

## What Are the Right Institutions in a Globalizing World?

*And.... can we keep them if we've found them?*

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### **Abstract:**

Greater trade integration has often been viewed as requiring greater standardization in institutions, without which the benefits of trade do not materialize. There are many current debates concerning the degree and area of standardization needed and these debates are likely to continue for the foreseeable future. This paper, drawing on both the fiscal federalism and the trade literature, argues that increasing trade integration is consistent with a wide array of institutional choices. The final outcome, in terms of which institutions have prevailed, has depended substantially on political pressures for standardization and not necessarily on a clear assessment of economic gains.

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As international economic integration has deepened, countries have been increasingly concerned about whether globalization is diminishing their ability to hold to the policies and institutions that they consider important to enhancing domestic welfare. The concern is that globalization reduces the set of choices a country can make in terms of domestic institutions by “forcing” standardization and by so doing diminishes a country’s chances of raising growth and protecting the poor. Countries and firms choosing institutional diversity are seen to be turning their backs on the gains to be garnered from global economic integration. In theory, arguments could be found to support either hypothesis: that more standardization or increased diversity in institutional design should surface with greater economic integration. This paper contends that the empirical evidence indicates that it is possible to maintain substantial institutional diversity while simultaneously benefiting from increased economic integration.

This paper does not aim to focus on the myriad economic forces influencing institutional design but instead asks whether the sum total of these forces always leads to (or should lead to) greater standardization in institutions across countries. This paper does not aim to prove that countries are more or less integrated (or globalized) than they were 10-20 or 500 years ago, or that institutions have not changed or will not change as globalization proceeds further, but simply that a large degree of integration is consistent with countries choosing different institutional paths. It supports this argument by presenting evidence from countries or regions that have seen large increases in trade. A stronger test would be to create an index of “institutional diversity” and to see how this index affects overall trade. However, currently there is no such index and I resort to analyzing the experience of a number of countries that have seen increasingly greater

integration with other countries in order to support the hypotheses discussed in the paper.<sup>2</sup>

In this paper, I draw on the public finance/fiscal federalism literature to shed light on the positive and normative aspects of the relationship between economic integration and institutional standardization/harmonization. In one sense, economic integration among different states within a nation or of different countries in a global economy can be viewed as a set of points along a continuous line representing larger and larger entities—with one glaring difference at the political economy level. Nation states are overseen by an entity that (ideally) promotes the overall growth and poverty reduction goals within a country and that will take the redistributive measures necessary to achieve these goals, while the international economy does not have such a sovereign entity. In terms of the influence exerted, the international setting is dominated by wealthier or larger countries and large multinational firms (at the country level the analogy being large firms or wealthy landowners). Imbalances in the influence exerted by different countries and the absence of a sovereign power make choosing any international rule difficult, and may be expected to bias the outcome of such a rule to a greater extent in favor of the economically powerful.

Alesina and others (1997, 1999, 2001, 2004, 2002), Feldstein (1997), Casella and Feinstein (1990), and Sachs and Sala-i-Martin (1997) among others have differentiated between the economic and the political desire to unify or harmonize countries' policies and institutions in the context of multiple sovereign nations trading together. Much of this work has focused on the particularities of the progressively tighter links between the

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<sup>2</sup> “modified” in the sense that the paper does not discuss one country over a period of time but several countries at a point in time.

members of the European Union (EU). In fact, these authors contend that much of the pressure for harmonization comes from the desire to have a tighter *political* union. Feldstein (1997) for example has argued that the economic rationale for a common currency in Europe did not exist. Rather, Europe's desire to integrate closer through the adoption of a common currency has had a primarily political basis.

Sachs and Sala-i-Martin compare fiscal federalism in Europe with the approach of the United States (US) using the notion of optimum currency areas. They view the US as a set of regions tied by "irrevocably fixed exchange rates" and argue that this system is reasonably efficient because the federal system absorbs a substantial fraction of interregional shocks (there is therefore no need for nominal exchange rate alignments). They discuss the need for greater insurance/better compensation mechanisms in unions where there is greater centralization, more centralization implying greater standardization of objectives or means or both.

As Alesina, Angeloni and Etro (2001) point out, centralization can generate substantial benefits if there is a high degree of economic interdependence to begin with while heterogeneity or diversity in endowments or preferences calls for diversity in policies and institutions. The former tendency or centralization of rule-making (which often results in standardization) is limited by information and political constraints just as diversity of institutions may also be limited by political constraints. (Oates, 1999). Alesina and Wacziarg (1999) argue, however, that the lower the barriers to trade (or the greater the degree of economic integration), the lower the need for "political" integration since countries can benefit from being small and heterogeneous if trade barriers are small (as long as these sources of heterogeneity are not in themselves barriers to trade). Note

however that it is in practice difficult to distinguish between regulations/rules that affect purely domestic or non-trade activities and those which constitute barriers to trade.

Casella and Feinstein (1990) develop a model in which an initial expansion in trade is accompanied by the integration of political units in order to support trading activity. Over time increased profitability of trade in larger markets leads to reduced transactions costs and a desire for political diversity. This is accompanied by less harmonization. Therefore, depending on the relative returns to diversity (which are increased with heterogenous preferences and endowments) and standardization (lower transactions costs), the outcomes will differ over time and for different groups of countries.

Alesina, Angeloni and Schuknecht (2002) contend that too strong a pressure for centralization in policies and regulations (standardization) can increase pressures for opting out of any intergovernmental union, particularly when there is a large degree of heterogeneity among the members. They argue that the benefits of harmonization /standardization depend on the policy area considered. In terms of the legislation required to ensure a “common” market, they conclude that “a certain degree of approximation of domestic laws is necessary to guarantee a level playing field. On the other hand excessive harmonization may at times become an infringement rather than a support of free area-wide competition.” Others (Dur and Roelfsema, 2002) demonstrate that centralization of decision making may fail to internalize policy externalities and may lead to either over/under provision of public goods.

Baldwin (1970) argues that the world will be divided between rich countries linked together by mutual recognition agreements and less developed countries that face

hegemonic harmonization (rules set by rich countries). He concludes that in reality harmonization is a practical goal only for countries that are not “too” different.

