countries that are successful in increasing per capita incomes are often graduated out of the programs.
4. Donor countries often reserve the right to withdraw preferences if imports become too competitive with domestic products.
5. Many import-sensitive products of major export interest to developing countries have been excluded from GSP schemes.
6. Preferences have increasingly been subject to various forms of conditionality (such as human and labour rights and environmental standards) and ideological or geo-political factors (such as the perceived efforts of countries to combat terrorism).
7. Complex rules of origin have often diluted the value of GSP preferences, preventing developing countries from producing goods most efficiently.
8. Preferences cause trade diversion from developing countries that do not receive preferences to those that do. Thus, while preferences may benefit some developing countries in the short term, they are unlikely to benefit developing countries overall and they create inducements to distort comparative advantage, which puts the recipients of prefer-

¹⁸ See Dani Rodrik, *One Economics, Many Recipes* (Princeton, NJ: Princeton University Press, 2007).

¹⁹ G. Karsenty and S. Laird, 'The generalized system of preferences: a quantitative assessment of the direct trade effects and of policy options' (UNCTAD Discussion Paper No. 18, Geneva, 1987).

ences at risk in the long term if and when the preferences are withdrawn.²⁰

9. Finally, and most importantly, because these preferences are non-reciprocal, developing countries have forsaken significant bargaining leverage in negotiations with developed countries – without a *quid*, there is often a very meagre *quo*. This is simply to acknowledge the *réal politique* of trade negotiations – one has to give in order to get.

Despite these reservations about the past and prospective efficacy of SDT, some prominent and respected commentators continue to defend its continuing vitality and indeed argue for its strengthening and expansion. For example, Nobel Laureate Joseph Stiglitz, in two recent books,²¹ argues that the empirical evidence demonstrating the economic benefits of a liberal trading regime for most developing countries is much more ambiguous than conventional thinking acknowledges. He points to the gradualist and sometimes strategic approach to trade liberalization adopted by most of the high-growth East Asian economies, the relative failure of the so-called Washington consensus to stimulate high and sustainable growth in much of Latin America, and the devastating short-term economic consequences of 'shock therapy' in Russia.

Stiglitz argues that even if, in the long run, an open trading regime is to the benefit of developing countries, the absence of most of the adjustment cushions that exist in developed countries means that many developing countries face relatively more severe adjustment costs from trade liberalization. From these premises, he argues for a radically expanded form of SDT, where countries would be divided into various per capita income tranches; countries in higher income tranches would be required to liberalize all trade with countries in lower income tranches and amongst themselves, while countries in lower income tranches would only be required to liberalize trade with countries in even lower income tranches and amongst themselves but not with respect to trade with countries in higher income

²⁰ G.M. Grossman and Alan O. Sykes, 'A preference for development: the law and economics of GSP' (2005) 4 *World Trade Review* 41.

²¹ Joseph Stiglitz and Andrew Charlton, *Fair Trade for All: How Trade Can Promote Development* (Oxford: Oxford University Press, 2005); Joseph Stiglitz, *Making Globalization Work* (New York: W.W. Norton & Co., 2006), Chapter 3 'Making trade fair'; See also, Ha-Joon Chang, *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism* (New York: Bloomsbury Press, 2008); Dani Rodrik, *The Globalization Paradox: Democracy and the Future of the World Economy* (New York: W.W. Norton & Co., 2011). For a more radical recent critique of conventional economic rationales for free trade, see Roberto Unger, *Free Trade Reimagined* (Princeton, NJ: Princeton University Press, 2007).

tranches. Proposals such as this, which have been vigorously endorsed by prominent international NGOs such as Oxfam, have significantly widened the fault-line between developing and developed countries in the multilateral trading system, and therefore it is difficult not to be pessimistic about the prospects of finding any consensus or middle ground.

With the multilateral trading system in this state of stasis, it is important to note a relevant and rapidly growing phenomenon – the proliferation of preferential trading agreements (PTAs), entered into between or among developed and developing countries, and between or among developing countries themselves. Since Cancun, for example, the United States has announced that it will aggressively pursue PTAs with friendly developing countries, and indeed has done so. As to whether this strategy provides an effective response for developing countries to the fault-lines between developing and developed countries in the multilateral system noted above, there are reasons for pessimism.

Negotiations between large developed countries and small, poor developing countries on a bilateral basis entail much greater inequalities of bargaining power than developing countries encounter in the multilateral system, at least if they strategically negotiate as blocks or informal coalitions, exploiting the consensus decision principle that governs the multilateral system. Indeed, they are likely to end up assuming so-called WTO-plus commitments in areas such as intellectual property and investment. In turn, PTAs between or among developing countries cannot, for the most part, ensure greater access to their most important potential export markets in developed countries.

Moreover, a world trading system that is dominated by (in Jagdish Bhagwati's terms)²² a 'spaghetti bowl' of preferential trading arrangements, apart from the transaction costs entailed in negotiating and maintaining a host of these agreements and the complex rules of origin that are required as a predicate of these agreements, stands in sharp antithesis to the non-discriminatory world trading system that the architects of the Bretton Woods system (such as John Maynard Keynes) envisaged at the beginning of the post-war era as a response to the political and economic factionalism that characterized international relations in the inter-war years – with catastrophic consequences.²³

²² Jagdish Bhagwati and Arvind Panagariya, 'Bilateral trade treaties are a sham', *Financial Times* (28 July 2003) 17; Bhagwati and Panagariya (eds), *The Economics of Preferential Trade Agreements* (Washington DC: AEI Press, 1996).

²³ See, more generally, Jagdish Bhagwati, *Terms in the Trading System: How Preferential Agreements Undermine Free Trade* (Oxford: Oxford University Press, 2008); Sally Razeen, *New Frontiers in Free Trade: Globalization's Future and Asia's*

In our view, in the current Doha Round member countries should agree to provide immediate, unconditional and non-reciprocal duty-free access to their markets for all exports (without exceptions) from the least-developed countries that are the focus of Collier's concerns. Developing countries in higher income tranches, in contrast, should follow a different path. It is likely to be in their long-term interests to phase out reliance on SDT and bargain reciprocally for enhanced access to developed countries' markets, albeit with longer transition periods, more gradual reductions in trade barriers, more expansive safeguard protections, and cross-issue bargaining where reductions in developed country trade barriers can be exchanged for not only reductions in foreign direct investment and services. In addition, specialized agreements like TRIPS and TRIMS should in future generally be plurilateral rather than multilateral in nature (as they were prior to the Uruguay Round), leaving more policy flexibility for developing countries on the scope and timing of commitments beyond the general GATT principles.

C. Institutional Implications of Trade Policy

A growing body of literature finds a positive two-way relationship between trade policy and domestic institutional quality: countries with better domestic institutions (especially legal institutions) tend to be more successful exporters (especially of more complex products) because of credible commitments they can offer to their customers,²⁴ and in turn more open

Rising Role (Washington DC: Cato Institute, 2008) Chapter 5; Kyle Bagwell and Robert Staiger, *The Economics of the World Trading System* (Cambridge, MA: MIT Press, 2002) Chapter 7. For a more sympathetic view of PTAs see Arie Reich, 'Bilateralism versus multilateralism in international economic law: applying the principle of subsidiarity' (2010) 60 *University of Toronto Law Journal* 263 (arguing that PTAs can better accommodate differences in regional conditions than the multilateral system).

²⁴ See James Anderson and Douglas Marcouiller, 'Trade insecurity and home bias: an empirical investigation' (1999) National Bureau of Economic Research Working Paper 7000; Joseph Francois, Johannes Kepler and Miriam Manchin, 'Institutions, infrastructure and trade' (2007) World Bank Policy Research Working Paper 4152; Marion Jansen and Hildegunn Kyvik Nordas, 'Institutions, infrastructure and trade flows' (April 2004) World Trade Organization Staff Working Paper ERSD-2004-02; David Dollar and Aart Kraay, 'Institutions, trade and growth' (2003) 50 *Journal of Monetary Economics* 133; Daniel Berkowitz, Johannes Moenius and Katharina Pistor, 'Legal institutions and international trade flows' (2004) 26 *Michigan Journal of International Law* 163. For a recent collection of essays on PTAs see Kyle Bagwell and Petros Mavroidis (eds), *Preferential Trade*

trade policies tend to strengthen domestic institutions because of the ability of traders to vote with their feet if the domestic institutional environment is not conducive to trade (thus enhancing inter-jurisdictional competition).²⁵ This evidence once again places a premium on domestic institutional quality – this time in external economic relations. The positive feedback effects of more open trade policies on domestic institutions suggest a case for a general orientation to trade openness. However, even with such an orientation, domestic institutional capacity constraints argue for less developed countries placing a priority on enhancing their bargaining power (often in coalitions with larger, more sophisticated developing countries) in the multilateral trading system rather than attempting to negotiate and administer a plethora of bilateral PTAs. Such constraints also suggest that, to the extent that developing countries feel a need to protect various economic sectors from international competition, a premium should attach to very simple, broad gauge policies – a common tariff across all such sectors, for example, rather than a highly calibrated tariff structure that lends itself to rent-seeking and corruption in its formulation and administration.

Unfortunately, many poor developing countries that have pursued import substitution (infant industry protection) policies, especially those with small domestic markets, have become captive to a form of path dependency where, once having implemented these policies, they have become saddled with a range of increasingly costly, uncompetitive and inefficient industries, along with interest groups and rent-seekers with a vested interest in their perpetuation. These interests are a severe impediment to a shift of focus to an outward-oriented, export-led growth strategy that holds out the only prospect for long-term economic growth. Even less poor developing countries with large potential domestic markets have very mixed experiences with import-substitution policies, enjoying some successes in promoting infant industries, but also being saddled with costly and increasingly uncompetitive industries in the face of vested interests that demand ongoing and often increasing support.²⁶

Agreements: Law, Policy and Economics (Cambridge: Cambridge University Press, 2011).

