Trading to Prosperity and Freedom: Developing Countries in Perspective

Sarath Rajapatirana *

American Enterprise Institute

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1. Introduction

Two developments over the past half century have induced economists to tackle the relationship between political regime and economic performance, which before was under the purview of sociologists and political scientists. First, in mainstream economics, free trade, not restricted trade, has been shown to be the path to prosperity in developing countries. The theoretical foundation of this association dates to Ricardo, and empirical research continues to support the link between free trade and prosperity, particularly with respect to experience of developing countries over the past fifty years. Compared to the industrialization of the currently advanced economies, which took place over one hundred and fifty years, the recent growth of developing countries has not only happened three times more quickly, but has incorporated a larger portion of the world's population.

A second phenomenon among developing countries in the last half-century has been the spread of democracy (defined by two components -political and civil rights-Gastil (1990)), which seems to have become an important goal in itself. In 1973 there were 30 democracies in the world. Notably, the number had risen to 58 by 1990

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(Huntington 1991) and by some accounts up to 120 by the year 2000.[1] The remaining countries tend to openly espouse democratic principles more than ever before. This is new too.

Although some have noted the high correlation between the freer trading, more prosperous, and democratic countries, the causal links between free trade, prosperity, and freedom remain ambiguous.[2] There has been interest in the link between prosperity and freedom, by one account, going back to Aristotle.[3] And perhaps the best known modern inquiry into the topic was carried out by Seymour Lipset (1959), who concluded that economic development is an important factor leading to democracy. However, there have been surprisingly few empirical tests of Lipset's original claim. There have been many recent attempts to test whether democracy leads to prosperity—which is the inverse of the relationship that we are examining—but such attempts have at best yielded ambiguous results and at worse indicated that democracy could be inimical to prosperity.[4]

Our attempt here—to trace the indirect channels linking free trade and democracy—is a more narrow inquiry that follows from the work of Barro (1996), Helliwell (1994), Rodrik (1997), Hanke and Walters (1998) among others, who argue

[1] Latest 2000 comes from a Freedom House study entitled "Democracy's Century: A Survey of Global Political Change in the 20th Century."
[2] Griswold (2004) notes the high correlation between economic openness (ranking countries in quintiles based on Fraser Institute data) and civil liberties and political rights (ranking countries as free, partially free, or not free, based on the Freedom House index). But this is not a new observation. In fact, Milton Friedman (1962) noted that capitalism and democracy reinforce each other in a simple statistical exercise he conducted at the time.
[3] Lipset (1959)
[4] For a review of the empirical attempts to test the proposition that democracy can inhibit prosperity, see Limongi (1993).

that prosperity tends to promote democracy, rather than vice versa.[5] We proceed from known empirical findings to explore the channels by which trade could be related to freedom. We find that channels linking free trade and freedom do exist in an incentive compatible framework. We consider the links between freer trade and prosperity and between prosperity and freedom.

We claim that free trade leads to freedom through two channels. First, there is a well-known direct channel that links free trade to prosperity and prosperity to freedom. Second, there is an important indirect channel that operates due to the nature of free trade as a conduit for information that is closely associated with transaction costs that are more specific to trade. As a conduit for information, trade influences political, institutional and organizational characteristics between trading partners. Moreover, since the transfer of information, whether economic or political, is subject to transaction costs, we argue that free trade tends to minimize these transaction costs. Further, we argue that this indirect channel is particularly important when developing countries trade with rich democracies. Developing countries that open their economies to trade may find it increasingly difficult to deny political rights and civil liberties to their people. Although we note that certain analytical difficulties – especially time inconsistency, long lags and the neglect of transaction costs – render it difficult to claim that the relationship between free trade and democracy is unidirectional and uni-causal, such a relationship has strong theoretical

[5] Barro (1996) wrote "The positive relationship between democracy and prior measures of prosperity- the Lipset/Aristotle hypothesis- is well established as an empirical regularity. Given the strength of this association, it is surprising that convincing theoretical models of the relation do not exist. Thus, development of such a theory is a priority for future research."

basis to exist.[6] We provide the sketch of a preliminary transaction cost approach to model this indirect channel between trade and freedom (see Appendix B).