Eisenmann and Verdier (2002) distinguish between different types of regulation/rule setting: (1) unilateral, (2) negotiated reciprocity where countries agree to set their standards in a mutually beneficial way, with harmonization as a special case, and (3) mutual recognition defined as agreeing on ultimate objectives but leaving the definition of the means at the discretion of the country. In this case countries trust each others’ certification processes. Alesina, Angeloni and Schunehcht (2002) provide a good summary of how the EU treats legislation/standards within member countries and a discussion of the types of policy areas that might benefit from centralization/standardization and those that might benefit from diversity and customization in terms of both objectives and means (of implementation). As is clear from a reading of their paper it is difficult, if not impossible, to find areas where à priori countries will always favor standardization or always favor diversity.

Bagwell and Staiger’s (1999) theoretical work is closely related to the hypothesis and findings of this paper. In their work, barriers that affect trade work together to determine the actual access to a market. Thus regulations/standards and tariffs work together, an increase in one in a given country can be offset by a decline in another. Thus one of their main messages is that if governments were granted more sovereignty over their policy choices (but asked to maintain a given level of market access), GATT’s rules would deliver globally efficient outcomes.

This paper is also related to the international trade literature, which views standard setting as a strategic exercise as in Brander and Spencer (1985), Fischer and

Serra (2000), Barrett (1994), and Kennedy (1994). In these models standards/regulations are designed with a view to limiting entry and keeping competitors out of the market rather than with a view to lowering transactions costs.

Finally, this paper is related to the extensive literature on institutions and trade, such as the works by Milgrom, North and Weingast (1990), Greif(1977a, 1977b), Perotti and Modigliani (1990), World Bank (2001), and Islam (2002), which discuss the relationship between various institutional designs and trade.

In terms of what the evidence shows regarding institutional structure in today's globalized world, I would like to make four points. First, globalization seems to be quite consistent with diversity. The distribution of the sources of diversity, i.e., new innovations in institutional design (either countries or regions) can be expected to change with changing economic realities. Second, the empirical evidence indicates that particular institutional differences (diversity) may or may not consistently affect overall resource flows in the directions expected because of countervailing factors. Third, it is more important to think about the overall institutional composition of a country than about the role of *particular* institutions in influencing resource flows across borders and in influencing economic outcomes. Fourth, a growing number of sovereign and non-sovereign bodies are at work establishing *international* institutions that attempt to produce conformity in processes/product standards/regulations. The effect of any institution on efficiency and distribution depends broadly speaking on where it is set relative to where countries are initially, for example, in their initial income and literacy levels. Also, countries at different income per capita levels, with heterogeneous preferences and endowments, may have dissimilar objectives. Thus it follows that if

benefits/costs are to be more “fairly” spread, then all countries need to collaborate on the “level” of any new rule or standard and on the phasing of such change over time. And it follows that the case for additional international regulations/standards need to be carefully scrutinized.

The rest of the paper is organized as follows. First, I discuss some definitions and the reasons why greater economic integration may influence institutional design. I follow this discussion with some empirical evidence linking trade and institutional structure in countries, and a consideration of international institutions. The final section concludes.

### **Some Definitions and Why Trade Affects Institutions**

Before proceeding further, the first order of business is to clarify what is meant by institutions. In the economics literature it is defined as the informal and formal rules (including regulations, laws, norms/customs) that influence behavior. Institutions may be differentiated from policies, though in practice the distinction is sometimes blurred. Policies may be thought of as the goals that governments or others want to attain (such as 100% rural electrification or a stable exchange rate, or a certain rate of inflation), and the institutions as the rules governing the actions of individuals such that these outcomes are realized (World Bank, 2001). These rules could be those within an organization for example, or those governing how different entities/organizations interact with each other. In common parlance (though not in this text), the word institution is used to denote an organization as well, examples being the judiciary, the government, and private companies. In this text, as in economic theory, I distinguish between the rules and processes that govern actions and the actors (e.g. organizations) that undertake the

actions-only the former being “institutions”. So, the institutional structure of the judiciary, or of government or of private companies, in this text, would mean the procedures, laws, regulations or norms, internal or external to the organization/group that determine how individuals *within* the judiciary, within government, or within private companies, behave. Following economic theory, institutions affect economic outcomes by influencing both the *incentives* and the *opportunity sets* of individuals/ entities.

Second, it is necessary to state what I am referring to as globalization.

Globalization is increased trade in goods and services, movement of labor and capital across borders, information exchange and the internationalization of ideas, and physical changes in one country resulting from increased trade in goods and services. Changes in technology and enhanced economic integration has induced structural changes in economic markets as evidenced by the number and nature of the players dealing across borders- such as large multinational companies, and multinational NGOs, the WTO, the large integrated community called the EU and the 200 or more Free Trade Agreements that have been signed and that formally bind countries to act according to some common rules. As a result, the proliferation and design of institutions which guide commerce are heavily affected by both sovereign and non-sovereign actors working within and outside domestic borders—making for very complex structures and a complex process of institutional change. Sometimes globalization refers to these structural changes (e.g. the proliferation of multinationals or the fragmentation of the production process) as well, though not in this text.

It is useful at this point to ask how greater economic integration affects institutional design. Opening borders for economic exchange subjects countries to

greater competition from an increased flow of goods and services or from new goods and services, and opportunities are presented through access to larger markets and the realization of potential economies of scale and scope. Prospective returns to trade in goods and services also change as a result of greater information/technology flows across borders. Countries borrow and adopt good ideas and countries find new designs /processes (technology) in order to compete better on world or domestic markets. Over time flows across borders also change individual tastes. Changes in regulations/ standards therefore generally arise for one or more of the following reasons:

- Reduce transactions costs associated with trade (i.e. to facilitate trade)
- Increase the ability to compete better in markets vis a vis others and to take advantage of new knowledge (even in non-traded sectors) to raise productivity
- Prevent entry/ restrict competition in markets
- Reduce spillovers once borders are opened (e.g. finance)

In short, changes in relative prices (including wages) set in motion by economic integration affect net returns and the distribution of returns associated with pursuing a given set of policies and relying on a given set of institutions. All these forces work on institutional structure and *within* each country, may either lead to greater differentiation in institutional design or to greater similarities (the extreme form being standardization) as institutions are changed to improve performance (World Bank, 2001, Islam, 2001, 2003).