²⁵ Shang-Jin Wei, 'Natural openness and good government' (2000) National Bureau of Economic Research Working Paper 7765; Dani Rodrik, Arvind Subramanian and Francesco Trebbi, 'Institutions rule: the primacy of institutions over geography and integration in economic development' (2004) 9 *Journal of Economic Growth* 14.

²⁶ See Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton, NJ: Princeton University Press, 1995) Chapter 6 ('State firms and high technology husbandry').

Beyond issues bearing on the relationship between domestic institutional quality and trade policy, major international institutional issues arise in the formulation of international trade policy. According to Joseph Stiglitz, developed countries impose far higher – on average four times higher – tariffs against developing countries than against developed countries. Rich countries have cost poor countries three times more in trade restrictions than they give in total development aid.²⁷ Data like this provides fodder for dependency theories noted in Chapter 1 that attribute the plight of many or most poor countries to an unfair international economic system that is rigged in favour of developed countries.

Professor Gerald Helleiner, a distinguished development economist, in his Paul Prebisch lecture²⁸ argues that developing countries, accounting for over 85 per cent of the world's population, are severely under-represented in current governance arrangements for the global economy. Decision-making on key global economic issues remains highly concentrated in the major industrial powers and the major international financial institutions which they control. The selection processes for the leadership of key multilateral financial institutions demonstrate no regard for the principles of due process, with the presidencies of the IMF and the World Bank vested with the EU and the US respectively. Groups such as the G7 countries exclude entirely developing countries from their membership. Even the G20, which includes some larger developing countries, entirely excludes smaller and poorer developing countries. Whereas developed countries account for only 17 per cent of voting strength in the United Nations and 24 per cent in the WTO, they account for almost three-quarters of total World Bank membership, where they hold 40 per cent of total votes.²⁹

While we do not share the view that all or most of the problems that afflict poor countries are attributable to the international economic system, it is easy to be persuaded that substantial reforms are required to this system in order to more fully integrate developing countries into the global economy, and on a fairer and more efficient basis.

In the case of the WTO, at least in principle, decision-making authority is distributed equally, with each of the 153 member countries entitled to a vote (from smallest to largest), and most major decisions taken by

²⁷ Stiglitz, *supra* note 21 at 78.

²⁸ Gerald Helleiner, 'Markets, politics, and globalization: can the global economy be civilized?' 10th Paul Prebisch Lecture, Geneva, 11 December 2000.

²⁹ The South Centre, 'Reform of World Bank governance structures' (September 2007), available at http://www.southcentre.org/index.php?option=com_docman&task=cat_view&gid=45&Itemid=182&lang=en&limitstart=140.

consensus. However, the reality has been that negotiations in the late and critical stages of previous negotiating rounds under the GATT, and more recently the WTO, have typically been dominated by the so-called triad – the US, the EU and Japan – and the results of their three-way negotiations in the so-called ‘Green Room’ simply presented to other countries as largely a *fait accompli*. As with the domestic formulation and administration of trade policy, the multilateral trade regime has been afflicted with a form of path dependency reflected in the serious difficulties the regime has experienced in outgrowing its institutional origins as a small, ‘rich man’s club’ to a genuinely multilateral organization, the vast majority of whose members are developing countries, including some of the largest, most rapidly growing economies in the world (China, India and Brazil).

However, developing countries have struggled to play an effective role in this regime. Multilateral trade negotiations have become increasingly complex and protracted, with an ever-expanding agenda of issues – the Uruguay Round took seven years to complete (1986 to 1993) and the current Doha Round, which began in 2001, has still not reached a conclusion ten years later. Negotiations place an enormous strain on the expertise, resources and institutional capacity of smaller and poorer delegations in countries, many of which cannot afford even to maintain delegations in Geneva. Those countries that have such delegations expect these delegations to assume responsibility for many more matters than trade policy issues vested in various other international agencies located in Geneva. Even delegations with a more limited mandate confront the fact that WTO processes involve at least 45 meetings per week in Geneva, most of which are technically complex and highly legalized, and find it next to impossible to get clear, consistent and informed directions from their home governments, which typically lack the institutional capacity to provide informed judgments or directions on the complex trade-offs that are often required. In the past, developed countries have often pursued a divide-and-conquer strategy with various groups of developing countries, further weakening their negotiating leverage. Only in recent years have developing countries been able to form more effective negotiating coalitions that hold out considerable promise for redressing bargaining inequalities between developing and developed countries.

Once negotiations have been concluded and countries have made various commitments to each other, adherence to these commitments raises the possibility of disputes. The WTO maintains a sophisticated dispute settlement system for adjudicating formal disputes between member countries, beginning with informal consultations, followed by formal proceedings before ad hoc panels, and then appeals on matters of law to a standing Appellate Body. Again, many smaller and poorer developing countries

find that they lack the resources, expertise and institutional capacity to be effective litigants, either as complainants or respondents, in this sophisticated and demanding dispute settlement process. Even in the event of a small developing country prevailing in a dispute against a large developed country, the ultimate sanction for non-compliance is the imposition of authorized retaliatory trade sanctions against the non-compliant country. For large developed countries that prevail in disputes against small developing countries, this is a serious threat, but obviously the converse does not apply, implying yet a further asymmetry in the multilateral institutional arrangements governing international trade.³⁰

These various asymmetries between developing and developed countries in the institutional arrangements governing international trade require urgent attention, but they should not obscure the imperative that for developing countries to participate effectively even in a fairly designed international trading system and its governance, effective domestic institutional capacity that facilitates such participation is an essential precondition – in other words, fair international institutions and effective domestic institutions are complements, not substitutes.

III. FOREIGN DIRECT INVESTMENT AND DEVELOPMENT

A. Policy Concerns

Foreign direct investment (FDI) should be distinguished from portfolio investment. FDI typically involves some form of effective control and active management of assets in host countries, while portfolio investment typically involves passive investments in enterprises or government bonds in host countries. Over the last several decades, there has been a dramatic increase in FDI around the world, much of it between developed countries, but increasingly developing countries have been major recipients of FDI, including countries such as China, and in some cases have themselves become exporters of FDI (again, China is a prominent example).³¹

³⁰ See Chad Bown, *Self-Enforcing Trade: Developing Countries and WTO Dispute Settlement* (Washington, DC: Brookings Institution Press, 2009).

³¹ See generally, Americo Zampetti and Pierre Sauvé, ‘International Investment’, in Andrew Guzman and Alan Sykes (eds), *Research Handbook in International Economic Law* (Cheltenham, UK: Edward Elgar, 2007); Ha-Joon Chang, *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism* (New York: Bloomsbury Press, 2008); Dani Rodrik, *The Globalization Paradox*:

More than 40 per cent of world FDI inflows are directed to developing countries and FDI flows to developing countries now exceed foreign aid flows by a factor of about 5 to 1.³²

In their early post-independence years, many former colonies viewed FDI with scepticism and, in some cases, outright hostility, viewing it as holding the potential for creating a new form of economic imperialism (reflected in dependency theories of development that were influential in many developing countries in the 1950s and 1960s). More recently, many developing countries have come to see FDI as having at least the potential for making significant contributions to their economies – as a source of investment in infrastructure, as a source of technology transfers and spillovers, as a source of investment in human capital and skills upgrading, as a source of investment in major natural resource extraction projects, and as a major source of local employment in low-wage, low-skilled manufacturing activities.³³ Foreign direct investors, in turn, sometimes see international trade in goods or services and FDI as complements and in other cases as substitutes. Where host countries have large protected domestic markets, FDI may be the most effective way of accessing these markets behind prevailing tariff walls – particularly the case with host countries with large growing populations and hence significant potential demand for the goods or services that foreign investors can produce. In this case, FDI is a substitute for trade. In other cases, foreign investors are able to expand their opportunities for international trade in goods or services by accessing lower cost inputs (for example, natural resources or low-cost labour) in host countries and thereby gain a comparative advantage in export markets. In this case, FDI and trade are complementary.

Democracy and the Future of the World Economy (New York: W.W. Norton & Co., 2011). See also Deborah Brautigam, *The Dragon's Gift: The Real Story of China in Africa* (Oxford, New York: Oxford University Press, 2011), showing that sometimes China's involvement in Africa cannot be clearly classified either as FDI or as foreign aid, but suggesting nevertheless that it has a positive impact in the region.

³² UNCTAD, 'Assessing the impact of the current financial and economic crisis on global FDI flows', 19 January 2009.

³³ See, e.g., Theodore Moran, 'Enhancing the ability of developing countries to attract and harness FDI for development', in Theodore Moran (ed.), *Harnessing Foreign Direct Investment: Policies for Developing Countries* (Washington, DC: Brookings Institution Press, 2006); Theodore Moran, Edward Graham and Magnus Blomstrom (eds), *Does Foreign Direct Investment Promote Development?* (Washington, DC: Peterson Institute, 2005); OECD Report, *Foreign Direct Investment for Development: Maximizing Benefits, Minimizing Costs* (Paris: OECD, 2002).