The paper proceeds as follows. After the introduction in Section 1, Section 2 addresses some definitional issues. Section 3 examines the state of knowledge on the direct links between prosperity and democracy. Section 4 examines the state of knowledge on the links between free trade and prosperity, and between free trade and freedom. Section 5 discusses some developing country antecedents. Section 6 discusses the indirect channels between free trade and freedom using the transaction cost approach. Section 7 summarizes our conclusions.

2. Definitional Issues

We begin by defining terms. By "free trade" we mean unrestricted trade, such that private agents in one country are free to buy from and sell to private agents in other countries.[7] State trading does not meet our definition of free trade because it carries a variety of disincentive-related, institutional and organizational limitations that raise transaction costs significantly and rob it the character that could lead to prosperity.[8] State

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[6] Romer (1990) notes that in evaluating growth models through cross country regressions misses important facts about discoveries that foster growth, the intricacies of intra-industry trade when the final goods assumption is dropped or for our purposes when organizational and institutional factors are conveyed from country to country. He notes that these types of facts do not come with a t-statistic attached to them.

[7] Note that we have a broader definition of free trade than what traditional trade theory provides such as low protection, reliance on tariffs rather than quantitative restrictions and low variance in protection. Our definition includes all these attributes, but in addition the nature of the organization of trade, that it is private agent based.

[8] State trading has been a dismal failure in the developing countries, not to mention its failure in the former Soviet Union. The Soviet Union practiced state trading as a means of controlling its satellite countries and exploited them by fixing prices of goods and services at lower levels than warranted by their opportunity costs and reaped strong terms of trade gains at the expense of these countries. Its satellites did not have much of a choice in the matter. Also, Soviet trading with South Asia (India, Sri Lanka, Bangladesh and Pakistan) led to similar losses to these economies. The deference of these countries was motivated by their desire to show affinity (the exact word used was "solidarity") with the Socialist block during the period of

trading relies on fiat and administrative decision-making, rather than true market-based transaction costs minimizing decision making as in the private sector. Despite some special cases in which state trading was primarily confined to certain goods such as petroleum and other mineral resources, state trading has not been a vehicle for prosperity. Even when there has been successful state trading in petroleum, the exploitation of monopoly power by the main producers led to many problems, not least of which was the inability of those countries to adjust to oil price hikes related economic booms (Nigeria, Indonesia and Venezuela are examples).

By “prosperity” we mean a sustained increase in the standard of living that reaches a level such that citizens can live comfortably and free to pursue their own interests. For our purposes, we designate a level of per capita income of $5000 using Summers-Heston estimates of per capita income that allow for differences in purchasing power. Some countries can become temporarily prosperous due to a resource discovery, price, investment or foreign capital inflow related booms. But this may not be sustained (Argentina of the 1990s). Some countries can temporarily lose their prosperity (South Korea, Thailand and Taiwan in the late 1990s). But these countries are recovering their prosperity with good policies including freer trade, even more than before.

By “freedom” we mean the presence of political rights and civil liberties, whereby citizens chose their governments and governments can lose their power. We use the term

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the Cold War. Unlike the satellite countries, South Asian countries imitated Soviet trade to “save foreign exchange” and “minimize” the use of hard currency by having bilateral payments agreements with the Soviet block. This practice was abandoned by developing countries upon realizing that this was not a good economic proposition for them. South Asian countries became more successful traders based on private initiative following the liberalization of their trade regimes from 1977 to 1993. India moved towards free trade rather late, only after 1991 and has experienced strong growth since then.

"democracy" as an equivalent term without losing much meaning.[9] An extended condition of democracy is that that democracy implies majority rule, universal suffrage in contested elections and the condition that the group of actors who participate in the selection of political leaders comprise "the selectorate." In a democracy, the adult population forms the selectorate.[10] For convenience we use the Freedom House ranking of countries as free, un-free, and partially free.[11]

We assume that freedom is desirable for its own sake. Human beings everywhere crave freedom: it is their nature to desire it. Moreover, freedom and prosperity are complementary. Without freedom, prosperity loses much of its value.[12] Conversely, it is difficult to enjoy freedom without some base level of prosperity. At one end, there is Saudi Arabia—with a per capita income about three times higher than the minimum definition of prosperity used in this paper ($ 5000 see below)—prosperous, but not free. At the opposite end, there is India (with a per capita income of $ 2,200 (Summers and Heston - The Penn Tables 1991))—free, but not prosperous.