History provides some interesting insights into the impact of competition. In the 13<sup>th</sup> and 14<sup>th</sup> centuries for example, much of Europe could be characterized as city-states

that traded intensively with each other. Merchants and states endeavored much as they do today to increase their share in gains from trade. As Pistor et al (2000) show, competition among neighboring countries such as England and France led to the adoption /adaptation of company laws within countries as firms in each country worked with their governments to promote a more efficient business environment. In Europe, during the 19<sup>th</sup> century businesses operated under a concession system in which rulers granted entrepreneurs the right to incorporate on a case-by-case basis, often as a special favor. In the latter part of the century, England instituted a system of company registration such that the right to incorporate was granted automatically on meeting certain minimum requirements predetermined by the state. In this way, the government took an arms length approach to market transactions that allowed for more competition and set in place a process whose outcome depended more on the merits of the case than on personal connections. In France, the shift was induced by the competition French businesses faced from English companies on the continent (Pistor and others, 2000). However, in the actual design the corporate laws differ.

In the latter part of the 19<sup>th</sup> century, as transport costs declined, and international trade expanded, Thailand experienced a rice export boom. Prior to this period, Thailand's land markets were relatively underdeveloped and one could classify the country as relatively land-abundant and labor scarce. Changing relative prices and large new export markets increased the demand for land, and, most interestingly, for formal institutions governing rights to land- previously these had been mostly determined by traditional practice. New institutions were demanded to reduce the transactions costs with acquiring land in the more profitable environment. Beginning in 1892 and

continuing for several decades thereafter, the government responded to the need for formal land market institutions by implementing a series of procedural and administrative changes (Siamwalla and others, 1993 , World Bank, 2001).

Soesastro (1998) writes how with increasing globalization, there has been strong competition among countries in the East Asia region as they have vied with each other to make their policies and institutions more attractive to investors. More recently, others have shown that international competition has affected local institutions but has not necessarily led to a uniform design of laws nor to a race to the bottom (Rodrik 1997, Freeman 1994a), as some had feared.

Examples abound showing how good innovations/ideas in one country have led to adaptations of these new ideas in other countries (trading of information). In other words the “demonstration effect” has teeth. The Grameen Bank, a micro-credit organization in Bangladesh was an institutional innovation designed to provide credit to poor landless women. Grameen practices group lending ensuring collective responsibility for loan repayment and it has an active social/ community development plan. This Bangladeshi initiative has ignited interest all over the world with countries from Latin America and Africa attempting to establish their own microcredit organizations.

### **Diversity in Institutions**

The above examples demonstrate some of the ways in which globalization may affect institutional design and provide an impetus for change—namely through the forces of competition, the opportunity for profit and for learning. What about the tension between the move towards standardization and the need for customization/innovation? Grameen’s example already provides the first data point, and the corporate laws of

England and France (discussed earlier) the second. In the Grameen case, a “standardized” Grameen structure was not put in place around the world. Instead, each country has adapted (or innovated) around the original Grameen Bank design. For example, Bolivia’s BancoSol has replicated Grameen’s group lending model but does not focus on social services; it also lends to individuals and reaches the relatively richer income groups (Murdoch, 1976). Grameen’s founder helped set up the Good Faith Fund in Arkansas- a program which lends to poor women and also a la Grameen, implements a set of complementary plans targeted to development of the community including the provision of technical assistance for female entrepreneurs.<sup>3</sup>

The European Union (EU) provides a striking example demonstrating the truth of the propositions mentioned earlier in this paper that diversity and trade can coexist, that no single institution determines a country’s competitiveness (or resource flows across borders) that overall institutional quality matters and that more global standards/ regulation face difficult efficiency and distributional issues, particularly with heterogeneous preferences and endowments. Since the conception and establishment of the European Economic Community (EEC) in 1957, there have been a number of institutional changes within the community with several attempts at, and continued commitment to harmonization fostered by the belief that such harmonization was critical to closer integration. Economic integration has progressed, but income, social and political factors have differed enough among the countries such that varied institutional solutions to similar issues have evolved and been maintained. The EU countries use a differentiated range of binding and non-binding legal instruments in order to maintain their institutional diversity while enhancing economic and political integration. In some

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<sup>3</sup> <http://www.goodfaithfriend.org>. Feb 25, 2004.

areas, they actively harmonize regulations; in others they have directives, that they agree to share common objectives but are free to approach the issue concerned in their own specific ways. In still other areas, they follow a policy of mutual recognition, in which each country recognizes the other's legislation/regulation/standard. In other words, there is quite a bit of room in many policy areas for differentiation among countries in terms of both detailed/specific objectives and means.

According to the accepted theory of public regulation and public service delivery in federal systems (alternative referred to as the "subsidiarity" issue in the EU), it is better or more effective to regulate activities having primarily local consequences (and few cross border spillovers) at the local level. When regulation is delegated to the local level, there is some expectation that there will be differences between localities and it is obvious how institutional diversity may arise. What is often overlooked is that the case for diversity is strong even in areas where it makes sense to regulate at a national or higher (than local) level of government. As long as the desired policy objectives are attained, there is nothing that says that there needs to be institutional standardization *within* the jurisdiction of the government.

While most of the EU countries have chosen to be united by a common currency and to share free borders, the countries in the EU differ in many ways. First, they even vary in terms of the types of companies they recognize. More specifically, company laws define different categories of ownership. In the United Kingdom's (UK) law, three main types of company are recognized (namely, companies limited by shares, companies limited by guarantee and unlimited companies), under Dutch company law two types are recognized (company limited by shares and a private company with limited liability).

French company law recognizes two main types of companies – commercial and civil. Commercial companies are of three types: unlimited liability companies, those where the liability of the shareholders is limited to their contribution to the capital of the company and those which comprise mixed shareholders- that is those who are personally liable and those shareholders whose liability is limited. A civil company may not engage in any commercial activity.

A simple comparison of the some of the corporate laws in different EU countries reveal differences in tax regulations. The corporate tax rate is 25% in Germany (though some types of companies have a special status), in the United Kingdom (UK) there is a two-tier tax rate with corporations whose profits are less than GBP 1.5 million paying 19% and the others 30%. The corporate tax rate is around 35% in the Netherlands (Richard, ed., (1992- 2004)).