In principle, the theory of comparative advantage should apply as much to international movements of FDI as to international trade in goods or services – capital is likely to gravitate to where its marginal productivity is greatest. If unqualified, this presumption would suggest the case for an international regime that facilitates the free movement of FDI, and constrains countries from adopting domestic policies designed either to encourage it – for example, through subsidies, tax breaks or tax incentives – or to discourage it – for example, through regulations pertaining to local sourcing, minimum export requirements, restrictions on exports, trade balancing requirements that restrict the value or volume of imports to the value or volume of exports, technology transfer requirements, and so on. In fact, many countries have adopted a wide range of domestic policies that either encourage or restrict FDI either generally or, more commonly, in particular sectors.

Restrictions on FDI by host countries may be motivated by a range of concerns.

1. There are likely to be concerns about foreign investors acquiring domestic organizations where the nature of the activities in question raise national security issues – concerns that have been exacerbated by the rapid growth of Sovereign Wealth Funds.³⁴ Foreign governments who control these funds may gain access to sensitive national security technology or information, through foreign acquisitions.
2. While there are few inherent legal constraints on the application of domestic jurisdiction to the activities that foreign investors engage in within a particular country, there may be significant practical constraints in the effective application of domestic laws where the bulk of the organization's assets, many of its senior personnel, and much of the information about its activities and decision-making are located abroad.
3. There may be concerns about attempts by home country governments to enforce their laws and foreign jurisdictions through foreign subsidiaries of home country parent corporations – that is, the extraterritorial application of the laws of the home country.
4. There may also be concerns that foreign subsidiaries will be managed in such a fashion as to reflect home country bias in business decisions – for example, by purchasing inputs from home country affiliates or

³⁴ See Jackie Van Der Meulen and Michael Trebilcock, 'Canada's policy response to foreign sovereign investment: operationalizing national security exceptions' (2009) 47 *Canadian Business Law Journal* 392.

using personnel from home country or other affiliates rather than local personnel, perhaps in some cases motivated by a desire to appear to be a 'good corporate citizen' in the home country in order to maximize political influence in that jurisdiction.

5. There may be concerns that foreign investors will seek to protect their investments in specialized technology and know-how by restricting access to them by domestic organizations or individuals in the host country, thereby reducing the benefits of technological spillovers and human capital enhancements in the host country.
6. There may be cultural and political sovereignty concerns with permitting FDI in certain sectors such as the print and electronic media.

Foreign direct investors, in turn, are likely to confront their own set of concerns in contemplating investments in a foreign country. These may include political and policy instability (including macroeconomic instability); where investments are sunk, subsequent governments may have incentives to behave opportunistically towards foreign direct investors who lack direct political voice in host countries³⁵ by unilateral *ex post facto* re-specification of the terms on which the initial investment was made; weak protection of private property rights and ineffective enforcement of contracts; law and order; and corruption in the administration of state functions (including legal functions).

B. Multilateral Regulation of Foreign Direct Investment³⁶

Historically, the GATT was almost exclusively focused on international trade in goods, and not international trade in services or international movement of capital. However, a GATT panel decision in 1984³⁷ – in response to a complaint by the United States relating to various undertakings obtained from foreign investors pursuant to Canada's Foreign Investment Review Act – held that certain features of domestic foreign investment regulations may fall within the purview of the GATT where these affect international trade in goods. In this case, the US challenged undertakings that required foreign investors to commit to certain local

³⁵ A proposition that is challenged by David Schneiderman, 'Investing in democracy? Political process and international law' (2010) 60 *University of Toronto Law Journal* 909.

³⁶ See generally M. Sornarajah, *The International Law on Foreign Investment* (Cambridge: Cambridge University Press, 2010).

³⁷ *Canada: Administration of the Foreign Investment Review Act* BISD 305/140 (1984).

sourcing and minimum export requirements as a condition for approval of their investments in Canada. The Panel held that the local sourcing requirements violated the National Treatment principle in Article III of the GATT by treating local suppliers of these inputs more favourably than foreign suppliers, although it held that minimum export requirements did not violate any provision in the GATT.

At the beginning of the Uruguay Round in 1986, the US proposed that the multilateral negotiating agenda for this round should include a comprehensive agreement on foreign investment. The Agreement on Trade-Related Investment Measures (TRIMS) that emerged from the round is, in fact, much more modest than the initial US proposals, and builds on the prior GATT Panel ruling in 1984 by prohibiting domestic regulations that would violate the National Treatment principle in Article III.4 of the GATT, including local sourcing requirements, trade balancing requirements, or export restrictions. This illustrative list is non-exhaustive. The TRIMS Agreement has attracted very little subsequent formal dispute settlement activity, in large part because it does little more than reaffirm the application of Article III.4 of the GATT to certain forms of regulation or FDI that may influence imports or exports of goods by foreign direct investors.

Disaffected with this modest outcome from the Uruguay Round, the US and other developed countries sought to shift the venue for multilateral negotiations on a comprehensive investment treaty from the WTO to the OECD, where it was assumed that the predominance of developed countries would yield a readier consensus on liberalizing restrictions on FDI than the WTO, where the preponderance of developing country members with more sceptical, or at least cautious, views of the merits of FDI was likely to preclude achievement of a consensus on a more ambitious set of international disciplines. The expectation was that non-OECD members would be able to accede to any resulting treaty, and that there would be strong inducements to do so in order to compete effectively for FDI. From 1996 through to 1998 negotiations on a multilateral agreement on investment (MAI) proceeded within the OECD, but negotiations were non-transparent, even clandestine, and the leaking of a draft of the agreement to various NGOs precipitated an international firestorm of criticism of the draft agreement and the process by which it was being negotiated. The principal criticism was that it would confer extensive rights on foreign direct investors but with few, if any, concomitant obligations on their part to host countries or their citizens, for example, with respect to technology transfer, health and safety, the environment, labour standards and international human rights. In the face of these criticisms, the MAI negotiations were formally abandoned in December 1998. Proposals to

include negotiations over FDI in the Doha Round of the WTO were also abandoned at the Cancun Ministerial in September 2003 in the face of opposition from developing countries.

C. Bilateral Investment Treaties

While attempts at negotiating a comprehensive multilateral treaty on FDI appear to have been abandoned, at least for the time being, a notable contrasting phenomenon has been the dramatic proliferation since 1990 in the number of bilateral investment treaties (BITs) or international investment agreements (IIAs) that have been negotiated – from just over 400 in 1990 to more than 2600 today.³⁸ The primary impetus behind this proliferation of BITs appears to be that in the competition for foreign direct investment, many countries, especially developing countries, feel obliged to provide investors with certain legally enforceable protections of their investment, although BITs are not limited to developed–developing country dyads (only about 40 per cent); about a quarter of all BITs are between pairs of developing countries.³⁹

BITs typically include provisions on the scope and definition of foreign investment; admission of investment; national and most favoured nation treatment; fair and equitable treatment; guarantees and compensation in respect of expropriation and compensation for war and civil disturbances; guarantees of free transfer of funds and repatriation of capital and profits; subrogation on insurance claims; and dispute settlement, both state-to-state and investor-to-state (typically by international arbitration, most often the International Centre for Settlement of Investment Disputes (ICSID) affiliated with the World Bank).

The proliferation of BITs has raised a number of controversies:

1. The 'fair and equitable' standard of investment protection lacks precision and consistent interpretation or clearly articulated exceptions or qualifications for measures by host countries to address health, safety, and environmental concerns or financial crises, which has led to criticisms of BITs as unduly constraining the political sovereignty of host countries.
2. The expropriation provisions in most BITs also lack clear definition

³⁸ See Gus Van Hartert, *Investment Treaty Arbitration and Public Law* (Oxford: Oxford University Press, 2007) Chapter 2; Stephan Schill, *The Multilateralization of International Investment Law* (Cambridge: Cambridge University Press, 2009).

³⁹ UNCTAD, 'Recent developments in international investment agreements', IIA Monitor No. 3 (2009).

and may be interpreted as extending beyond outright transfer of title to foreign investors' assets or physical dispossession of those assets to various forms of regulatory 'takings' that can be viewed as significantly impairing the value of these assets; this again is criticized for constraining or 'chilling' legitimate spheres of regulatory autonomy.

3. Given that many countries have signed multiple BITs with various other countries, each of which typically contains a most favoured nation clause, major disputes have arisen as to when foreign investors are able to invoke ('cherry pick') either substantive or procedural provisions in BITs other than the BIT to which their home country is a party which are more favourable to their claims than their own BITs.
4. The National Treatment principle, which is contained in most BITs, also gives rise to ambiguity as to when foreign investors have been treated less favourably than domestic investors in 'like circumstances'.
5. The international arbitral dispute resolution system has been criticized as lacking transparency, consistency and scope for effective third party (amicus) interventions, and in general being biased towards the interests of foreign investors.⁴⁰
6. It is argued that BITs largely remove foreign investors as a political constituency for domestic legal reform in host countries by providing them with privileged supra-national legal protections.⁴¹

A new generation of BITs attempts to strike a finer balance between the interests of investors and the interests of host countries by adding interpretive provisions, general exceptions clauses, and new preambular language as to the purpose of the agreements,⁴² but how arbitrators are likely to interpret such provisions and whether they are effectively justiciable in a consistent and credible manner remains to be tested by experience. As to

⁴⁰ For a review of many of these critiques, see David Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise* (Cambridge: Cambridge University Press, 2008).

⁴¹ Tom Ginsburg, 'International substitutes for domestic institutions: bilateral investment treaties and governance' (2005) 25 *International Review of Law and Economics* 107. For a contrary view, see Susan Franck, 'Foreign direct investment treaty arbitration and the rule of law' (2007) *Pacific McGeorge Global Business and Development Law Journal* 337.