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[9] Huntington (1991). "The central procedure for democracy is the selection of leaders through competitive elections by the people they govern."

[10] Bueno de Mesquita, Morrow, Silverson and Smith (1999). Where there are ethno-linguistic and religious differences and when such divisions are not well balanced, the selectorate is dominated by a majority who may deny fundamental rights to all citizens. In that case, democracy is limited since the selectorate is limited. Thus, majority rule does not guarantee democracy for all, as one notes in the South Asian context where some minorities do not feel that they have a say in the political system. They have attempted to secede as in the case of Sri Lanka which failed in the attempt to provide a measure of self rule and ended up in a prolonged ethnic conflict.

[11] The first systematic attempt to measure political and civil freedoms grew out of the work of Gastil (1984) and later developed further by Gastil and Wright (1988). The index scores most free to least free countries from one to seven respectively. The various measures of freedom are reviewed by Hanke and Walters (1998). There is a close correlation between political rights and civil rights, so that one can use a single index representing the state of freedom that equates to the state of democracy in broad terms.

[12] The notion of high income itself has no meaning without being related to some degree of freedom. This could be seen from those that are incarcerated in high income countries. Those incarcerated in the United States prisons have an average expenditure per prisoner of $20,000 (equivalent to per capita income given it is the value of goods and services received). More than 90% of the 186 countries in the world have per capita incomes of less than a quarter of the expenditure per prisoner of $20,000.

3. The State of Knowledge on the Topic

The state of general knowledge on the topic can be broken into answers to two questions. (a) First, *does democracy lead to prosperity*? (b) Second, *does prosperity lead to democracy*? A wide body of literature has aimed to determine the answers to those questions throughout the second half of the last century. But most of the analysis relating regime type to economic performance has largely excluded trade openness as a predictor of regime type. Hence, we aim to fill a lacuna in the current state of knowledge.

(a) *Does democracy lead to prosperity?*

Many economists, including Przeworski and Limongi (1993), claim that there is no systematic relationship between economic growth (prosperity as we defined here is a sustained growth of per capita income) and democracy, noting the ambiguous findings of a series of papers on the subject. Rodrik (1997) claims that democracy is a factor leading to economic development and shows that democracies yield higher and more predictable long run growth rates compared to authoritarian regimes, not least because they handle shocks better and pay higher wages. However, Rodrik notes that the relationship between democracy and economic development is not strong, since after controlling for initial income, education and the quality of government in a standard regression model, the relationship is only partial.

Barro (1991) (1996) finds that after holding constant the favorable effects from the maintenance of the rule of law, free markets, small government consumption, high human capital, and high initial levels of GDP, democracy actually has a weakly negative effect on growth. However, he also notes that his results suggest a positive, non-linear relationship between democracy and economic development, such that at low levels of political freedom, the emergence of democracy leads to economic development, but beyond a certain point, marginal increases in freedom can actually inhibit growth.

Hanke and Walters (1997) found that five different measures of economic freedom have significant power to explain variations in per capita income, such that an increase in the index of economic freedom could be expected to raise per capita income. From their results we note that free trade is the best correlate with competitiveness, especially in the case of developing countries that do not have monopoly power in world trade. This is particularly true for small economies that have narrow resource bases and substantially large tradable sectors.

In sum, the principal studies that have examined the issue whether democracy leads to prosperity have reached diverse conclusions. We conclude that democracy could lead to free trade in a few circumstances, but the link seems weak. We now examine the inverse proposition that prosperity leads to democracy.

(b) Does Prosperity lead to Democracy ?

The earliest work on this link was done by Seymour Lipset in his 1959 paper "The Social Requirement of Democracy." He revisited that work in his 1993 Presidential address to the American Sociological Association.[13] These two papers provide a good starting point to answer the above question.