The procedures required to start a business also vary. In France, minimum capital requirements amount to 7,500 Euros for a private limited liability company. In Germany, the minimum capital requirement for the same is 25,000 Euros and in the UK there is no minimum capital requirement. To register and clear the proposed name of the company requires eight days and 38 Euros in France, and in Germany it requires one day and there is no fee. To register new firms, there are altogether 10 distinct procedural/legal requirements in France, requiring over 53 days to complete at a total cost of 704 Euros. In the UK, the comparable numbers (at time of writing) are 6, 18 and \$US 264, and for Germany, 9 steps, 45 days and 1,425 euros.<sup>4</sup>

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<sup>4</sup> Source: Doing Business Database, The World Bank 2004.

Despite a high degree of potential labor mobility, regulations covering the conditions of employment are not uniform. For example, the maximum duration of fixed term contracts in Germany is 96 months, in Spain it is 36 months while in the UK and in Belgium there is no maximum duration. There is no mandatory minimum wage in Germany or Italy, but there is one in both the UK and in Belgium. The rules governing severance pay also fluctuate among the countries of the EU. In Portugal, 20 months of full wages are payable as severance pay after covered employment of twenty years. The corresponding number of months for Belgium, Spain, Germany and the UK are 0, 12, 0 and 7.5.<sup>5</sup> In the UK and Belgium, it is not considered unfair to terminate the employment contract without cause. In both Italy and Germany, it is.

Notwithstanding borders that are unrestricted in terms of capital flows, banking regulations and capital market institutions vary significantly within the EU. Several research papers have been written analyzing bank-based versus market-based banking systems and the impacts of particular institutional structures on growth and development yet none have indicated that one or the other system will penalize economic outcomes in open economies. Recent research indicates that there is no particular institutional design that is critical to capital accumulation and growth but rather what is important is the overall level of development of the financial sector and legal system and the efficiency with which it allocates financial resources (Beck and Levine, 2002).

With respect to financial reporting, the EU member states have significant differences in national practices, yet follow a mutual recognition policy. They have acknowledged that financial statements from the other states must be accepted in all other member states without any need for restatement or reconciliation (Hegarty, 1997). This

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<sup>5</sup> Source: Doing Business Database, The World Bank 2004.

has been accompanied by some liberalization of accounting services. As Hegarty explains, under the agreement reached by the EU countries, a French company listed on the Frankfurt Stock Exchange can file its accounts according to French standards and is not under an obligation to indicate how the statements would be different if done under German standards- showing a conscious acceptance of differences in regulatory design.

A recent debate in the EU about tax policy demonstrates how, in the absence of a clear economic rationale for continuous harmonization, decisions eventually become very politicized. EU finance ministers are interested in harmonizing the base on which company taxes are calculated. However opinion is divided on this issue. Countries such as Britain and Ireland and some of the newer members from Eastern Europe are reportedly not interested in tax base harmonization while France and Germany are. The former group believe in the value of tax competition and institutional diversity while the latter believe in stopping “unfair” competition.<sup>6</sup> Another debate demonstrates how different economic and social values, that could easily remain “different” come under attack once the harmonization bandwagon has taken off. An EU directive limits the number of hours an employee can work to 48 in a week. The UK has managed to opt-out of this directive but it seems that a strengthening of the directive could deprive the UK of this right.<sup>7</sup> Time and political bargaining will tell which side wins out.

The laws (and regulations ) of different countries in a given area may vary both in the substance and also in the degree to which there are detailed prescriptions or guidelines. Furthermore, there may be one or several laws/regulations that determine the conduct of any entity in a single transaction type. For example, in Spain the legal sources

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<sup>6</sup> Financial Times, Monday, September 13<sup>th</sup>, 2004. Pg 4.

<sup>7</sup> Financial Times, Tuesday September 14<sup>th</sup>, 2004. Pg 4.

covering both the substantive and procedural aspects of company bankruptcy are spread among five different laws - The Commercial Codes 1829 and 1885, The Civil Procedural Rules, The Civil Code 1889, and the Suspension of Payments Act 1922 (Philippe & Partners and Deloitte & Touche, (2002)). In every EU state there exist legal procedures that allow for the reorganization or rehabilitation of businesses encountering difficulties. However reorganization procedures vary a great deal with respect to how they are administered and what effects they have on various stakeholders. To add to this, any student of law or legal systems would readily point out that in all countries there is also a multitude of informal practices or “customs” that complement these laws/regulations and affect how these formal rules play out in practice.

As acknowledged by the EU itself, attempts at harmonization are motivated by both economic and political considerations. Furthermore, the EU, in its attempts to represent itself as a single entity has established EU-wide organizations with authority over its members. Experience shows that once an organization is established it takes on a life of its own; these organizations are busy designing various kinds of legislation that would have EU-wide implications. It would be a difficult thing to argue that the net increase in intra-EU trade from increased harmonization’s would be so much higher as to justify the costs of additional standardization in the details of all legislation. This is so particularly so because some standardization of objectives could be had without standardizing institutional design. But even the need for standardization of objectives is arguable. While proponents of free trade would argue that all trade related barriers should be reduced for economic efficiency, it seems from recent debates at the WTO and

within the EU that it is not a simple matter to decide what is trade related (as Bagwell's article on overall market access shows) and what is not.

Lessons for international economic integration can be drawn from the consolidation of states over time within what are sovereign nations today. Within countries, where mobility of factors, goods and services are high, and where income per capita differences (and other initial conditions) may be expected to vary less than across countries, one might expect not to see much institutional diversity. However, the evidence indicates otherwise. The United States in the 18<sup>th</sup> and 19<sup>th</sup> centuries, Australia, Canada, Brazil, and India are examples of large countries that have had to deal with integration among provinces/states that differed in their social, political, and economic conditions. Integration has not been easy as the American civil war bore witness. Even after the United States became one country with a central government, barriers to trade between the states existed. Now, though an integrated economy, several institutional and policy variations have been maintained at the state level. Looking at the labor market for example, the minimum wage in Ohio is 2.65 dollars an hour as opposed to 5.15 in Idaho (Table 1). The unemployment benefit varies from state to state. The corporate tax rate is 10% in Pennsylvania and 7.5% in New York (Table 2). The laws and regulations governing dispute resolution/arbitration show differences among the states. These variations are clearly the result of heterogeneous preferences among residents and governments and the different economic realities of the 50 states.