⁴² See Suzanne Spears, 'The quest for policy space in a new generation of international investment agreements' (2010) 13 *Journal of International Economic Law* 1037; see also Peter Muchlinski, 'Holistic approaches to development and international investment law: the role of international investment agreements', in Julio Faundez and Celine Tan (eds), *International Economic Law, Globalization and Developing Countries* (Cheltenham, UK: Edward Elgar, 2010).

whether BITs actually increase FDI flows to host countries that are signatories to them has yielded a rather mixed body of empirical evidence.⁴³ The most recent and comprehensive study⁴⁴ finds (contrary to some earlier studies) that BITs do promote FDI flows to developing countries (although yielding declining marginal impacts as more BITs are signed) and may even substitute for weak domestic institutions, though probably not for unilateral measures such as opening up previously restricted industries, removing foreign ownership restrictions, promotional efforts and tax and fiscal inducements.

Nevertheless, the extent to which BITs can substitute for weak domestic institutions is limited in part because arbitral awards still need to be enforced in the domestic courts of host countries, and in part because purely private disputes may still need to be resolved in these courts unless the parties have contracted out of the jurisdiction through (increasingly common) choice of law and choice of forum clauses – although even in these cases foreign judgments or arbitral awards need to be enforced in host countries' courts.⁴⁵ It needs to be acknowledged more generally that the empirical evidence on how important a host country's legal system is as a determinant of FDI is contested terrain, with scholars pointing, as counter-evidence, to the case of large recent inflows of FDI into China, despite relatively weak legal institutions, at least on conventional criteria.⁴⁶

Chapter 11 of NAFTA, while involving three parties, exemplifies many of the issues and controversies that have arisen with respect to BITs and has been a prominent lightning rod for critics of NAFTA. When Chapter 11 was initially negotiated, it was thought likely to apply in practice mostly to Mexican laws and regulations pertaining to FDI, given a long and somewhat tangled history in Mexico of cycles of nationalization and liberalization of FDI. However, Chapter 11 has provoked a number of formal complaints (in excess of 30 to date), including a number against measures adopted in Canada and the US.

Chapter 11 of NAFTA contains a National Treatment provision in

⁴³ For a review of this evidence, see Amnon Lehaví and Amir Licht, 'BITs and pieces of property', 36 *Yale Journal of International Law* 115 at 126–8.

⁴⁴ Matthias Busse, Jens Koniger and Peter Nunnenkamp, 'FDI promotion through bilateral investment treaties: more than a bit?' (2010) 146 *Review of the World Economy* 147.

⁴⁵ See Jans Damman and Henry Hansmann, 'Globalizing commercial litigation' (2008) 94 *Cornell Law Review* 1.

⁴⁶ See Amanda Perry, 'Effective legal systems and foreign direct investment: in search of the evidence' (2000) 49 *International and Comparative Law Quarterly* 779; cf. Agnes Benassy-Quere, Maylis Coupet and Thierry Mayer, 'Institutional determinants of foreign direct investment' (2007) 30 *The World Economy* 5.

Article 1102 (subject to reservations that the three parties have entered in schedules to NAFTA) and a most favoured nation treatment provision (Article 1103). Article 1105 (Minimum Standard of Treatment) requires that each party shall accord to investments of investors of another party treatment in accordance with international law, including fair and equitable treatment and full protection and security. Article 1106 (Performance Requirements) prohibits a long list of performance requirements, including those contained in the TRIMS Agreement but extending to other performance requirements such as technology transfer requirements. Article 1110 (Expropriation and Compensation) provides that no party may directly or indirectly nationalize or expropriate an investment of an investor of another party in its territory or take a measure tantamount to nationalization or expropriation of such an investment except (a) for a public purpose; (b) on a non-discriminatory basis; (c) in accordance with due process of law and Article 1105; and (d) on payment of compensation.

Chapter 11 then sets out a procedural regime for the resolution of disputes which permits private investors to file complaints with international arbitral panels, primarily the International Centre for Settlement of Investment Disputes (ICSID). Awards issued by such arbitral panels – which provide for monetary compensation for foreign investors who have been able to satisfy an arbitral panel that the host country's measures in question violate one of the substantive provisions of Chapter 11 – are enforceable in the domestic courts of host countries.

The arbitral case law that has emerged under Chapter 11 has raised major uncertainties as to the interpretation and application of key substantive provisions in Chapter 11, especially the international minimum standard of treatment requirement in Article 1105 and the expropriation provisions in Article 1110, which different arbitral panels have interpreted both expansively and narrowly but without a system of appellate review or precedent to resolve inconsistencies. Critics of Chapter 11 argue that its provisions and the investor-driven complaints dispute settlement process have undesirably constrained the domestic political autonomy of member countries and imposed a regulatory chill on legitimate environmental and health and safety measures that host countries have sought or might seek to adopt.⁴⁷ Moreover, the expropriation provisions of Chapter 11 risk standing the National Treatment principle on its head by requiring

⁴⁷ See Chris Tollefson, 'NAFTA's Chapter 11: The case for reform', in John Kirton and Peter Hajnal (eds), *Sustainability, Civil Society, and International Governance* (Aldershot: Ashgate Publishing Limited, 2006) Chapter 10.

II. NORMATIVE RATIONALES FOR FOREIGN AID

Many people feel there is a moral duty to assist those in need, including those living in conditions of extreme deprivation in developing countries. For libertarians, as exemplified by the views of Canadian philosopher Jan Narvedson,¹⁴ this duty is limited only to those who suffer from evils which donors have inflicted on them, no matter where, and donors owe these people compensation. In a foreign aid context, one might argue that in the case of developing countries that were formally colonies, there may be a duty of compensation on the part of the former colonial powers. In this analysis, a debt is owed to countries where development was inhibited by colonial powers which adopted policies that undermined traditional belief systems and forms of social organization – including, in some cases, the promotion of slavery, the exhaustion of natural resources or the drawing of arbitrary borders that created dysfunctional states. However, this argument does not account for aid given to contemporary developing countries that were never colonies such as China, Ethiopia, Iran and Thailand. Furthermore, many decolonized countries have become very successful middle or high income developing countries post independence (for example, Singapore, Hong Kong, Taiwan, South Korea, Malaysia, Chile, Botswana), so there is not a close correlation between earlier colonial experience and a contemporary need for foreign aid.

From a utilitarian perspective – or at least a global utilitarian perspective – it seems obvious that global well-being is likely, in principle, to be increased by the wealthy in developed (and some developing) countries, making what for them is likely to be modest sacrifices to dramatically enhance the well-being of the most destitute in poor countries. Peter Singer, in a recent book,¹⁵ takes this view, arguing from the analogy of a stranger encountering a child drowning in a pool of water who can be easily rescued, perhaps at the minor expense of a new pair of shoes that the stranger is wearing. However, these arguments, which rest on a moral obligation to assist those living in developing countries, are critically contingent on a demonstration that such transfers of wealth will in fact make the needy in poor countries better off. Whether this is true or not is essentially an empirical question on which (as we have noted) the evidence is not generally encouraging. The utilitarian case for foreign aid

¹⁴ Jan Narvedson, 'We don't owe them a thing: a tough minded but soft hearted view of aid to the faraway needy' (2003) 86 *The Monist* 419.

¹⁵ Peter Singer, *The Life You Can Save: Acting Now to End World Poverty* (New York: Random House, 2009).

may be strengthened when aid results in a peace or security dividend for donor countries by stabilizing recipient countries whose failure may lead to military conflicts, a major exodus of refugees that require resettlement, or provide a haven for international terrorists.

A theory of global distributive justice might also seem to be implied by Rawlsian social contract theory,¹⁶ although in later writing Rawls ascribes a very limited role to the application of principles of distributive justice among nations, in the absence of a world government to oversee the social contract¹⁷ – a position strongly contested by other political philosophers.¹⁸

The normative case for expansive forms of foreign aid is perhaps strongest when based on some notion of intrinsic universal human rights and basic universal individual freedoms – a kind of Kantian categorical imperative of mutual support for basic human dignity by virtue of our common humanity – as articulated, for example, by Amartya Sen in his book, *Development as Freedom*.¹⁹ In this case, the argument in favour of aid does not assume that its primary goal is directly to promote economic growth or to reduce global inequalities of wealth between nations. Rather, it suggests that aid may enhance the agency and dignity of individuals in developing countries, although whether it actually does so rests again on empirical judgments,²⁰ and where the state is the major source of deprivation of these freedoms makes institutional reform, again, a central objective of foreign aid (however intractable).

¹⁶ John Rawls, *A Theory of Justice* (Cambridge, MA: Harvard University Press, 1971).

¹⁷ John Rawls, *The Law of Peoples* (Cambridge, MA: Harvard University Press, 1999).

¹⁸ See, for example, Charles Beitz, *Political Theory and International Relations* (Princeton, NJ: Princeton University Press, 1999, revised edition), and Thomas Pogge, *Realizing Rawls* (Ithaca, NY: Cornell University Press, 1989).

¹⁹ Amartya Sen, *Development as Freedom* (New York: Alfred A. Knopf, 1999).

²⁰ A recent trend in this field suggests that foreign aid should be based on trials and randomized experiments, as many policies that are well-designed in theory do not work in practice. Based on that, some argue that collecting empirical evidence through randomized control trials of certain policies should precede any foreign aid investment. See, for instance, Dean Kaplan and Jacob Appel, *More than Good Intentions: How a New Economics is Helping to Solve Global Poverty* (New York: Dutton, 2011); and Abhijit Banerjee and Esther Duflo, *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty* (Public Affairs, 2011).

