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**DOES OPENNESS MATTER?**

**HOW TO APPRAISE THE EVIDENCE**

by

Deepak Lal\*

University of California, Los Angeles

Dept. of Economics  
UCLA  
405 Hilgard Avenue  
Los Angeles, CA 90024

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\*James S. Coleman, Professor of International Development Studies, UCLA, and Professor of Political Economy, University College, London. I am extremely grateful for comments on an earlier draft by Harold Demsetz.

## ABSTRACT

The paper considers various aspects of the ideas and evidence responsible for the third protectionist wave since the Second World War. It looks at recent theoretical developments, econometric studies and historical studies on the relationship of "openness" to growth. It also provides an alternative explanation based on the control function of private wealth in industrial organizations to the "functional" dirigisme advocated by the "market governance" school of Chalmers Johnson, Amsden and Wade. A final section re-examines the twin case for laissez-faire and free trade as supported by the classical economists.

## INTRODUCTION

At the Kiel Week Conference of 1986, Rajapatirana and I (Lal and Rajapatirana (1986)) had surveyed the empirical studies of the static and dynamic gains from trade to date, as well as the historical comparative studies of trade regimes of developing countries undertaken in the 1960s and 1970s.<sup>1</sup> An expanded version (1987) also took account of the first wave of the counter-revolution which has sought to subvert the consensus which had appeared by the early 1980s, (see Lal (1983), Little (1982)) on the desirability of the openness arising from "outward oriented" trade regimes in promoting growth. Since then, what was merely a trickle, has become a flood of revisionism, with the prime exhibit in the "outward oriented" cupboard (Korea and Taiwan) being converted into shining examples of the success of dirigiste trade and industrial policies (see Amsden (1989), Wade (1990)). This seems to have even shaken the confidence of at least one of the Bretton Woods institutions, The World Bank, which following the robust statement of the "outward oriented" case in its 1987 World Development Report, in its 1991 report spoke with a forked tongue-hedging its bets!. While its own statistical exercises (see World Bank (1991), pp. 46 and 82) support its earlier views, it is now cautious about the relationship between trade policy and growth (as expressed in Box 5.3), concluding: "The majority of the evidence now available shows a positive relation between openness -- however measured -- and growth. Yet the difficulties in isolating the impact of trade policies per se and establishing causality suggest that the debate is not fully resolved" (ibid., p. 99).

In this paper, rather than repeating the surveys of the evidence put together in Lal and Rajapatrana (1987) and Lal (1992), I consider various aspects of the ideas and "evidence" which have led to the rise of the third

protectionist wave since the 2nd World War.<sup>2</sup> The first section looks at recent theoretical developments, the second at econometric studies, and the third at historical studies on the relationship of "openness" to growth. As it is people's "priors" which are really at issue in the continuing debate about the appropriate trade and industrial policies to promote growth, I also provide an alternative explanation for the relevance of the "functional" dirigisme which the "market governance" school of Chalmers, Johnson, Amsden and Wade see as the major explanation for the success of Korea and Taiwan. For them they are no longer prime examples of the validity of the neoclassical policy paradigm. The alternative explanation, given in the fourth section, is based on ideas concerning the control function of private wealth in industrial organization due to Demsetz. A final section provides a stock-taking of the twin case for market economies and free trade, which has swung from one end of the pendulum towards the other over the last 150 years.

# 1. OPENNESS AND GROWTH IN THEORY

The major lacuna in establishing the case for the link between openness and growth in the eyes of many was that growth theory did not provide any direct link between "outward orientation" and growth. All the gains from trade lead to level rather than growth effects in what was the standard Solow-Swan neoclassical model of equilibrium growth. Scott (1989) has argued persuasively that this is because of deep conceptual flaws in the neoclassical growth model. At the same time a "new" growth theory has emerged (Romer (1989), Lucas (1988)) which seeks to "endogenize" technical change, the ultimate determinant (together with exogenous population growth rate) of the steady state growth rate in the Solow-Swan model. This has now been extended to trade theory in the work of Grossman and Helpman (1991).

I must confess that I do not find the economics underlying this theory persuasive. It seems to be motivated essentially by its mathematical tractability (see Stern (1991) for a critique of the "new" growth theory, and the arbitrary assumptions on which it is based). The treatment of endogenous innovation which is modelled in the Grossman-Helpman model, essentially in the spirit of Arrow (1962), is subject to the devastating criticism of this approach in Demsetz (1969), while the continuing use of the neoclassical production function as the building block of the theory of growth is subject to the persuasive critique of Scott.<sup>3</sup> At the moment the "new" trade and growth theories are interesting deductive schema which capture some important aspects of "openness" -- like the role of imitation in reducing costs and improving product variety and quality -- but which are not really robust enough to illumine policy questions.