**Table 1: Labor Laws in Selected States**

<b>Labor Laws</b>	<b>Minimum Wage</b>	<b>Overtime</b>	<b>UI – Benefit Formula</b>
<b>California</b>	6.75	Time and half	HQ – 1/23-1/33
<b>Oregon</b>	7.05	Time and half	AW – 1.25%
<b>Idaho</b>	5.15	None	HQ – 1/26
<b>Pennsylvania</b>	5.15	Time and half	HQ – 1/23-1/25
<b>Ohio</b>	4.25	Time and half	AWW– 50%+DA
<b>Kansas</b>	2.65	Time and half after 46 hours per week	HQ - 4.25%

**Sources:** <http://www.dol.gov/esa/minwage/america.htm>,  
<http://ows.doleta.gov/unemploy/sigprojan2003.asp>,  
[http://www.ows.doleta.gov/unemploy/uilawcompar/2003/monetary\\_entit.pdf](http://www.ows.doleta.gov/unemploy/uilawcompar/2003/monetary_entit.pdf)  
 HQ – High Quarter Formula: weekly benefit is fraction of quarterly income in the highest income quarter in the base period  
 AW – Annual Wage Method: weekly benefit is percentage of annual wages in the base period  
 AWW – Average Weekly Wage: weekly benefit is percentage of average weekly wage in the base period

**Table 2: Business Taxation in Selected States**

<b>Taxation</b>	<b>Corporate Tax Rate (%)</b>	<b>Tax Brackets (No. of brackets)</b>	<b>Minimum Tax (\$)</b>	<b>State Sales Tax (%)</b>	<b>Local Sales Tax Max (%)</b>
<b>California</b>	8.84	Flat rate	800	6.00	2.50
<b>Oregon</b>	6.6	Flat rate	10	No	No
<b>Idaho</b>	7.6	Flat rate	20	5.00	3.00
<b>New York</b>	7.5	Flat rate	100-1500 (depending on payroll size)	4.00	4.50
<b>Pennsylvania</b>	9.99	Flat rate	No	6.00	1.00
<b>Ohio</b>	8.5	3,000 -50,000 (2)	No.	5.00	2.00

**Sources:** [http://www.taxadmin.org/fta/rate/sl\\_sales.html](http://www.taxadmin.org/fta/rate/sl_sales.html),  
[http://www.taxadmin.org/fta/rate/corp\\_inc.html](http://www.taxadmin.org/fta/rate/corp_inc.html)

In Canada, there are obvious differences between the provinces, as Tables 3 and 4 show for some labor regulations and business taxes. Canada’s case is complicated by the fact that some states like British Columbia have an English legal tradition while Quebec’s legal tradition is linked with that of France. India is a large developing country where states have quite different institutional structures. While the Industrial Disputes

Table 3: Labor Regulation in Selected Provinces of Canada

	<b>Quebec</b>	<b>Ontario</b>	<b>British Columbia</b>
<b>min. wage</b>	\$7.45/hour	\$7.15 per hour	\$8/hour (general)
<b>lay-off notice</b>	written notice of lay-off must be given one (1) week in advance if you have between three (3) months and one (1) year of service; two (2) weeks in advance if you have one (1) to five (5) years of service; four (4) weeks in advance if you have five (5) to ten (10) years of service; eight (8) weeks in advance if you have ten (10) or more years of service.	No employer shall terminate the employment of an employee who has been continuously employed for three months or more unless the employer, (a) has given to the employee written notice of termination in accordance with section 57 or 58 and the notice has expired; or (b) has complied with section 61. 2000, c. 41, s. 54.	The B.C. Employment Standards Act requires that employees who are terminated receive compensation based on length of service. No compensation is required if an employee is given advance written notice of termination equal to the number of weeks for which the employee is eligible. Please note that this notice MUST be in writing. An employee can also be given a combination of written notice and compensation equal to the number of weeks' pay for which the employee is eligible.

**Sources:**

- Quebec <http://www.cnt.gouv.qc.ca/en/fiches/index.asp>  
[http://www.educaloi.qc.ca/TLR\\_Law/F01A\\_Capsules/?no=96](http://www.educaloi.qc.ca/TLR_Law/F01A_Capsules/?no=96)  
<http://laws.justice.gc.ca/en/search.html#CSTATS>
- Ontario <http://www.gov.on.ca/LAB/english/news/2003/03-65f.html>  
<http://www.gov.on.ca/LAB/english/about/leg/index.html>
- British Columbia <http://www.labour.gov.bc.ca/esb/esaguide/>

Table 4: Business Regulation

	<b>Quebec</b>	<b>Ontario</b>	<b>British Columbia</b>
<b>corporate income tax</b>	16.25% (as of Dec. 2002)	14% (as of end of 2003)	13.5% (general)
<b>corporate capital tax</b>	.69% ~ 1.29% depending on type of business	0.30%	0% ~3% (financial corporation pays higher rate) depending on the type of business, only for those with net paid up capital (or are part of an associated group that have net paid up capital) in excess of \$1,500,000
<b>tax credit</b>	67 entries relating to tax credit, for example, R&D or innovation tax credit is 35% (federal level, another 20-35%)	10 types of special tax credit, including Ontario Innovation Tax Credit (OITC) which is 10%, for a max. qualifying \$ 2 m; there are 4 tax incentives (offers tax deduction) related to education and welfare of employees, such as Workplace Child Care Tax Incentive (WCCTI)	9 programs for tax credits, including tax credit for film and TV, scientific R&D, manufacturing and processing, book publishing, etc. "family farm corporations" and four other forms of corporations are exempted from capital tax.

**Sources:**

- Ontario [http://www.trd.fin.gov.on.ca/userfiles/page\\_attachments/Library/3/Ctie\\_02Guide.pdf?N\\_ID=3](http://www.trd.fin.gov.on.ca/userfiles/page_attachments/Library/3/Ctie_02Guide.pdf?N_ID=3)  
[http://www.trd.fin.gov.on.ca/userfiles/HTML/nts\\_3\\_3367\\_1.html](http://www.trd.fin.gov.on.ca/userfiles/HTML/nts_3_3367_1.html)
- Quebec [http://www.revenu.gouv.qc.ca/documents/eng/formulaires/co/co-17-g-v\(2002-12\).pdf](http://www.revenu.gouv.qc.ca/documents/eng/formulaires/co/co-17-g-v(2002-12).pdf)  
[http://www.revenu.gouv.qc.ca/eng/services/sgp\\_inscription/index.asp](http://www.revenu.gouv.qc.ca/eng/services/sgp_inscription/index.asp)
- British Columbia <http://www.rev.gov.bc.ca/itb/itacit/itacit.htm>  
<http://www.rev.gov.bc.ca/itb/cct/cct.htm>

Act of 1947, is a piece of federal legislation governing industrial policies, there have been several amendments at the state level since its adoption. All states started at the same point but diverged over time (Besley and Burgess, 2004) such that today employer-employee relations are governed by quite different rules. Minimum wage legislation in Table 5 shows one aspect of disparity between the states.