III. IS THE CURRENT AMOUNT OF FOREIGN AID ENOUGH?

Sachs argues that many developing countries are caught in a 'poverty trap' which prevents self-sustaining growth.²¹ The trap results from a lack of investment as a result of low or non-existent savings rates, accompanied by disinvestment caused by depreciation of existing capital and population growth. Large infusions of foreign aid can break this trap by facilitating investment in human capital, business capital, infrastructure, natural capital, public institutional capital and knowledge capital (although the existence of poverty traps has been strongly contested).²² Sachs argues that successes with foreign aid programmes to date warrant confidence that they can be effectively scaled up to help developing countries escape the poverty trap. In this respect he identifies as successes the Green Revolution in Asia, the eradication of smallpox, the global alliance for vaccines and immunization, the control of African River Blindness, the eradication of polio, the spread of family planning, the development of export processing zones in East Asia, and the mobile phone revolution in Bangladesh and elsewhere.

Sachs argues that incremental investments of foreign aid often fail to address all the links in a causal chain that explain chronic poverty. For example, if children of primary school age lack access to schools, aid donors could build classrooms, but these would be of little or no value without teachers to staff them. In turn, teachers are of little or no value if they have not received proper training or if children lack basic textbooks. In turn, classrooms and teachers are of little value if young children are unable to attend school because of poor roads or debilitating diseases or economic imperatives within the family that they work rather than acquire an education. To mitigate these family pressures, expanded economic opportunities need to be provided to parents or other forms of financial support, and in order to motivate both parents and children to attend school and take education seriously they need to be offered economic opportunities after an education has been acquired to justify the investments in this education.²³

Sachs notes that Americans in public opinion polls regularly report on

²¹ Sachs, *supra* note 7.

²² For sceptical views on the existence of 'poverty traps', see William Easterly, 'Reliving the 1950s: the big push, poverty traps, and takeoffs in economic development' (2006) 11 *Journal of Economic Growth* 289; Aart Kraay and Claudio Raddatz, 'Poverty traps, aid, and growth' (2007) 82 *Journal of Development Economics* 315.

²³ Sachs, *supra* note 17.

average that foreign aid accounts for 20 per cent of the federal budget, roughly 24 times the actual figure.²⁴ Peter Singer argues that if we accept the premise that all lives have equal value, wherever they are lived, the small amount that Americans contribute to foreign aid is morally indefensible.²⁵ He starts with the top 0.01 per cent of US taxpayers, earning an average of US\$12775000 per year and assumes that they could each give a third of their annual income. For the next 0.1 per cent, he assumes they could give a quarter of their income; the next 0.5 per cent could give one-fifth of their income; the next 1 per cent could give 15 per cent of their income; and the remainder of the nation's top 10 per cent could give 10 per cent of their income, producing a total of US\$404 billion from just 10 per cent of American families. If such a scheme were extrapolated worldwide it would generate revenue of US\$808 billion annually for development aid – vastly in excess of the figure that even Sachs thinks is required to lift most developing countries out of poverty.

Easterly, on the other hand, while not necessarily opposed to increases in levels of aid, views such increases as an exercise in futility unless there are reasons for assuming that they will be more effective than the US\$2.3 trillion in aid provided to developing countries over the past five decades, including US\$568 billion to Africa over the past 45 years.²⁶ He favours piecemeal or incremental initiatives that are subject to rigorous independent evaluations of their efficacy. Instead of funding 'grand plans' administered by poorly functioning aid agencies and corrupt recipient governments, foreign aid should focus on small-scale social or business entrepreneurs, or 'searchers' (rather than 'planners') as he calls them, who seek out innovative development solutions. He advocates more emphasis on demand-driven aid initiatives by citizens and communities in developing countries, rather than supply-driven initiatives from external donors. By funding these alternative development agents, inadequate governance can be bypassed, which will allow modest development advances through gradual and small-scale change. Only when institutional stability

²⁴ Jeffrey Sachs, 'The Development Challenge', *Foreign Affairs* (March/April 2005).

²⁵ Peter Singer, 'What Should a Billionaire Give – and What Should You?', *New York Times* (December 17, 2007), subsequently slightly modified in Singer, *The Life You Can Save: Acting Now to End World Poverty* (New York: Random House, 2009).

²⁶ Easterly, *The White Man's Burden*, *supra* note 9; Easterly, 'Introduction', in Easterly (ed.), *Reinventing Foreign Aid*, *supra* note 9. But see Joseph Hanlon, Armando Barrientos and David Hulme, *Just Give Money to the Poor: The Development Revolution from the Global South* (Sterling, VA: Kumarian Press, 2010).

allows for expectations to develop which promote domestic savings and investment can large-scale foreign aid make fundamental changes to the economic systems of developing countries. This again depends on success and stability in institutional reform.

Once donors make aid commitments, it is crucial to development efforts that they are fulfilled.²⁷ As noted above, the gap between commitments and actual aid flows can be dramatic, and the aid that is delivered is often volatile and unpredictable, as donor priorities change or agency capacity to disburse funds varies. This prevents long-term policy formation and creates expectations of volatility which establish perverse incentives for recipient governments to focus spending on short-term consumption, rather than investment. This has a generally negative effect on aid effectiveness, and undermines government policy in recipient countries.

IV. WHICH COUNTRIES SHOULD RECEIVE AID?

If one takes the view that an expansion in levels of aid should be predicated on reasonable assurances of efficacy, it is then appropriate to turn to factors that have limited the efficacy of aid in the past (other than the factors noted at the outset of this chapter) as a prelude to consideration of reforms of the institutional architecture of the foreign aid system. Are some aid environments more supportive of effective foreign aid than others? In a widely cited World Bank study reviewing the post-war aid experience, published in 1998,²⁸ the authors conclude from the empirical experience that aid works best in good policy and institutional environments and is often wasted or dissipated in other environments. This conclusion, as a matter of intuition, seems compelling, although it has been challenged empirically,²⁹ but even if well founded it raises a major foreign aid dilemma: developing countries with good policy and institutional environments will often have less pressing claims for aid, as measured on many common economic and social indicators, than developing countries that lack these environments.³⁰ As Moises Naim puts it (perhaps rather

²⁷ Oya Celasun and Jan Walliser, 'Predictability of aid: do fickle donors undermine aid effectiveness?' (2008) *Economic Policy* 545.

²⁸ David Dollar and Lance Pritchett, *Assessing Aid: What Works, What Doesn't and Why* (Oxford: Oxford University Press, 1998).

²⁹ See William Easterly, 'Can foreign aid buy growth?' (2003) 17 *Journal of Economic Perspectives* 23; and Riddell, *supra* note 1 at 232.

³⁰ See Jakob Svensson, 'Absorption capacity and disbursement constraints', in Easterly (ed.), *Reinventing Foreign Aid*, *supra* note 9.

too dramatically), 'the paradox is that any country capable of meeting such stringent requirements is already a developed country'.³¹ Failed or fragile states present this dilemma in its most acute form, but many developing countries exhibit a mix of good and bad policies and good and bad institutions.

According to Paul Collier, in his book, *The Bottom Billion*,³² foreign aid should be concentrated on the 60 or so developing countries comprising the poorest billion citizens of the world and suffering from one or more of the various traps that Collier describes – the natural resource trap, the landlocked-with-bad-neighbours trap, the civil conflict trap and the bad governance trap. But, of course, these countries are precisely those where the good aid environment described by the World Bank in its review of the post-war foreign aid experience generally does not exist. For multilateral, regional and bilateral aid agencies already facing a significant level of public scepticism in donor countries as to the efficacy of aid, this may be viewed as an extremely high risk aid strategy if providing aid to countries that need it most is unlikely to have the desired effects because of institutional and policy failures.

V. HOW SHOULD AID BE COORDINATED?

Coordination problems manifest themselves in a wide range of dimensions in the foreign aid field. First, within large multilateral aid organizations – such as the World Bank and a plethora of UN agencies, and replicated to some extent in regional and bilateral aid agencies – personnel and budgets are typically organized into various subject area groupings, for example, rural development, infrastructure, governance reform, sustainable development and gender issues, which in turn are overlaid by geographic groupings by country or region. Aid dispensers experience strong incentives to disburse money quickly, as a readily observable measure of activity, while resisting both independent evaluations of outcomes and acknowledgements of failure (from which lessons for the future may be learned).³³ Within recipient governments, there is a somewhat parallel set

³¹ Moises Naim, 'Washington Consensus or Washington Confusion', *Foreign Policy* (Spring 2000) 87 at 96.

³² Paul Collier, *The Bottom Billion: Why the Poorest Countries are Failing and What Can Be Done About It* (New York: Oxford University Press, 2007).

³³ See Lant Pritchett, 'It pays to be ignorant: a simple political economy of rigorous program evaluation', in Easterly (ed.), *Reinventing Foreign Aid*, *supra* note 9.

of organizational issues, with various line ministries of government – for example, health, education and infrastructure – often in some tension with central ministries such as finance in competing for donors' assistance, again with similar incentives to 'move the money', while avoiding honest and rigorous evaluations of results.