A much simpler, more general and powerful dynamic case for "openness" comes from what Harry Johnson called the "capital theoretic approach" to development policy -- following Irving Fisher. Scott's (1989) model is the fullest working out of this approach -- unfortunately for a closed economy! However, the efficiency of investment, given by the rate of return to investment -- broadly defined in Fisherian terms in terms of consumption foregone as the cost of change -- is central to this approach. One implication of the Scott model would be that these rates of return would vary positively with "openness". The Little-Scitovsky-Scott study was in part based on the social rates of return calculated on Little-Mirrlees (1974) lines for a sample of projects in the countries they studied. I was involved in making the estimates for India. This endeavor and its results formed an important part in changing my own "priors" about "openness". Unfortunately we do not have such rates of return available for a large

number of countries and over time to provide the conclusive case in favor of "openness" and growth that the skeptics seem to want. However, the 1991 World Development Report correlates the rates of return, estimated on the basis of Squire-van der Tak (1975), with a measure of trade orientation based on an index of tariff and nontariff barriers in 32 countries for projects financed by the World Bank and the International Finance Corporation. The estimated ex post rates of return fall systematically with the restrictiveness of the trade regime (World Bank (1991) p. 82-83). The same is true of various other measures of "distortions" such as the black market premium on foreign exchange. But these conclusions are heavily dependent upon the classification of countries by differing degrees of "openness" -- a problem that has bedeviled all extant statistical studies of its relationship to growth -- a subject we turn to in the next section.

But before that, we need to briefly mention the development of the self-styled "new trade" theory taken by some to provide a theoretical justification for departing from "openness" through the adoption of activist trade and industrial policies (see Stewart (1984), Helliner (1985)) -- though not (one should add) by the progenitors of the theory (see for instance Krugman (1987)). This conclusion has obviously been challenged and denied by the "old" trade theorists (see Baldwin (1991), Corden (1990), Habeler (1989), Srinivasan (1989)). Being middle-aged, I recognize the technical virtuosity of the "new" but also subscribe to the wisdom of the "old"! The simplest way to see this is in the refurbished Baldwin "envelope" type diagram within which Bob Baldwin has neatly encapsulated the "new" trade theory (see Fig. 1, and its explanatory note). This shows that part of the "new" trade theory's case for intervention is another variant of the classic "terms of trade" type argument for trade intervention and

another part for a variant of the "infant-industry" argument for the domestic promotion of industry (but not its protection). As the practical irrelevance of both types of argument have been discussed threadbare in the trade and welfare literature (see Baldwin (1992) for a restatement), these "new" arguments for protection and industrial policy are unlikely to persuade these of my ilk!<sup>4</sup>

## 2. ECONOMETRIC EVIDENCE

Establishing a conclusive econometric causal link between openness and growth is the Holy Grail for the positivist temperament of many contemporary economists. This search has been bedeviled by two lacunae. The first being the lack of a properly specified theoretical model which would predict the effects of "openness" on growth (the issue discussed in the previous section). Lacking such a "model" various ad hoc justifications have been provided for econometric exercises that have hitherto been undertaken to link various measures of "openness" to growth. (Apart from the studies surveyed in Lal and Rajapatirana see Barro (1991)). The second is that it has proved very difficult to provide a statistical measure of "openness". What is required is a measure which in, say, the standard diagram of a "two by two" open economy facing constant terms of trade, shows the deviation of the economy's actual production and trade equilibrium point from what it would have been under free trade. Apart from Hong Kong no other country has been a complete free trader, nor is any country completely autarkic, so statistical tests looking at changing trade regimes over time in one country, or at differences in trade regimes across countries, must have some summary measure of these differences. The earlier studies (e.g., Little-Scitovsky-Scott (1970), Balassa (1971)) used measures of average effective protection (EPR) or domestic resource costs (DRC). But it is immensely time

consuming to obtain decent EPR estimates, particularly when protection in developed and developing countries increasingly takes the form of non-tariff barriers (NTR's) of growing complexity. Hence, EPR estimates are few and far between,<sup>5</sup> so that they cannot be used to conduct a conclusive time series or cross section econometric analysis of "openness" and growth. Two alternative measures used are first, subjective indices of trade bias (World Bank (1987), Papageorgiou et al. (1991)), and second, rates of export growth (or some variant) as a proxy for different degrees of anti-export bias (see references in note 1). They are taken to be the independent variables in regressions testing the effects of "openness" on growth. Neither has been found persuasive by the skeptics, as there seems to be no agreement on the subjective indices, while the studies using the "exports" route are subject to a fatal criticism recently levelled by Sheehy (1990). He shows that, similar bivariate tests between the growth rate and other components of GDP also support the "promotion" of all major components of GDP. As he rightly concludes: "These results in no way overturn the case for an export promotion strategy. They merely indicate that a large body of evidence that is supposed to demonstrate the superiority of this strategy has no bearing on the controversy" (p. 115).

Dollar (1992) has constructed an openness index for the period 1976-85 based on the distortions in real exchange rates and in their variability, derived from the Summers and Heston (1991) data on relative price levels and corrected for the effects of differing factor endowments (proxied by per capita GDP) on the price of non-traded goods. As he himself notes there are serious anomalies in the rankings. Thus Hong Kong, which is as "outward oriented" an economy as you can get, is found to be less outward oriented than Sri Lanka, Pakistan and a whole host of other countries. Taiwan is



nearly at the bottom of the most open quartile (and more closed than Peru), Korea is in the middle! Nevertheless, using this index he finds "it highly correlated with per capita GDP growth in a large sample of developing countries" (p. 540).