**Table 5: Minimum Wage Schedules in Selected Indian States**

Central Government/States/Union Territories	No. of Scheduled Employments for which Minimum Wages have been fixed/revised	Range of Minimum Wages per day (in Rs.)	
		Min ***	Max
Andhra Pradesh	62	25.96	78.77
Goa	18	21	140.26
Kerala	35	30	184.26
Madhya Pradesh	36	51.8	74.34
Maharashtra	63	8.46	119.35
Orissa	83	40	40.4
Uttar Pradesh	65	58	83.42
West Bengal	45	48.22	96.17

*The information is based on the notifications received in Labour Bureau till 12.06.2001 from different States/Union Territories and excludes wages fixed on piece rate basis. India has minimum wages that vary by industry.*

*Source: <http://labourbureau.nic.in/wagetab.htm>*

While all states in India collect property taxes, states are now putting forth new initiatives in an effort to improve the transparency and effectiveness of their tax collection methods; yet these initiatives are independent of each other. The traditional method of levying property taxes was based on the annual rental value of the property. In practice this value was not estimated through the “market” but relied a great deal on

administrative/discretionary measures. A few municipalities and states have moved away from this system to establish a more transparent method based on tangible items such as location, land use, area among other things. Andhra Pradesh uses sample surveys of prevailing market rents for different categories of properties (Mathur, 2001).

The point is that much variation can be maintained to take account of differences in values and economic needs while trading to enhance welfare. By extrapolation, the presumption is that as other countries integrate (foster flows of goods and services across borders), they too will be able to maintain their institutional diversity.

At this stage one might ask what the evidence says about the effect of institutional differences on cross-border flows of goods and services? The available empirical evidence on how certain types of institutions affect trade flows and competitiveness is mixed. It is intuitively obvious that domestic institutions as well as international ones will affect the pattern of trade and are affected by it but it is not obvious whether in affecting a particular flow a single institutional feature would always have more of an effect than others. To be more precise, it is not obvious that labor standards alone would be a determining factor for competitiveness of a country's exports or that corporate tax rates would always be the determining factor when choosing incorporation in one country versus another.

Rodrik (1997) does find that countries with less expensive labor standards have a comparative advantage in labor intensive products. Freeman (2003) on the other hand, argues that looking at labor standards alone as directing trade flows is misleading. While labor standards may increase labor costs, lower wages, or depreciation may be used to counter the higher costs. Others have found that reducing direct regulations on cross

border flows (that is reducing tariffs) may not boost exports if macroeconomic policy causes real exchange rate appreciation. Most studies do not find environmental regulations to have had a large adverse effect on competitiveness (Jaffee et al, 1995). On the other hand another paper (Hines, 1995), documents how domestic legislation towards corrupt trade practices in other countries put US firms at disadvantage. The Foreign Corrupt Practices Act of 1977 made it illegal for US businesses to pay bribes to foreign officials. The design of regulations in export processing zones has affected the flow of trade but most studies attribute this to the overall set of regulations rather than to a specific regulation (Madani, 1999). The literature on capital flows across borders indicates that while reducing restrictions to capital flows may positively influence cross border flows of capital, other features are very important as well: for example growth prospects, macroeconomic and fiscal policies, exchange rate regulations, and implicit or explicit government guarantees on debt among other policy and institutional factors.

Another point to keep in mind is that trade flows are not affected only by profit or cost considerations and focusing on these aspects may fail to give the whole story. Demand for goods by consumers can be affected by “moral” values or put another way “tastes” (or norms). For example, consumers may refuse to purchase tuna, if the method of fishing used harms dolphins. Dyck and Zingales (2002) report how restaurant chains in the United States took tuna off the menu until it was “dolphin safe.”

The fact that the empirical results do not systematically point to differences in a single institutional feature as being critical in explaining flows across borders should not be surprising for two fundamental reasons: (a) that there is no one- to -one correlation between institutional structure and function (World Bank 2001) and (b) comparing any

single institution across countries does not necessarily provide a clear indicator of how the whole system functions or how profitable a trade is. The total returns from engaging in a particular activity depends on a host of factors; it makes more sense to think of the whole set of institutions which have relevance for a particular transaction as being important in determining cross border flows. The eventual impact of these institutions on the economy and on the *incentives* provided to different actors depends very much on the whole policy and institutional framework and how well the institutions support the transaction in question. If one accepts this – then it is easier to understand how institutional diversity- that is differences in particular institutions can be maintained.

To be more precise, if the transaction is repayment of a loan by a debtor through the intervention of the formal legal system a number of institutions become relevant (Islam 2003): the substantive law outlining the conditions under which the loan is said to be in default, the procedural law determining what steps need to be taken by the debtor and the creditor to resolve the matter in court, the rules governing the market for lawyers (and thus their incentives to bring the matter to a speedy conclusion), the regulations governing the actions of judges and their clerks and so on. When an investor chooses to invest in Bangladesh, Sri Lanka, or Malawi for the production and export of garments he/she is concerned labor market regulations, the condition of infrastructure (which in turn is determined by the policies and institutions in that sector), education and literacy rates, trade regulations (including preferential trading arrangements and the Agreement on Textiles and Clothing), and so on. Which factor (and which institution) becomes the “binding constraint” varies from time to time and from country to country.

Depending on each state/region's initial conditions and assets, policy *responses* to globalization will also be very different. Let us take the forces of competition. As Soesastro (1998) states there was strong competition among the countries in Asia arising from a desire to do better in the global economy. One way this has manifested itself is a desire to improve educational institutions in Vietnam, since global integration is being expected to raise the returns to skilled labor (World Bank, Asian Development Bank, 2002) and thus returns to education. Provinces within Canada have been characterized as having an "interesting diversity of labor market institutions" (Bowles 1998); Canadian provinces have also chosen responses customized to their particular context. British Columbia saw expanded post-secondary education, greater emphasis on vocational skills and investment in infrastructure as the appropriate response to competition from global markets. In Ontario, they focused on reducing business regulations and the levels of support to the unemployed and to social safety nets. This model, according to Bowles "follows a free market route to competing in the global economy."