On the donor side of the equation, these problems are compounded horizontally by donor proliferation, where many donor agencies (recalling that most aid is bilateral) are active in the same subject areas and countries or regions, each reflecting its own citizens' or taxpayers' preferences or priorities³⁴ (or else there would be only one global aid agency). Each country's aid agency has strong political incentives to 'plant the flag' on as many visible projects as possible, and in many cases in as many countries as possible, even though the result is often dozens or even hundreds of donors or their agents involved in various aid projects in a given development country.³⁵ Each aid recipient country receives official development assistance from an average of 26 different official donors and upwards of 30 substantial NGOs.³⁶ Donor agencies are often unaware of the multiple donor agencies working on similar projects, and thus make aid allocation decisions with imperfect information about the overall funding going to a particular sector. On the recipient side, disbursing aid from multiple sources burdens recipient governments with high transaction and managerial costs in complying with each donor's reporting and accountability requirements, reducing general governmental capacity and undermining the government's ability to attend to basic functions.³⁷ Problems of horizontal coordination on the recipient side are compounded when sub-national levels of government, community organizations, local or foreign NGOs, or 'ring-fenced' aid projects are involved in the aid delivery process (such problems are often compounded by 'poaching' by these organizations of some of the most knowledgeable employees of the host government at much higher salaries). From the recipient side, Ashraf Ghani, the first Minister of Finance in the post-Taliban government in Afghanistan, describes how the central budgetary process was undermined by the

³⁴ See Ritva Reinikka, 'Donors and service delivery'; Stephen Knack and Aminur Rahman, 'Donor fragmentation'; Berton Martens, 'Why do foreign aid agencies exist?' in Easterly (ed.), *Reinventing Foreign Aid*, *supra* note 9.

³⁵ See Polman, *supra* note 8.

³⁶ Riddell, *supra* note 1, at 52, 54; Ashraf Ghani and Clare Lockhart, *Fixing Failed States: A Framework for Rebuilding a Fractured World* (New York: Oxford University Press, 2008), Chapter 5.

³⁷ Nancy Birdsall, 'Seven Deadly Sins: reflections on donor failings' (2005) Center for Global Development, Working Paper No. 50.

proliferation of donors, contractors and sub-contractors, NGOs and projects. This confusion undermined government attempts to establish a coherent set of strategic priorities.³⁸

Individual donor agencies also face problems of vertical coordination, when aid is delivered through a chain of contracts and sub-contracts with local or foreign contractors or NGOs. There would seem to be obvious gains in aid effectiveness to be realized by bilateral aid agencies developing substantial expertise in a few sectors in a few developing countries (and hence achieving a comparative advantage in these sectors and countries). However, there appear to be powerful institutional and political incentives driving in the opposite direction, such as desire for donor visibility within many recipient countries and the international aid community.³⁹

Here again we confront the 'aid-institutions' paradox identified earlier in this discussion of foreign aid: bypassing governments in recipient countries (even those with weak governments) poses various risks. Many charities and NGOs suffer from their own problems of transparency, accountability and effectiveness.⁴⁰ Setting up a composite body of government, donor and NGO representatives ('independent service authorities') in recipient countries to address the problems of coordination (as Collier and Riddell propose)⁴¹ raises similar issues of transparency and accountability, as well as the risk of dysfunctional internal politics within such bodies and the creation of a parallel *de facto* government that further undermines the legitimacy and effectiveness of the *de jure* government.⁴² However, channelling all aid through weak governments – in its purest form, simply enhancing the central government's budgetary capacity – runs its own set of risks: the risk of gross misallocation, even misappropriation, of aid resources and, even in more favourable circumstances, being unappealing to donor countries whose domestic political constituencies may be unimpressed by the seeming irresponsibility of writing blank cheques to foreign governments in developing countries without visible projects to point to as the result of aid expenditures.

³⁸ Ghani and Lockhart, *supra* note 36.

³⁹ Danielle Goldfarb and Stephen Tapp, 'How Canada can improve its development aid: lessons from other agencies' (Toronto: CD Howe Institute, Commentary No. 232, April 2006); John Richards, 'Can aid work? Thinking about development strategy' (Toronto: CD Howe Institute, Commentary No. 231, April 2006).

⁴⁰ See Polman, *supra* note 8.

⁴¹ Collier, *supra* note 32 at 118–20; Riddell, *supra* note 1 at 396.

⁴² See Reinikka, *supra* note 34.

VI. SHOULD AID BE CONDITIONAL AND ON WHAT?

An attempt to address the conflicting relationship between the interests of aid donors and those of developing country governments is the use of conditionality in the terms on which aid is provided to encourage recipient governments to comply with donor interests or expectations. Some forms of aid conditionality are, on their face, quite perverse from a development perspective. In particular, tied aid – whereby donors require recipient governments to commit to purchasing inputs, goods or services from firms in donor countries – has been found to diminish the value of aid by 15 to 30 per cent relative to what the amount of aid could purchase on the open market. This also freezes out local suppliers in developing countries from the growth opportunities which arise from participating in the aid delivery process. Tied aid still accounts for a significant percentage of bilateral aid (approximately 50 per cent), although substantial progress has been made in recent years, through the OECD, in reducing this percentage.⁴³

In other cases, aid conditions reflect what donor agencies believe recipient countries should accord a high priority to in development objectives, regardless of whether these priorities are shared by the population or governments of the recipient countries. Just as there are problems of non-alignment of preferences among donors, there are often problems of non-alignment of preferences between donors and recipients; these problems reflect broken information (accountability) feedback loops where citizens/taxpayers in donor countries are ill-informed as to the effects of aid in recipient countries, and citizens in recipient countries have no political voice in donor countries.⁴⁴ If governments in recipient countries are weak, incompetent, corrupt or unaccountable to their citizens, there may be reasons for circumspection about recipient governments' articulation of aid priorities. Thus, in many cases, governments in developing countries are the problem, not the solution. In such cases, aid conditions should ideally be informed by some broader canvassing of priorities amongst representative groups of citizens of the developing countries in question if the problem of broken information (accountability) feedback loops is to be mitigated. This is not easy for external donor agencies to orchestrate in the absence of established broadly based consultative mechanisms, and in the face of potential resistance from the recipient country's government itself. Thus, in many cases, aid conditions are routinely violated or imper-

43

See Riddell, *supra* note 1, at 100–101.

44

See Martins, *supra* note 44; Svensson, *supra* note 30.

fectly followed by the governments of recipient countries, and almost as routinely ignored by many donor agencies facing imperatives to continue to disburse the aid to meet expenditure commitments, regardless of the unmet conditions.⁴⁵

This phenomenon is exacerbated by the problem of conditions imposed by different donors at cross-purposes with one another, and by the problem of effective monitoring of compliance with aid conditions because of the fungibility of money. For example, if a country commits itself to allocating aid that it receives to primary school education, it may simply reallocate resources of its own that it would otherwise have spent on primary school education to other purposes (military expenditure, for example), while claiming that the aid received has been allocated to its intended purpose. In some cases, aid conditionality, particularly when a new reform-oriented government in a recipient country has taken office, can serve the useful function of providing a credible commitment to an agreed agenda of policy and institutional reform, as well as sending credible signals to domestic and foreign economic agents (including foreign investors) that the new government is committed to a well-defined, long-term development strategy. These cases, however, seem very much the exception rather than the rule.

VII. WHAT ENDS SHOULD AID ATTEMPT TO SERVE?

One view of the purposes of foreign aid (largely espoused by Easterly) is that aid should be confined to serving basic humanitarian needs at the grassroots levels and attempt to relieve the most severe forms of destitution or deprivation. On a different view (largely espoused by Sachs), aid should serve much more ambitious purposes and espouse an activist pro-development agenda that sets poor developing countries on a self-sustaining path to greater economic prosperity in the future.

These two views have important implications for how aid should be delivered. On the first view, much humanitarian aid might be most effectively delivered through local community organizations and local and international NGOs, largely sidestepping governments, at least in failed or fragile states, although problems of coordination will remain a daunting challenge. On the second view, this much more ambitious

⁴⁵ Jakob Svensson, 'Why conditional aid does not work and what can be done about it?' (2003) 70 *Journal of Development Economics* 381.

pro-development agenda requires a capable, activist and well-motivated state to coordinate major investments in infrastructure such as roads, ports, communications systems, education and health care systems and the administration of justice. Incongruously in our view, Singer – who supports Sachs' arguments for much larger volumes of foreign aid – seems to imagine that this objective can be achieved solely or primarily through the local, decentralized initiatives of community organizations, charities and NGOs (which resonates much more closely with Easterly's more modest views of the ends of foreign aid).

A yet further view, espoused by Hubbard and Duggan, is predicated on the premise that very few societies throughout history have become prosperous without a thriving private sector. According to them, akin to the Marshall Plan, aid should be focused single-mindedly on promoting the growth of the private sector and providing complementary inputs in the form of physical and institutional infrastructure that are preconditions to its growth, on the assumption that greater revenues from growth can then finance various social investments in, for example, health and education. However, one might question whether some of these investments are indeed pre-conditions to the emergence of a thriving private sector.⁴⁶

VIII. FOREIGN AID AND INSTITUTIONAL REFORM

It is useful to place the institutional capacity issues noted above primarily in the context of the Sachs–Easterly debate about foreign aid. Sachs, in arguing for a 'big push' on foreign aid, largely ignores these institutional issues, rather casually pointing to the fact that there are several governments in sub-Saharan Africa that possess the institutional competence and integrity to use more aid effectively (leaving as an unanswered mystery what should happen in the many other cases). Easterly, on the other hand, in the face of these institutional dysfunctions, seems largely to throw up his hands in despair and resign himself to aid being deployed on the margins of the development enterprise in small, incremental, local initiatives (such as drilling wells for local villages, providing mosquito nets and vaccinating against various tropical diseases). Singer attempts to skirt

⁴⁶ R. Glenn Hubbard and William Duggan, *The Aid Trap: Hard Truths About Ending Poverty* (New York: Columbia University Press, 2009); see also Kurt Hoffman, 'Placing enterprise and business thinking at the heart of the war on poverty', in Easterly (ed.), *Reinventing Foreign Aid*, *supra* note 9; see Polman, *supra* note 8.

issues of institutional capacity entirely by focusing on private, voluntary donations to NGOs and charities. For Moyo, aid has mostly pernicious effects, so the less aid the better, making irrelevant any question of how to reform aid policies.