The most serious attempt at a rigorous derivation of an openness index is by Leamer (1988). He estimates the net trade flows and trade intensities from a Hechsher-Ohlin model with nine factors of production, calibrated for one year -- 1982. The residuals between the "predicted" and actual trade intensity ratios are taken as an indicator of trade barriers. Two indices are produced, one for "openness" -- which measures the effects of trade restrictions, and another for "intervention" which also includes the effects of export subsidies.

Leamer provides a detailed critique of his own indices. The most credible are his "adjusted trade intensity measures". But as he concludes:

As I examine these results, I am left with a feeling of skepticism regarding the usefulness of the adjusted trade intensity ratios as indicators of trade barriers. I see tastes (Japan's coffee [imports are too high]), omitted resources (Iceland's fish [exports are too high]), and historical accidents (Switzerland's watches [net exports are too high]). I am not sure that I see trade barriers. What seems clear is that in the absence of direct measures of barriers, it will be impossible to determine the degree of openness for most countries with much subjective confidence. (Leamer (1988) pp. 198-9)

Nevertheless Edwards (1992) argues that, "the Leamer indexes are imperfect proxies (although I think the best available ones) of the theoretical trade intervention and trade distortions index" (p. 16). He then uses them to run regressions for a simple endogenous model of trade and growth, in which the standard technological progress term in the Solow-Swan model, taken to depend upon the "country's ability to appropriate world technical innovations, [itself] depends positively on the degree of openness of the economy" (p. 7). The proxy for this "knowledge gap" which is

effected by openness (a) is a "catch up" variable, namely the initial level of per capita GDP and (b) number of engineers per thousand inhabitants. He finds a robust positive relationship in a cross-section of 30 developing countries (for which the Leamer indices are available), between growth rates of per capita GDP for 1970-1982 (and also 1960-1982), and the Leamer "openness" and "trade intervention" indices. The regressions also include the ratio of aggregate investment to GDP, and the "technology gap" measure as independent variables which also have the expected positive signs. He further uses nine alternative indicators which have been used in earlier studies, and again finds "that more open economies tend to grow faster than economies with trade distortions". He then applies a battery of statistical procedures to test for the robustness of his results in the hope of persuading those "people whose priors are not confirmed by empirical work" and who "tend to question the appropriateness of the data, the validity of the estimation methods and the relevance of the time periods selected" (p. 29). However as one emerging law is that "all econometric evidence is equivocal", I doubt if the die hard positivists with different priors will be persuaded by this!<sup>6</sup>

### 3. EVIDENCE IN COMPARATIVE ANALYTICAL ECONOMIC HISTORIES

The most persuasive evidence, in my view, for the relationship between openness and growth comes from the large number of (what I term) analytical economic histories of developing countries conducted within a comparative studies framework, and the testimony of "witnesses". My own dirigiste priors, for what this is worth, were first weakened by working on the famous Little-Scitovsky-Scott study of trade and industrialization in the late 1960s and then were changed further by working full time in the Indian Planning Commission and, subsequently, with the Economic Planning Board in

Korea in the early 1970s (see Lal (1990)). The method underlying comparative historical studies is the English classical method outlined by J.S. Mill in his A System of Logic (esp. Book III, Chp. IV). It was applied with great skill by De Tocqueville in his Democracy in America and by Marc Bloch in Feudal Society. Unlike the current positivist stance of most economists which only permits quantitative induction, the method also encompasses qualitative induction (see J.M. Keynes (1890) for how both forms of induction are indispensable in economics). Having recently written on the justification for this classical method on epistemological grounds, and contrasted it with the positivism espoused by many economists (Lal (1992), which also provides detailed references to the philosophical and methodological literature), I need only note a few points here. First, the general persuasiveness of the case for openness amongst the "general public" has depended upon these comparative studies rather than any econometric evidence produced by either side. Second practitioners of the classical method are aware that the method is a form of what I term "forensic storytelling". It is the weight of all the evidence available which matters, as there cannot be any "sure fire" ultimate "test" to establish the "truth" about alternative "counterfactuals" concerning the dynamic processes which determine differences in growth performance. Thus Bhagwati (1978) in his synthesis volume on the NBER studies, concerned as he was with the "dynamic" effects of alternative trade regimes, persistently assessed the importance of the weight of various bits and pieces of evidence (see pp. 82, 90, 184, 191). Third, it is the qualitative evidence produced by three counter-revolutionaries concerning Japan, Korea and Taiwan (Chalmers-Johnson (1982), Amsden (1989), Wade (1990)) which has been found the most persuasive by many in questioning what Little (1982) called the "neoclassical" consensus on trade

and growth.<sup>7</sup>

We therefore turn to two of these studies. The most cogent is the book by Wade on Taiwan. He concedes that:

It is clear that many of the conditions prescribed by neoclassical development theory were present in Taiwan by the early 1960s. Since then, the real exchange rate has been kept roughly equal ... Effective protection has been low --- Wages have been at market-clearing levels, bank interest rates have been kept relatively high, government has run budget surpluses, savings and investment have been very high, the labour force has been well trained, the industrial structure includes a sizeable sector of small firms unable to exercise oligopoly power, and the domestic environment has been stable ... In short Taiwan seems to meet the neoclassical growth conditions unusually well. Yet other evidence shows that the government has been intervening for decades, often quite aggressively, to alter the trade and industrial profile of the economy in ways that it judges to be desirable. We then face a formidable identification problem. How can we decide to what extent Taiwan's exceptional economic performance is due to the presence of many of the neo-classical growth conditions and to what extent to the government's selective promotion policies? Ultimately I cannot resolve the issue. (Wade (1990) p. 72)

But he believes that neoclassical economists have overlooked the fact that "the government has indeed been guiding the market on a scale much greater than is consistent with neo-classical prescriptions or with the practice of Anglo-American economics" (ibid.). It is this fact about the undoubted dirigisme to be found in Taiwan, Korea and Japan which seem to be at the heart of the dispute (reflecting their "priors") between those who believe that interventionist trade and industrial policies are desirable and those who do not. The question boils down to what were their governments doing which was different from what was done in many other developing countries e.g., India, and was their stellar growth performance due to or despite this dirigisme? Most mainstream economists not being able to find any functional justification for the observed intervention within the traditional public policy analytical framework, have concluded that their success was despite their dirigisme. My own most recent review of these

issues, Lal (1992), examines the possible infant industry type of justification for such intervention, and finds little supporting evidence. There are, however, some aspects of the industrial organization (IO) perspective, suggested by Demsetz (1988), (1992), which I think might provide an antidote to this continuing irritant in the debate about openness and growth.

#### 4. DIRIGISME, ENTERPRISE CONTROL, AND THE EFFECTUATION OF DYNAMIC COMPARATIVE ADVANTAGE

While much of the recent marriage between trade theory and IO has been concerned with various price theoretic aspects of monopolistic competition, little use has been made of the aspects which cover problems of corporate governance when there is a separation of ownership and control. The relevant issue is what Demsetz (1988, Chp. 14) calls the control function of private wealth, and the inequality in its distribution.

This role is based on the problem of maintaining beneficial control over resources in the presence of economies of size. I do not refer here to the wealth required to pay for inputs on a scale demanded by large firms, but, rather to the wealth required to reduce the degree to which ownership is separated from the control of these resources. The maintenance of such control requires large amount of individual, private wealth in settings where large-scale enterprise would be efficient except for resolving the problem of control. The large-scale enterprise requires an ownership interest sufficiently large to encourage the owner(s) to undertake the task of overseeing management and other inputs, and of setting a proper course for the enterprise.

A diffuse ownership structure discourages this undertaking because of well-known free rider problems. No owner of a trivial fraction of equity has enough interest or power to take the problem of control seriously; leaving this task to someone else makes more sense. However, this someone, if he or she is to exist, must own a large personal stake in the firm. An undivided large equity stake requires considerable personal wealth when the efficient size of the firm is large.

Collectively owned assets, whether owned by the state through socialism or through diffuse corporate shareholdings, do not offer a practical substitute for a large private and personal equity stake. The collective characteristic of such alternatives frustrates the resolution of the free rider problem. Neither nationalization nor diffuse private shareholdings can be expected

to establish the beneficial control that is characteristic of a large, private, individual equity stake. Hence, if large enterprises are to be maintained efficiently, it is important that many individuals hold enough private wealth to finance large equity stakes in these firms. Resolution of the control problem is a productive function of the having of wealth.

(Demsetz (1988) p. 231)

Furthermore, Demsetz (1992) notes that: "For U.S. companies as large as the Fortune 500, the aggregate fraction of equity owned by the five largest shareholders is about one-fourth. For Japanese and several important European countries this fraction is much larger" (p. 6). The implication for this for developing countries is that:

A country's resources, climate, and state of technical art help determine the lines of activities in which its comparative advantages reside, but these considerations are not sufficient in and of themselves to determine comparative advantage because they take the control of enterprises for granted. The degree to which enterprise control can be realized depends on considerations that go beyond the state of technical art, and among these are a country's wealth and wealth distribution. Firms that demand a large amount of capital can be controlled more effectively if located in wealthy countries and in countries tolerant of unequal distributions of wealth and foreign ownership, whereas firms that demand only small amounts of capital suffer relatively less loss of control for being in poor, egalitarian countries. The theory of comparative advantage, or our interpretation of it, is inadequate in that it does not explicitly acknowledge the importance of control problems or the role of wealth and its distribution in setting constraints on the solutions of these problems. In the matter of enterprise control wealth has a productivity dimension that has been ignored ... Since capital-demanding enterprises are more likely to be in heavy industry, this suggest that better economic development can be achieved by poor countries if they favor agriculture, services, and light industry. Only after investments in these controllable enterprises have caused wealth to increase can controllable investments be made in heavy industry.

(Demsetz (1992) pp. 14-15)

The implications for the theory of trade and growth are that, within the two factor HOS model, as countries dynamic comparative advantage shifts up the ladder of comparative advantage with capital-labor ratios rising with capital accumulation and growth, this control problem will become worse. To effectuate their emerging comparative advantage in more capital intensive

and ipsofacto larger scale enterprises, they will have to solve the control problem. The example of the four Southeast Asian NICs and that of India then provide examples of how this effectuation can come about. It also provides an explanation for the different outcomes from the alternative types of dirigiste industrial policies adopted, in, for instance, Korea and India.