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[13] Until recently economists have not attempted to tackle the issues of political regimes and economic performance. Sociologists and political scientists have taken the lead in this inquiry. The received wisdom among the economics profession was that the nature of the regime does not matter for economic development. Some even favored enlightened and benevolent authoritarian regimes as one could glean

In his 1959 paper Lipset employs a number of indices of wealth, industrialization, education and urbanization to trace the relationship between economic development and democracy, and he found that more prosperous nations are more likely to sustain their democracy. He noted that only in a wealthy society with relatively few poor citizens could the mass of the population participate in politics and develop the self-restraint necessary to "avoid succumbing to irresponsible demagogues." The four independent variables that Lipset considered (wealth, industrialization, education and urbanization) are close correlates of income, and hence the support for the proposition that prosperity leads to democracy.[14]

In his Presidential Address to the American Sociological Association, Lipset (1993) dilutes his previous claim by noting that prosperity is perhaps a necessary condition, but not a sufficient one for the emergence of democracy. In another paper, Lipset et al (1993) notes that "cross-national historical evaluations of the correlates of democracy have found cultural factors appear even more important than economic

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from the literature on the success of the East Asian countries. See the "Asian Miracle Study" (1993) done by the World Bank and the work of Alice Amsden (1989), Robert Wade (1990), Sanjaya Lal (1987), and Joeseph Stiglitz (1996) extol the virtues of authoritarian regimes' ability to insulate decision makers from the hustle and bustle of democratic politics so that these countries allegedly were able to save and invest more by not fritting away the gains for growth as would be the case under a democratic setup. In the event, the Asian crisis of the late 1990s showed that this was certainly not the case. The bureaucrats that these economists liked so much were far from being isolated. They were in the pockets of the ruling elites as predicted by Public Choice Theory developed by Buchanan and Tullock (1980).

[14] In Lipset's original account, these variables help the citizens to develop longer term perspectives that reduce their commitment to extreme ideologies and induce them to take a more complex and gradualist approach to politics. The political role of the middle class—which tends to expand under economic development—transforms the stratification of the society from an elongated pyramid (with the poor at the base) to a diamond, signifying the growth of the middle class. A growing middle class does not want to risk their prosperity to quick - fix extreme political parties, and therefore this development tends to moderate political parities and "penalize extreme groups." Also, greater wealth leads to the creation of intermediary organizations and institutions that countervail a single, dominating power.

ones."[15] Lipset (1993) is careful to say that the various factors, such as initial level of development, culture, leadership, types of executive and electoral systems can "shape the probabilities of democracy but they do not determine the outcomes." To be sure, however, in the decade following Lipset's reevaluation of his initial thesis, a variety of newly developing democracies and recent economic data allow us to re-evaluate his more guarded conclusion.

Helliwell (1994) uses panel data on 125 countries from 1960-85 to examine the link between democracy and economic growth (freedom and prosperity in our parlance). He finds that the effects of growth on democracy are "robust and positive." His work is done with great care to avoid the pitfalls of standard regression models using panel data. Helliwell finds that a 10 percent increase in per capita income raises the predicted value of freedom by 2 points on a 100 point scale. Geographic and cultural differences (e.g. OECD countries versus developing countries in different regions) diminish the strength of the link, but income remains a significant determinant of the transition to democracy. Like others, Helliwell found that democracy is a statistically insignificant determinant of economic growth. It is noteworthy that regional factors (read: cultural factors) that Lipset (1993) found were confirmed by Helliwell's results.

Barro (1991) (1996) finds the most robust evidence in support of the proposition that prosperity leads to freedom, rather than vice versa. Building on his observation that the general effect of democracy on growth is slightly negative, he concludes that

[15] Their conclusion stems from the observation that democratic systems originated in the Western European tradition and that developing countries that are former British colonies are highly likely to be democratic. India is cited as the prime example. In contrast, French, Dutch and Belgian colonies did not readily emerge as democracies.

improvements in the standard of living, measured by real GDP per capita, life expectancy, and education, make it more likely that political institutions will become more democratic over time.[16]

In sum, there is stronger evidence that leads us to believe that prosperity leads to democracy, compared to the earlier question of whether democracy leads to prosperity. The level of income remains the strongest factor that determines the move to democracy after controlling for other factors such as culture, historical experience and initial conditions.