The enormous challenge, largely unaddressed by these authors, is whether limitations on institutional capacity and legitimacy can be addressed effectively so that a much larger volume of aid can responsibly be provided to developing countries with some reasonable confidence in its likely efficacy.⁴⁷ Setting these institutional issues to one side, or treating them as of second-order importance, in debates over foreign aid is largely to condemn aid to ineffectiveness in precisely those environments where citizens are the victims of the most severe forms of deprivation. However, confronting these issues requires donors to forego the illusion that aid is a largely technocratic rather than political exercise and that tensions with traditional Westphalian notions of state sovereignty can be avoided. We can no longer persist with the fallacy that poorly performing governments in developing countries simply lack information, technical expertise and resources (which aid can provide), but are otherwise well motivated towards their citizens.⁴⁸

Our starting point is to acknowledge that aid agencies require, as committed clients, self-identified agents of institutional reform with self-identified agendas for reform supported by significant and broadly resentative constituencies within developing countries. In some (rare) cases this may be the government itself, but is more likely to be pockets of reformers within agencies of government, or constituencies outside government, who are committed to an institutional reform agenda. This agenda cannot be imposed from outside by pretending that 'Djibouti is Denmark' or by 'skipping straight to Weber',⁴⁹ but requires an authentic domestic political constituency with a reform agenda that is sensitive to the particularities of its country's context, history, politics and culture.

Given such a reform constituency, foreign aid donors can provide both financial and technical support to such constituencies to assist them in pressing their reform agenda and also exert leverage on government and its agencies by withholding or terminating government-to-government aid for failure to respond to this reform agenda against well-specified milestones. Increasing the percentage of aid channelled through multilateral

⁴⁷ See Riddell, *supra* note 1 at 373–7.

⁴⁸ See Chakravarti, *supra* note 12.

⁴⁹ Lant Pritchett and Michael Woolcock, 'Solutions where the solution is the problem: arraying the disarray in development', in Easterly (ed.), *Reinventing Foreign Aid*, *supra* note 9.

institutions is likely to increase this leverage (although at the risk of larger systemic policy errors and less policy experimentation at the level of the individual donor). Reforming the governance structure of such institutions to make them more fairly representative of the developing and developed world is also likely to enhance the legitimacy of exerting such leverage. Invoking accession negotiations for membership of trade or broader economic cooperation regimes, offering valuable long-term benefits (as the EU has done with some success with new member countries from Central and Eastern Europe) to extract, monitor and enhance meaningful institutional reform commitments that enjoy support from substantial domestic constituencies is an analogous strategy that has some promise (but has been insufficiently exploited more generally).⁵⁰

At the end of the day, if one believes that institutions matter to development, to give up on foreign aid as an important agent of institutional change is to condemn the citizens of many of the world's poorest and most misgoverned countries to a future of more or less perpetual deprivation. Rethinking the most effective bundle of 'carrots and sticks' to drive institutional change is the central unmet challenge on the foreign aid agenda. Until this 'aid-institutions' paradox is unlocked, foreign aid will largely fail to advance long-term development objectives.

9. Conclusion: in search of knowledge

I. INTRODUCTION

This book has sought to provide a concise introductory survey of the current state of academic knowledge about development, with a special focus on the ways in which development relates to institutions. As we conclude this task, the reader may be tempted to ask one of the most important questions faced by those concerned with development today: where does one start, if one wants to contribute further to the global discourse about institutional solutions to development problems?

In the first chapter we surveyed a number of theories of development, showing how each of them ascribes development to a different cause (the economy, geography, culture or a country's institutional arrangements). Despite their differences, all these theories share the belief that one can find a common set of factors that will determine a country's development prospects. There are, however, scholars who refuse to engage in such an exercise, rejecting the idea that there can be a single determinant of development and being sceptical as to the possibility of developing a 'universal theory' of development. In the view of these scholars, a country's fate will be determined by a series of factors that are quite unique and particular to that country. For these authors, the search for a general theory of development is futile: we should instead be trying to discuss separately the particular circumstances of, for example, Brazil, China and the Sudan.¹

This divergence of views regarding the existence of a 'universal theory' of development can also be found in microcosm in institutional theories of development. Some scholars believe that it is possible to conceive a general theory of institutional development or institutional change.² In contrast, strong scepticism is espoused by those who see the institution-building exercise as a complex and dynamic phenomenon, informed by a variety of

¹ David Booth, 'Marxism and development sociology: interpreting the impasse' (1985) 13 *World Development* 761–87; M. Edwards, 'The irrelevance of development studies' (1989) 11:1 *Third World Quarterly* 116–36.

² The most emblematic example would be the work of Douglass North, founder of the new institutional economics. For a more detailed discussion of this work, see Chapter 1.

⁵⁰ Michael Trebilcock and Ron Daniels, *Rule of Law Reform and Development: Charting the Fragile Path of Progress* (Cheltenham, UK: Edward Elgar, 2008), Chapter 10.

societal factors – such as politics and culture – that are beyond the reformers' (or perhaps anyone's) knowledge or control.³ While the first view subscribes to the idea that we can collectively engage in an institution-building exercise, the second view either sees this exercise as unique and particular to each country or each institution, or it rejects altogether the idea that it is possible to conceive of 'institution building': institutions grow organically and cannot be intentionally created or modified. The latter view rejects the possibility of conceiving of a theory of institutional change, while the former is based on the assumption that observable patterns or regularities should allow us to find a common path according to which all institutions are created and evolve.

This book lies somewhere in between these two extremes. If one believes that it is not possible to conceive of a theory of development, it would be impossible to talk about development in general. We reject that view. We believe instead that middle level generalizations are possible.⁴ While it may not be very useful or illuminating to compare Brazil with most low-income countries in Africa, we argue that Brazil has commonalities with Mexico or other middle-income countries that allow for comparison and limited generalization.

These middle level generalizations are also possible at the institutional level. It may be difficult to support the idea that every single institution emerges and evolves according to a universal pattern. Nevertheless, there may be useful commonalities that can be found among institutions performing similar functions in different countries.⁵ This is especially true when the political, social and economic circumstances under which these institutions are operating are very similar.

The possibility of middle level generalizations at the country level and at the institutional level are the two main assumptions that underlie this

³ Brian Z. Tamanaha, 'The primacy of society and the failure of law and development' *Cornell International Law Journal* [forthcoming], available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1406999; Duncan Kennedy, 'Three globalizations of law and legal thought: 1850–2000' in D. Trubek and A. Santos, *The New Law and Development* (Cambridge: Cambridge University Press, 2006).

⁴ See also Michael Todaro and Stephen Smith, *Economic Development* (London: Longman Group, 2012, 11th edn) at 56–70 (calling these 'diversity within commonalities'); Frans Schuurman (ed.), *Beyond the Impasse: New Directions in Development Theory* (London: Zed Books, 1993); P. Vandergesst and F. Buttel, 'Marx, Weber and development sociology: beyond the impasse' (1998) 16:6 *World Development* 683.

⁵ Mariana Prado and Michael Trebilcock, 'Path dependence, development and the dynamics of institutional reform' (2009) 59:3 *University of Toronto Law Journal* 341.

book. Each chapter suggests that lessons can be learned from institutions performing similar functions in other countries, while at the same time being mindful that comparisons among countries that have similar characteristics are likely to be more fruitful than comparing, for instance, institutions in developing countries with those of developed countries.

II. SHOULD REFORMERS FOLLOW BEST PRACTICES?

It seems intuitive that one could look at successful practices and functional institutions in other countries and try to mimic them. Successful institutions can be perceived as possible solutions to development problems, and may inspire reformers to replicate these institutions in other countries. It is this very basic intuition that informs the practice of many multilateral organizations, such as the World Bank or the OECD. These organizations often seek to identify best practices in order to translate them into recipes that are replicable in other contexts. The idea seems to work for some public policies and anti-poverty programs: microcredit has now expanded to more than a hundred countries after the initial success of the pilot project in Bangladesh.⁶ Similarly, conditional cash transfers are generating positive outcomes in Latin America, after the initial success of *Progresosa* in Mexico.⁷

Best practices or blueprints, however, have not been so successful with institutional reforms.⁸ Scholars have claimed that the main reason for this is the complex interaction between formal and informal institutions (often referred to as 'culture' throughout this book). This interaction does not leave room for blueprints or justify assumptions that transplanted institutions are likely to work in the same fashion as they do in their country of origin. A growing number of scholars currently argue that culture is the 'black box' of theories of development, and our lack of knowledge about culture often translates into a lack of knowledge about how to change dysfunctional institutions.⁹ The extreme position held by some of these

⁶ Muhammad Yunus, *Banker to the Poor: Micro-Lending and the Battle against World Poverty* (New York: Public Affairs, 2003).

⁷ Ariel Fiszbein and Norbert Schady, 'Conditional cash transfers: reducing present and future poverty', *World Bank Research Reports*, 2009.

⁸ Michael Trebilcock and Ronald Daniels, 'The political economy of rule of law reforms in developing countries' (2004) 26 *Michigan Journal of International Law* 99.