### **International Regulations**

What about the impact of globalization on international institutions (regulations/standards) designed at the international level by sovereign nations or private actors? These institutions may be designed with the intention of regulating negative spillovers between countries (as in the case of international financial standards) as well as to promote or restrict trade by lowering/raising transaction costs associated with trading goods and services. In order to evaluate the impact of such institutions some important questions to ask are: (a) What are the potential efficiency gains from setting international standards, i.e., lower transactions costs, and thus larger markets? or (b) Who will be left

out of markets through any entry/exit barriers being proposed? For example, rich countries could collude on process/product standards to keep out new or smaller players in markets, or could restrict the flow of ideas/technology developed across the border. What is therefore the distribution and magnitude of gains/losses across countries and within regions? (c) Are static and dynamic gains/losses substantially different in sign and magnitude? What discount rate should be applied to losses and gains? (d) In cases where some countries gain unambiguously and others lose, what compensation would there be for the losers? And (e) How will individual countries deal with within country distributional impacts?

As an example, consider the case of food standards. Developed countries may insist on certain processing standards with the declared intention of improving the safety of the products they consume based on economic and political considerations in their home country. Suppose also that these standards are already in effect in the developed countries and these become “international” standards. Among developing countries, one would expect some countries being able to adopt these new standards without incurring too high costs, namely those who are already producing close to this standard. In all cases, there would be costs incurred to gain access to the (previously free) market. Countries which were exporters of this food product could lose their market to more sophisticated/ richer producers; these new standards would effectively work as entry barriers for this category of exporters. Note that real resources would be required to meet standards and to monitor compliance. If the adoption of standards makes developing country products more attractive to consumers and demand increases enough for goods imported from developing countries at the higher standard, then exporters facing the new

standards may gain depending on how much demand shifts, and how prices change, if at all. Exporters whose standards were formalized into “international” standards gain to the extent the entry is restricted and competition reduced. But within developing countries new or smaller farmers may be unable to meet these costs and would be barred from access to these markets. Other examples of international standards are product standards for manufactured goods, or environmental standards. In all of these cases, as in the national context, implementing regulations/standards affects distribution as well as efficiency.

The recent debates over cheese made from raw (non-pasteurized milk) serve to illuminate how distributional concerns may come to dominate the dialogue on international standards. Italy, France, and Switzerland are the major producers of raw cheese in the EU. The Sanitary and Phyto Sanitary (SPS) Agreement of the WTO indicates that Codex (Russell, 1999) is the intergovernmental body for harmonizing food safety standards. Essentially Codex standards become international law. The WTO relies on them because Codex in turn relies on scientific analysis for its guidelines and standards. According to the SPS guidelines if a nation adopts standards higher than those set by international bodies such as Codex, they must justify them on scientific grounds. These types of justifications are expensive to do in practice.

Since the US is not an exporter of raw milk products, US constituents support standards requiring that dairy products be made from pasteurized milk. If Codex adopts guidelines requiring pasteurization of milk, US dairy producers could gain market share. US producers presumably would prefer to face less competition for their cheeses but may also have an additional concern. They may fear that illness arising from consumption of

any milk products may affect the dairy industry's reputation more broadly and that raw milk products significantly increase this risk. French farmers fear that if standards are harmonized, they will lose since the market for certain cheeses will shrink. The scientific evidence, in terms of whether raw milk products have caused illnesses in recent times, does not show conclusively that raw milk products have endangered health. For example, milk may be contaminated after pasteurization. Thus, there is no clear cut justification on purely "scientific" grounds for banning raw milk products based on health concerns. Since there do not seem to be compelling efficiency or public health related reasons for requiring pasteurization, it seems that the real issue is purely a distributional one between producers of these cheeses and their competitors. Even more interesting, it seems that for trade *within* the EU, the issue has been resolved, but not by using mandated standards such as pasteurization. Instead member countries that produce cheese from raw milk are allowed to assure its safety in another way, namely, by adopting additional (testing) measures to assume the safety of their products. Put in other words, the EU states allow institutional/regulatory diversity while achieving the same objective of consumer safety (Vermont Cheese Council, 2000).

Just as countries with greater political as well as economic strength will dominate the design of institutions, so will private entities with lobbying power. Large private multinationals or consumers through the exercise of their purchasing power in markets can affect international rules. The larger the consumer market or the greater the potential for firms to exercise their market power, the greater the influence there is likely to be on global markets. Thus consumers in the United States carry great weight with British/EU

producers and if diversification to serve many different tastes is costly, these producers will be more likely to standardize according to US tastes than to Ghanaian tastes.

The Trade Related Intellectual Property Rights Agreement was signed by WTO members rich and poor. Intellectual property rights (IPR) legislation aims to give market power (monopoly power) to firms in order to protect the profits resulting from the application of an innovation. The argument holds that since innovations can be copied, the innovator is unlikely to capture the benefits from the innovation though the innovating firm will have incurred costs to innovate. Thus in the absence of IPR protection, the incentives to innovate would be low and there would be an under-provision of innovation. A strong IPR regime however, raises the costs of acquiring new technology and products, shifting the global terms of trade in favor of technology producers (generally the rich countries) and against the technology consumers (generally the poor countries). Extended to the international trade arena, one might argue that stronger IPR protection worldwide would promote more innovation worldwide or a faster rate of technological change. Second, trade flows would be affected by the strength of IPR<sup>8</sup> and the changed pattern of trade may lead to lower global welfare. Though I will not review the literature here, it seems that neither of these statements can be shown to be true in practice. Yet an agreement protecting intellectual property was adopted and signed by all WTO signatory countries: some developing countries gave up their rights to obtain access to access to cheap medicines. Note that most developed countries did not adopt strong IPR protection regimes at early stages of development.