Essentially there are three ways in which "controllable" investment can be made to overcome the agency problem in large capital demanding enterprises. The first is through sufficient concentration of private wealth, and some institutional means for it to be spread over a number of enterprises while maintaining control by some concentrated "owners".<sup>8</sup> The second is by allowing foreign equity to control local large scale firms. The third is for the "government to gather the net wealth of its citizens into a tax supported fund that can be large enough to make investments in a large capital-demanding enterprise, while maintaining concentrated ownership positions in these enterprises" (Demsetz (1992), p. 6). This last is likely to be ineffective and inefficient for the usual reasons of "bureaucratic failure" as the functioning of numerous public enterprises in developing countries attests as compared to the other two forms where the self-interest of the "owner" is more clearly tied to the profitability of the enterprise.

The differences in "industrial policies" (or lack of them) and their relative efficiency in the four clearly outward-oriented NICs -- Korea, Taiwan, Hong Kong and Singapore and the inward-oriented India can now be assessed. The most striking feature of the effects of the dirigiste industrial policies in Korea was their promotion of the Chaebol -- a diversified business group on the pattern of the Japanese zaibatsu. The major instrument was long-term subsidized credits. Amsden (1989) provides details

of how the government used this instrument to favor a select number of industrial groups, once the industrial structure evolved away from light to medium and heavy industry. The selection was based on being ruthless in allowing the exit of badly managed or bankrupt groups, and using the attainment of export targets as a monitoring device for continuing the subsidies. Given that, by and large, the net effect of Korea's trade policies was "neutral", (as even the counter-revolutionaries accept), the export success of a "group" was a pretty good index of its efficiency. Moreover, while "Korea's stock market remained moribund, ... the chaebol remained closely held family concerns" (Amsden, p. 131). They moreover controlled a highly diversified set of enterprises (a pattern also found in many other developing countries -- see below), and gradually accounted for a large share of national product. "In 1984 the three largest chaebol alone accounted for a staggering 36% of national product" (Amsden, op. cit., p. 116).

Given the relative poverty of Korea in the 1960s, as well as the relative equality in its wealth distribution when it embarked on its spectacular industrialization, the "industrial policies" of Korea can be seen as creating highly concentrated private holdings of wealth, whose owners were "chosen" by a relatively efficient dynamic monitoring process based on export success (under a relatively neutral overall trade regime). The state transferred wealth from the rest of the citizens to the chaebol (through its credit subsidies), which they then multiplied through their spectacular growth performance. Amsden reports: "private firms in Korea contributed very little of their own capital to most investment projects .. internal financing in 1963-73 accounted on average for only 20% of total financing (compared with 32-35% for Japan (1952-67) and 65% for the U.S.



(1947-63). ... In 1983 the manufacturing sector in Korea ... financed only 9.9% of its business through retained earnings and capital increases" (Amsden, p. 95).

On the Demsetz theory it was the creation of this inequality in wealth holdings through its "industrial policy" which allowed the problem of control to be solved when Korea's dynamic comparative advantage shifted away from light towards more large-scale industry in the 1970s and 1980s. But "openness" was crucial both in providing a simple monitor of the relative efficiency of the new "wealth holders" and in ensuring that this industrial "promotion" did not go against the grain of the country's comparative advantage.<sup>9</sup> That this was the aim of Korea's dirigisme is given further strength by President Park Chung Hee's (who oversaw the Korean miracle) explicit statement in his 1963 book The Country, the Republic and I, "of allowing 'millionaires who promoted the reform' to enter the central stage, 'thus encouraging national capitalism'" (Park, p. 120). The millionaires were envisioned by Park to have created large-size plants to realize economies of scale. He saw the government's role as one of overseeing the millionaires to avoid any abuse of power" (Amsden (1989, p. 14).

In Taiwan, by contrast, the Nationalist government "has been much concerned to prevent large-scale capital from acquiring enough autonomy to shape the regime" (Wade, p. 270). This is in part because of its past ideological "anti-big capitalist conviction reinforced by fear of the political potential of native Taiwanese economic power" (Wade, op. cit., p. 296). The industrial structure has therefore been allowed to evolve more "naturally" with a preponderance of small firms mainly in light industry. The capital intensive industries when they were developed "like steel, shipbuilding and petrochemicals" were kept in the public sector (see

Scitovsky (1990, p. 136). This is the second route to effectuating emerging comparative advantage in more capital-intensive lines. Once again it is the "dirigisme" involved in the latter which it is suggested by Wade goes against the neoclassical policy paradigm on "openness". But once again it is better seen as a response to the agency problem in large scale, capital-intensive, firms outlined by Demsetz. Moreover, as one would expect, the efficiency of this "solution" compared to that based on the private sector is questionable. Wade (1990) reports:

A recent study compared the performance of 12 public manufacturing enterprises with that of the 300 top private firms in terms of financial indicators such as rate of return on sales and assets, over the 1976-84 period. By all indicators the public enterprises' average performance was worse. The study went on to compare the performance of the four public enterprises which face the most competition from private firms against that of their competitors. The result was the same. (p. 81).