⁹ Amir N. Licht, Chanan Goldschmidt and Shalom H. Schwartz, 'Culture rules: the foundations of the rule of law and other norms of governance' (2007) 35:4 *Journal of Comparative Economics* 659.

scholars suggests that, because of these cultural factors, any institution-building exercise based on best practices from elsewhere is likely to be in vain.¹⁰

Again, this book lies somewhere between these two extreme views. We believe that in certain cases it may be worthwhile to borrow ideas and insights from successful experiences in other countries or contexts. In this process, however, reformers should be mindful of the fact that institution-building requires a great deal of adaptation to the particular conditions of each country.¹¹

III. WHAT SHOULD BE THE SCOPE OF INSTITUTIONAL REFORMS?

A number of scholars subscribe today to the idea that a country needs 'good governance' or the 'rule of law' in order to develop.¹² How to achieve these objectives, however, is a fiercely debated matter. On the one hand, some argue that institutional interconnections are likely to render ineffective partial or piecemeal reforms.¹³ As institutions depend on each other to function effectively, reforms are unlikely to be effective unless they are all-encompassing and comprehensive. In sum, reformers need to 'think big'. In contrast, there are those who are sceptical about the possibility of promoting all-encompassing reforms.¹⁴ As a result of path dependence, political economy and other obstacles to institutional reform, some scholars believe that it is not possible to promote an institutional overhaul that will amount to something that we call 'good governance'

¹⁰ Lawrence E. Harrison and Samuel P. Huntington (eds), *Culture Matters: How Values Shape Human Progress* (New York: Basic Books, 2000); Lawrence E. Harrison, *The Central Liberal Truth: How Politics Can Change a Culture and Save It from Itself* (Oxford: Oxford University Press, 2006); Lawrence E. Harrison and Jerome Kagan, *Developing Cultures: Essays on Cultural Change* (London, New York: Routledge, 2006).

¹¹ See also Kevin E. Davis, 'Legal universalism: persistent objections' (2010) 60:2 *University of Toronto Law Journal* 537.

¹² See Chapters 1 and 2.

¹³ See, e.g., Rachel E. Kranton and Anand V. Swamy, 'The hazards of piecemeal reform: British civil courts and the credit market in colonial India' (1999) 58 *Journal of Development Economics* 1; William C. Prillaman, *The Judiciary and Democratic Decay in Latin America: Declining Confidence in the Rule of Law* (Westport, CT: Praeger, 2000).

¹⁴ Prado and Trebilcock, *supra* note 5. Mariana Prado, 'The paradox of rule of law reforms: how early reforms can create obstacles to future ones' (2010) 60:2 *University of Toronto Law Journal* 555.

or the 'rule of law'. Instead, reformers should confine their agenda to one institution at a time. For these scholars, the assumption is that 'thinking small' is the most promising strategy to making a particular institution functional.¹⁵ This dispute is often translated into divergent policy prescriptions, where the first perspective favours an all-encompassing approach to reforms whereas the second prefers to focus on piecemeal reforms and may question an overall agenda to promote 'good governance' or the 'rule of law'.

Yet again our book lies somewhere in the middle. We acknowledge that reformers are not writing on a blank slate. Path dependence is likely to create significant obstacles to any attempt to promote 'big bang' reforms (Chapter 1). This is a reason to favour piecemeal reforms in general, but not in absolute terms. In some cases, institutional interconnections will not allow for effective piecemeal reforms. Moreover, reformers need to be mindful that sequencing matters – in other words, piecemeal reforms should be conceived of as a part of a larger plan to promote more ambitious reforms over time.

Finally, we do not reject the idea that sometimes it is possible to promote all-encompassing and drastic reforms. Windows of opportunity for reforms may appear – a revolution, for instance, or the emergence of a charismatic leader. The problem is that reformers cannot count on those contingences, as they cannot be artificially created, are often unpredictable, and may not always be immediately identifiable.¹⁶ Thus, reformers are more likely than not to find themselves in circumstances that will require piecemeal reforms, although these will require attention to sequencing and to institutional interconnections. And even when there are windows of opportunity, we suggest that institution-building cannot be considered as a one-shot process. It is very unlikely that any institution will be functional from the beginning and will remain so for its entire existence. Instead, adjustments will be constantly needed, and it is the process of fixing one problem at a time that is likely to increase the chances – in the long term – that developing countries will be able to benefit from functional institutions.

¹⁵ We are using here the term coined by Jessica Cohen and William Easterly (eds), *What Works in Development? – Thinking Big and Thinking Small* (Washington, DC: Brookings, 2009).

¹⁶ See also Prado and Trebilcock, *supra* note 5.

IV. HOW CAN WE BEST EQUIP AND PREPARE FUTURE REFORMERS?

The central assumption of this book is that institutions matter for development and we have emphasized that, in this context, lawyers have an important role to play. The intricacies of institutional design set the context that will allow reformers to address the issues of middle-level generalizations, adaptability to context, sequencing and awareness of institutional interconnections noted above. The question that follows, then, is how to best train lawyers to engage in institutional reforms for development in a way that can potentially enhance the prospects of developing countries benefiting from them.

Contrasting theory with practice is a good way to learn how to avoid sweeping generalizations, while at the same time testing the limits of theory. By consulting the most comprehensive empirical evidence available, one can assess the validity of theoretical generalizations and possibly limit their scope.¹⁷ In this regard, lawyers should rely in part on the expertise of economists and political scientists in collecting and compiling empirical data in a systematic fashion.¹⁸ This can avoid many of the pitfalls that unwarranted generalizations may give rise to in the development context. There may be little point, however, in training lawyers to do this type of work themselves. Instead, lawyers should rely on what they do best: comparing cases.¹⁹ This skill set can be built into institutional analysis and institutional reforms in at least three promising ways.

First, while empirical evidence will confirm or not *whether* a certain claim is true or is able to be generalized, case studies are likely to illuminate *why* that claim is not true or cannot be generalized. This is a way in which empirical research can offer insights that may feed back into the theory and help improve and refine it. Thus, case studies are helpful in

¹⁷ For a popular instantiation of this argument, see Ian Ayres, *Super Crunchers: Why Thinking-by-Numbers is the New Way to be Smart* (New York: Bantam, 2007).

¹⁸ For a useful contribution that is likely to be helpful to lawyers, see Thomas Ulen, Robert M. Lawless and Jennifer K. Robbennolt, *Empirical Methods in Law* (New York: Aspen, 2010).

¹⁹ For an acknowledgement of the value of case studies in development studies, see Dani Rodrik, *In Search of Prosperity: Analytical Narratives of Economic Growth* (Princeton, NJ: Princeton University Press, 2003). See also Mary M. Shirley, *Institutions and Development – Advances* (Cheltenham, UK and Northampton, MA: Edward Elgar, 2008) at 4 (indicating how cross-country institutional analysis of institutions offers little guidance to reformers).

illuminating under which circumstances middle-level generalizations are possible or not.²⁰

Second, case studies may help to illuminate what kind of cultural, political and economic factors are likely to interact with formal institutions and under which circumstances. This will help lawyers work towards adapting institutional reforms to local contexts.²¹ In this regard, sociological, anthropological and political studies may be an additional tool that can help lawyers understand the context and identify the relevant factors that may affect reform in different countries. While the analysis here builds on socio-anthropological and related studies, it is aimed towards possible middle-level generalizations that will allow a legal scholar not only to understand what has transpired in a particular country, but to what extent this can yield lessons that are applicable to countries that face similar conditions.

Third, case studies can also indicate the relevance of institutional interconnections and sequencing, and may call attention to the different possible configurations that an institutional reform may take, and the possible outcomes that each of these configurations is likely to generate. Indeed, by looking at what worked and what did not work in other reforms, lawyers can begin to accumulate a tool set that can potentially be helpful in future reforms.²² The idea here is not of a blueprint of best practices. Instead, a particular case study can illuminate the effectiveness of a certain institutional feature, or a mechanism that could potentially be creatively adapted to another context, or could inspire innovations in other reforms. If this exercise is coupled with an awareness of the uncertainty and risks involved with institutional adaptation, the importation of limited and constrained insights from other reforms can be a fruitful exercise.

²⁰ In this aspect, we subscribe to the argument supported by Shirley, *ibid.* On the value of randomized control trials in many policy contexts, see Dean Kaplan and Jacob Appel, *More than Good Intentions: How a New Economics is Helping to Solve Global Poverty* (New York: Dutton, 2011); and Abhijit Banerjee and Esther Duflo, *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty* (Public Affairs, 2011).

²¹ See also Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions and Economic Growth* (Princeton, NJ: Princeton University Press, 2007) (arguing that we may have universal tools to identify problems, such as welfare economics, but institutional reforms and economic policies to address such problems need to be adapted to particular contexts). See also Dani Rodrik, *The Globalization Paradox: Democracy and the Future of the World Economy* (New York: W.W. Norton & Co., 2011).

²² For an interesting proposal to achieve this by creating a clearing house of academic knowledge and on-the-ground experience, see UNDP, *Making the Law Work for Everyone: Report of the Commission on Legal Empowerment of the Poor*, Vol. 1 (New York: United Nations, 2008) at 87.

V. AN AGENDA FOR FUTURE RESEARCH

The proposition that institutions are a major determinant of a country's development prospects is, in many respects, self-evident – the very conception of a 'failed state' exemplifies this proposition. While it has been helpfully validated by much recent empirical work, the mantra 'institutions (or governance) matters' is unhelpful in three key respects. First, it is often so coarse-grained as to lack policy-relevant implications. Second, it is not helpful in understanding the antecedent causes of, or contributors to, dysfunctional institutions, which will often be a necessary predicate to prescribing effective and feasible cures in particular contexts. Third, it is unhelpful in developing detailed reform strategies on the ground that are sensitive to prevailing path dependency, political economy, cultural and other impediments to reform in particular contexts.

This book has sought to demonstrate that broadening institutional perspectives on development to address these three key concerns is critical to progress on an institutional agenda for development.²³

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²³ See also Lindsey Carson and Ronald J. Daniels, 'The persistent dilemmas of development: the next fifty years' (2010) 60:2 *University of Toronto Law Journal* 491.

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