Reducing asymmetries in information about the actual costs and benefits of particular institutional designs can go a long way towards affecting institutional

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<sup>8</sup> See Maskus (2000) and Maskus and Penubarti (1995) and Maskus (2002).

outcomes. An example is provided by the campaign of the media and of NGOs aimed at changing the TRIPs agreement so that poor people suffering from AIDs could obtain cheap medicine. Private pharmaceutical companies feared that allowing other countries to make the relevant drugs cheaply would lead to increased supply and an overall decline in their profits. As the severe health crisis has continued, media and NGO activism have highlighted the critical public health perspectives and in particular, the number of poor people dying while multinationals reaped substantial profits. As a result of this activism and consequent pressure on pharmaceutical groups and governments, eventually, there has been a partial modification of the agreement to allow poor countries to produce medicines locally in cases of epidemics or national emergencies.

Another area of where consumer activism is rife is that of child labor. There are various consumer groups and NGOs that write about the injustice associated with using child labor to produce traded goods and about the need to establish regulations banning it. Some consumers in developed countries have viewed it as their “moral” responsibility to refrain from purchasing these goods. Surprisingly, the media has downplayed facts that would shed some light on the “other side” of the issue. The “other side” being a more comprehensive understanding of the poverty/child labor nexus and appropriate policy responses. Such a discussion would explain that children who currently work in factories producing exported goods, if pushed out of these sectors due to a consumer boycott would simply be pushed to work in the non-traded goods sector, or would find themselves not only poorer, but on the street without regular work. It would explain that, it is generally poverty that sends children to work; children work because their family

needs income for basic survival,<sup>9</sup> that in an ideal world, all school-age children would be in schools. But until these schools are built and a financially viable alternative provided to poor families without income, it is probably better in the short run to have girls in factories, from a “moral” as well as an economic point of view, rather than on the streets. The true benefit to a given set of people, at a given point in time, from a given policy/institutional design really depends on the feasible set of alternatives- since both the definition and the implementation of the ideal set is a difficult, if not impossible, thing.

At this point, it is useful to consider an analogy – that between the role of institutions and that of technology in economic development. Improved technology offers either a better (e.g. cheaper) way of producing the same thing or defines a new set of production possibilities. Better institutions facilitate the “production” of goods and services or even support the production of new goods and services. Institutions, like technology are an intermediate input to production and trade. Similar to the case of technological innovation, new institutions can be thought of as being “produced” by real endowments such as capital, labor, and other things such as the state of technology itself and may be affected by the initial distribution of wealth. As is true for technological changes, relative price movements change cost/benefit calculations for consumers and producers for a given set of institutions and create pressures for change. As for technology, there is an inherent conflict between the forces leading to innovation /customization and those favoring standardization. First, an innovation (and similarly, customization) that works well would tend to be standardized but, in a dynamic setting, raise the costs for *new* innovations to be accepted. Second, there are certainly technological developments that countries can adopt from others (standardization) with a

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<sup>9</sup> See Basu and Tzannatos (2003) for a discussion of these issues.

view to increasing output. Third, competition may increase pressures for new way of doing things rather than for standardization. Fourth, not all technologies are the “right” ones for all countries all the time—for example the use of computer technology may be a secondary priority where literacy is low.

Just as the appropriate technology may differ depending on initial conditions, so may institutions (for example, where community mechanisms of dispute resolution are strong and effective they may be used in preference to formal state-sponsored courts). Whether the standardized or customized solution will maximize output for a given country depends on the costs and benefits of each at a given point in time, and the overall objectives of each nation.

### **Conclusion**

To conclude, I would like to highlight four points. First, even while economic integration has increased, countries have maintained diversity in their institutional structures. In other words, the two can co-exist. This is easy to understand once one accepts that (a) there is not a one-to-one mapping from the design/structure of institutions to their functions and also that (b) the relevant institutional unit may not be one regulation or one law but the set of rules (including the norms) governing each transaction and therefore trade flows. It is usually the whole mix of incentives provided by (policies and) institutions rather than one institutional change that determines how trade flows proceed, though at some moments one or more may take overwhelming precedence in guiding transactions and trade (e.g. perhaps a large expected depreciation will take precedence in determining the direction of short term capital flows). The key issue for countries is how they can make each economic transaction more effective.

Second, in theory the choice between innovation/ customization and standardization in institutional design depends on a multitude of factors - the relative merits of each depending on conditions within a given country at a given point in time. Neither differentiation nor standardization is always “good”. Innovations can raise productivity – institutional diversity is often necessary to take account of different endowments and different initial conditions in a country. Under some conditions standardization of institutions will confer economic greater benefits in productivity and distributional impacts. Under others, it may not. Each country needs to weigh these costs and benefits.

Third, politics or the consideration of non-economic benefits may play a large role in determining institutional changes, as evidenced by the harmonization drive within the EU. The countries of the EU have decided that having a single set of institutions (which might be thought of as the extreme version of standardization) determining monetary policy a la Mundell’s optimum currency areas will ensure net positive benefits to a set of countries that are increasingly choosing to speak with one voice. This is not to say that a similar union including say India, China, Thailand or any other set of developing or developed countries would find similar benefits in such an arrangement either in economic or political terms.

Fourth, some contend that standardization of trade-related institutions across countries should be a priority since facilitating trade will bring benefits to all countries. There are at least two reasons why this is not as straightforward as it sounds. First, in practice countries need to decide on the standard, a decision that in itself will lead to redistribution of gains/losses across countries and these redistributions should be

acknowledged up-front and possible compensation designed. (A corollary is that institutional diversity can reduce the need for compensation). Second, there are innumerable institutions that affect trade between countries but which may serve other purposes and this distinction is not always useful.

While most countries would like to be able to trade more effectively and most governments would agree that better performance in export markets is good for growth, there is no accepted ranking of which precise outcome constitutes higher global welfare when the redistributive effects vary between outcomes. Institutional change, whether led by private entities or by sovereign ones, can benefit from the actions of informed coalitions acting as checks and balances. International institutions can foster a more equitable distribution of benefits by reflecting the views and requirements of all types of countries rather than those of a powerful elite. And this will probably mean leaving sufficient flexibility at *country* levels so that countries can vary in how they adhere to these rules and standards while achieving more or less common objectives. And it will mean understanding and accepting that all countries do not have to have the same objectives at all times in order to trade more. Finally, in between domestic and internationally determined institutions, there is another category not specifically discussed here – regionally or bilaterally determined ones. The principles discussed here apply there as well.

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