However, in Taiwan, outside the public sector there has been a growing importance of business groups<sup>10</sup> and in the concentration of industrial assets (see Wade, op. cit. p. 68 and following), which suggests that, if the government had not pre-empted the "basic industries" for itself, the emerging concentration of industrial wealth could have been expected to solve the Demsetz control problem.

Singapore represents an example of an open economy which has solved the control problem of effectuating its dynamic comparative advantage by relying on foreign equity investment (see Findlay, Wellisz and Associates (forthcoming)). In 1963, "foreign investment contributed 57% of value added and exports and 32% of employment in the manufacturing sector... In 1980 these ratios had risen to 81% of value added, 72% of employment and no less than 93% of exports" (Findlay and Wellisz, op. cit., p. 12). The government has been dirigiste, "involved in selective intervention into the pattern of production, consciously attempting to "pick winners" and to promote "high

tech" projects that are supposed to represent the wave of the future" (ibid.) But given the neutrality of its trade regime it has not attracted the "tariff jumping" type of direct investment which in other countries has led to low or negative social rates of return (see Lal (1975) and Streeten and Lall (1977)). But as in Korea in the late 1970s and early 1980s, this dirigisme has occasionally come unstuck. For instance, when the government raised minimum wages in the 1980s to induce investment in industries that were a couple of rungs up its "ladder of comparative advantage", it led the country into a serious recession. But as in Korea, these mistakes in resource allocation in labor abundant and land-scarce small economies are easily recognized (see Lal and Myint (1991), and they have been speedily reversed.

By contrast, Hong Kong has been a virtual laissez-faire economy. As a result, its industrial structure is dominated by "small plants owned and operated by local residents, using relatively little capital and unsophisticated technology. These small firms have been extremely adaptable and flexible, adept at moving into profitable lines and out of unprofitable ones very quickly. The early dependence on cheap clothing, footwear, plastic toys and so on has been replaced by more expensive clothing with higher value added including fashion items, and electronics" (Findlay and Wellisz, p. 11).

Before we conclude that the Singapore outcome is "better" than the Hong Kong one, we need to consider the productivity of capital in the two countries. If faut mieux we measure it by the incremental capital output ratio, in Hong Kong this ranged from 2.4 in 1961-73 to about 3 in the 1970s and 1980s. In Singapore by contrast it has risen from about 2.6 in the 1960-73 period to 6.2 in 1974-77 and about 5.0 in 1978-83 (Findlay, and

Wellisz, op. cit.) Hong Kong has therefore been able to maintain a higher growth rate of per capita consumption than Singapore "with a relatively modest investment rate of 25% as a result of efficient investments that are not heavily capital-intensive" (ibid., pp. 9-10).

Finally we consider India, whose history of industrialization provides a vivid illustration of the importance for efficiency of "openness" as well as the Demsetz control problem. India was one of the pioneers of industrialization in the Third World. The first modern textile factory was set up with Indian enterprise and capital in 1851, the first jute mill whose output was exported in 1854. The first steel mill in 1911. As this was a period when the British Raj followed the policies of free trade and laissez faire of the metropolitan power, these industries could not have had social rates of return below their private ones. Moreover, they clearly reflected India's comparative advantage. India's industrial performance, and manufacturing export performance was among the best in the world (Lal (1988)). The form of business organization that evolved to take account of the Demsetz problem (particularly in the more capital-intensive industries) was the business group, and the managing agency system. This allowed family businesses to exercise control over a number of industries by having a strategic equity holding in each (see Rungta (1970)). As Hazari (1966) noted in his detailed study of the structure of the corporate private sector in the 1950s (that is soon after independence) "the Tata's seem to hold only about 5% of the equity of Tata Steel, while the total controlling block (most of it, held by a trust), in Indian Iron equity is only 17%" (Hazari, p. 8).<sup>11</sup> He estimated that in 1951 the 13 largest business groups accounted for 33.09% of the share capital and 38-41% of the gross capital stock of all non-governmental companies in 1951.

With Independence, India turned its back on an open economy, and also on ideological grounds sought to counter "the economic power" of corporate business by reserving the so-called commanding heights of the economy -- capital intensive heavy industry -- for the public sector. As could be expected, even in industries like steel, (where India had a comparative advantage (see Johnson (1966))), the substitution of the public sector mode of dealing with the control problem rather than the private sector one based on "business groups" led to inevitable inefficiencies and lower, even negative rates of return on the investments made (see Lal (1988)). India, of course, also placed onerous controls on foreign equity on grounds of economic nationalism.) While the reversal of "openness" led to declining and eventually negative total factor productivity growth (TFP) rates in much of Indian industry (see Ahluwalia (1985)).

Enough has been said to suggest that, the success of the "industrial policies" of the NIC's as compared with India was due to their working with the grain of their comparative advantage, and in not preventing, or in actively promoting, an efficient private sector based solution to the Demsetz control problem. If this interpretation is correct, and is borne out by further research on other developing countries (which I am currently undertaking), then even the "dirigiste" policies of the Asian NIC's can be looked upon as supporting the "neoclassical" case rather than that of the self-styled "market governance" school deriving from Chalmers-Johnson, et al.

Nevertheless, it is also worth noting one important feature of the differences in response to the "control problem" in Singapore and Korea on the one hand and India and Taiwan on the other. It was the confidence of the state in itself in the former group that allowed it to foster what in

the latter were considered to be rival centers of economic and thence political power, while Hong Kong followed the "natural" evolution of its comparative advantage and its effectuation without any obvious political mediation. Enough has been said to show that in terms of its citizens welfare the Hong Kong route was certainly no worse and probably "better" than in the comparators. This leads naturally to questions concerning political economy.

##### 5. POLITICAL ECONOMY. OPENNESS AND PUBLIC POLICY

In his synthesis of the modern theory of trade and welfare, which provided the "grammar of arguments" underlying the persuasive Little-Scitovsky-Scott comparative study, Corden (1974) noted that, whereas since the 19th century, the case for laissez-faire and free-trade had been intertwined, the modern theory demonstrated that (except for the "terms of trade" case) the free trade case remained valid even though "laissez-faire" was impaired by the existence of "domestic distortions". However, with the introduction of political economy considerations, like "rent-seeking", which apply not only to trade intervention but also to the "tax-subsidy" panaceas accepted by modern trade theory to cure "market failure", the costs of the accompanying enlarged "by-product" distortion costs is likely to outweigh any of the purported benefits from government intervention. As a "second best", it might then be best to let well enough alone, that is accept "laissez-faire" as the least "bad" policy. Though it is now forgotten, this in fact was the argument that underlay the classical case for laissez-faire and free trade (see Robbins (1952) (1976)). Once we recognize the importance of political economy factors and that the state is not the benevolent cipher of "public economics", it becomes clear that much of the intellectual case against classical liberalism disappears. The case for

"laissez faire" and free trade are once again conjoined. Corden's dichotomous policy recommendations no longer make sense.

This brings us back to the basic question of "priors". One of the suggestive parallels noted in the Lal-Myint (1991) comparative study of "The Political Economy of Poverty, Equity and Growth" behind the mercantilist policies of the absolutist monarchies in post-Renaissance Europe and the neo-mercantilism of most of today's Third World (and one should add ex-Second World). This was the desire to create "nation-states" out of the medley of competing groups within their jurisdiction (see Heckscher (1955)). In both cases, however, their "dirigiste" policies rebounded. These policies sought to achieve "unification and power", making the "state's purposes decisive in a uniform economic sphere" (Heckscher, p. 21). But far from building cohesive nations the dirigiste policies led to national disintegration with the corruption, rent-seeking, tax evasion and the consequent black economy they stimulated. This led in extreme cases (in both periods) to what I have elsewhere called the unMarxian withering away of the State (Lal (1987)) -- most often expressed in the form of an acute fiscal crisis. It was to regain control over ungovernable economies that economic liberalization was undertaken in the 19th century's great Age of Reform, just as we argue it is today in the Third and Second World. This paradoxically, as Heckscher observed of the 19th century economic liberalization achieved the goal sought by mercantilism:

Great power for the state the perpetual and fruitless goal of mercantilist endeavour, was translated into fact in the 19th century...  
The result was attained primarily by limiting the functions of the state, which task laissez-faire carried through radically. The maladjustment between ends and means was one of the typical features of mercantilism, but it disappeared once the aims were considerably limited.... Disobedience and arbitrariness, unpunished infringements of the law, smuggling and embezzlement flourish particularly under a very extensive state administration

and in periods of continually changing ordinances and interference with the course of economic life. It was because the regime de l'ordre bore this impress that disorder was one of its characteristic features. (Heckscher, p. 325)

The resulting "liberal disposition towards public affairs" (Keynes (1928), p. 5) had its uses. As Heckscher notes:

free competition, individualism and the limitation of state encroachment often became pure dogmas among practical men of affairs and politicians ... without any conscious rational foundations. That such a normative outlook existed is, in itself, by no means a criticism of laissez-faire. Some norm or other is always behind conscious action. for every action presupposes such a conception of the norm as, in itself, is not demonstrable. Here it was a question, in fact, not of science, but of economic policy, that is not of thought "but action". [emphasis added]

These "priors" were then eroded by the rise of socialism and a "new" bout of economic nationalism towards the end of the 19th century. The spread and perpetuation of similar "priors" in our contemporary Age of Reform is undermined by the dominant academic "public economics" tradition based on "market failure" (see Lal (1990) (1992)) for a fuller discussion). It is this, which in part has led to these recurrent waves of support for protectionism, however lukewarm, in the increasingly unworldly groves of academe. The ultimately sterile debate on "openness" we have discussed in this paper is no more than a reflection of the fact that, in a deep sense, the charge labelled against the "classics" of being ideological is now more aptly levelled against the modern technocratic "welfare economics" school (see Robbins (1981)). If the case for "openness" was clearly seen by contemporary economists as part of that seamless web of arguments (encompassing ethics, economics and politics) supporting Adam Smith's system of "natural liberty" (see Hayek (1960)) there would be no need for this paper. That there is, tells us more about our upbringing than about any "truths" to be still discerned about the "static" and "dynamic" gains from openness!



## ENDNOTES

<sup>1</sup>This also included a detailed critique of the statistical study by Jung and Marshall (1985), and showed why we could not accept its conclusion that "many of the countries most famous for the miraculous growth rates that appeared to arise from export promotion policies (e.g., Korea, Taiwan, Brazil) provide no statistical support for the export promotion hypothesis" (p. 10). The other studies surveyed were: Balassa (1978); Bergsman (1974); Darrett (1986), Grais, et al. (1984), Harris (1983); Helliner (1986); Feder (1983); Michaely (1977); Michalopolous and Jay (1973); Heller and Porter (1978); Whalley (1984).

<sup>2</sup>For a discussion of the other two waves -- the first associated with Nurkse, Myrdal, Balogh, Prebisch and Singer, and the second with the later Lewis, Emmanuel and various "dependency" theorists, see Lal (1983).

<sup>3</sup>Scott's critique echoes an old debate about the measurement of capital, and the validity of the neoclassical production function. The latter is concerned with the change in the net stock of capital -- gross investment minus depreciation. This depreciation has either been taken to be due to a physical process or as a result of scrapping. Scott says neither notion of depreciation makes sense, as machines which are well-maintained can go on producing the rated output well past the date they disappear from the production function, while scrapping is an economic process which depends on the date they cease adding to net output. When machines which are profitless are scrapped no productive capital is lost. Hence, gross investment is the best measure of the change in the capital

stock. But there is no way in which a measure of this stock can be obtained, say by summing up all past gross investments. So the idea of the production function that links the level of output to the level of capital has to be abandoned, and all one can do is explain changes in output by changes in capital -- that is gross investment. The difficulty contemporary theorists bred on the neoclassical growth theory have in swallowing these commonsensical ideas is shown by the exchanges between Scott and eminent American economists in the Journal of Economic Literature (Sept. 1990) and Oxford Economic Papers (1991).

<sup>4</sup>In quantifying the implications of the "new" trade theory a major problem is to determine the industry's conduct -- how firm's compete with one another (Helpman and Krugman (1989), p. 156). The results of the empirical studies that have been conducted in this genre do not seem very robust, but the gain from trade intervention in the absence of retaliation appears to be small. Moreover, as Richardson (1989) notes, studies of trade liberalization under imperfect competition (with scale economies) have in fact strengthened the case for liberalisation, as they show even larger gains for trade than under the assumption of perfect competition, because of the "reductions in markups of price above marginal costs brought about by greater international competition and the increase in the average size of firms as competition eliminates small inefficient firms" (Baldwin, op. cit., p. 41).

<sup>5</sup>See Sampson and Yeats (1977); Cline et al (1978). Also as Leamer (1988) notes, the usual method of computing tariff equivalents of non-tariff barriers by comparing domestic with international prices, is only accurate for the case when the products are standardized and there is no market power.

<sup>6</sup>Another route to investigating the "openness" -- growth link is to examine the effects of recent World Bank structural adjustment programs, whose major aim is to influence the growth rate by reducing policy induced distortions and thereby improve the supply side of the economy. It is encouraging that a study by Mosley et. al. (1991), whose author's "priors" are clearly not in consonance with the "neoclassical consensus", concludes from the statistical and qualitative evidence of nine case studies that: "the evidence in favor of the proposition that compliance with conditions caused an improvement in GDP and export performance is stronger than the evidence in favor of the proposition that the finance associated with policy based lending caused such an improvement" (Vol. 1, p. 228).

<sup>7</sup>Witness the favorable review Wade (1990), the most economically, literate of these three, received in The Economist.

<sup>8</sup>But there are different ways in which this can be done, with different implications for equity. The state could tax and supply the proceeds to persons it favors. Alternatively, it could use the taxes to provide a fund from which all could borrow. Finally, it could provide capital for large ownership stakes simply by favoring policies that tolerate inequality in the distribution of wealth.

<sup>9</sup>But it should not be inferred from this that this policy was necessarily ideal in effectuating Korean comparative advantage. Amsden has estimated gross rates of return for the period 1971-82 for five classes of manufacturing outputs -- two labor intensive and two capital intensive. She concludes: "The data support three interrelated conclusions. First the

most labor intensive industries have the highest profit rates. Second, the youngest industries [the capital intensive ones which were promoted during Korea's dirigiste "Big Push" in the 1970s] have the lowest profit rates ... Third, the capital intensive industries have the highest export growth rates, besides having the highest overall rates of subsidization (measured by the loan to value added ratio)" (op. cit., p. 85)

<sup>10</sup>A number of authors (e.g., Leff (1978) (1979)) have noted that "big business groups have evolved into critical factors in late industrializing countries" (Amsden, op. cit., p. 119). But as she notes that no satisfactory explanation has been provided for this. The Demsetz hypothesis may well provide the answer.

<sup>11</sup>That the founder of the "house of Tata" was aware of maintaining the concentration of private wealth in exercising control over the enterprises he had created is shown by his creation of a family trust "which was indivisible from the beginning because of its objective of preserving jointly owned assets in perpetuity" (Yasuoka (1984), p. 28).

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