4. State of Knowledge on the Links between Free Trade and Democracy

There are surprisingly few papers that aim to test whether free trade could be related to democracy. This section will explore a couple of the principal papers on the subject. Córdova and Meissner (2005) ask the question whether international trade has promoted democracy over the long term, namely, between 1870 and 2000. They address the possible endogeneity between trade and democracy by employing the gravity model of international trade as developed by Frankel and Romer (1999). Their results indicate that after 1895 trade openness had a positive impact on democracy, and that the post-WWII period suggests that a one standard deviation increase in trade openness in countries such as Venezuela, Russia, or Indonesia would cause them to become as

[16] Note Barro's (1996) concluding remarks on the relationship between prosperity and democracy: "With respect to the effects of economic development on democracy, the analysis shows that improvements in the standard of living—measured by a country's real per capita FDP, life expectancy, and education—substantially raise the probability that political institutions will become more democratic over time. Hence, political freedom emerges as a sort of luxury good. Rich places consume more democracy because this good is desirable for its own sake and even though the increased political freedom may have a small adverse effect on growth. Basically, rich countries can afford the reduced rate of economic progress."

democratic as Great Britian, the US, or France. Córdova and Meissner conclude that "fundamental factors that drive openness to trade can help increase the process of building and consolidating democracy," but they note that it is "difficult to extract any unambiguous lessons… as to the channels through which globalization affects democracy."[17] Finally, they point out that a decomposition of their measure of democracy, the *polity score*, demonstrates the time-variant relative importance of the measure's three components (competitiveness and openness of executive recruitment, constraints on the chief executive and competitiveness and regulation of political participation), which motivates our inquiry into the particular indirect channels linking trade and democracy.

Our work differs from Córdova et al primarily on two grounds. First, our analysis is limited to the experience of 32 developing countries between 1970 and 2000, which allows us to look more closely at the recent analytical history of developing countries to determine the best path of those countries to prosperity and freedom. Note that Córdova and Meissner look over 130 years whereas developing countries only began to gain independence following colonial rule forty to fifty years ago. Second, we discuss the indirect channels through which trade can promote freedom, with special attention to the microeconomic elements of the relationship arising from transaction costs.

Burkhart and de Soysa (2003) offer some insight into the link between trade and freedom, and they carry out Granger causality tests between FDI, trade and democracy in 120 countries between 1970 and 2000. They find that the accumulation of FDI stocks Granger-caused democracy to a more significant extent than any other Granger causality

[17] Córdova (2005)

test they performed (trade Granger-causes democracy; democracy GR-causes trade; FDI Granger-causes democracy; democracy Granger-causes FDI). They do find that trade had a positive, but less significant impact on democracy, and they underscore the high correlation between the accumulation of FDI and their measure of trade openness from 1970 to 2000.

One reason why the links between free trade and prosperity and between prosperity and democracy have not been on the front burner of research is that growth models have not adequately captured some of the subtleties of these channels. This in turn arises from the absence of a fully specified growth model that can handle indirect channels of trade and growth in the first instance.[18] The original and augmented Solow Models, two of best-known neo-classical production functions, can only incorporate the effect of trade policy via the savings rate (which determines the investment rate), the state of technology incorporated in capital, and in the augmented model, via higher levels of human capital accumulation. In such a class of neo-classical models, market incentives, government policies including trade policies have no effect on discovery, diffusion and technological advance.[19] But observations of world trade show that trade polices are the conveyor belt of discovery, diffusion and technological advance.

[18] Romer (1994) indicates the problem rather well when he writes "…progress in economics does not come merely from the mechanical application of hypothesis tests to data sets. There is a creative act associated with the construction of new models that is crucial to the process."

[19] Mankiw, Romer and Weil (1992) include the accumulation of human capital, but for our purposes here this achieves very little. Higher levels of human capital accumulation could help to increase the diffusion of knowledge and the capacity of a country to imbibe technological change. Similarly, ideas are best imbibed by societies that have higher levels of human capital accumulation than those with low levels of accumulation. Thus for example, standard growth equations used today have the ratio of secondary school education to the cohort population as a variable and most studies find a significant positive coefficient for it.

The limitations of the neoclassical growth model were addressed by the introduction of endogenous growth models (Romer (1986) and Lucas (1988)) based on increasing returns and a more acceptable way of incorporating the state of technology. In these models, the tendency towards diminishing returns found in the neo-classical model is offset by externalities and research and development. While empirical testing of the model remains a challenge (Pack 1994), endogenous growth theory can explain forces that give rise to technological change, rather than treat them as exogenous. These models can accommodate policy changes and trace their effect on growth.

The implicit open economy framework of endogenous growth models allows for trade in a number of ways. First, trade policies can help a country move towards the world technological frontier if the country concerned has no scientific and financial wherewithal to incorporate new technology to raise productivity. Second, since such information is akin to a non-rival good, it could be available to firms without them having to pay for monopoly prices for it. Third, given the strong link between trade and foreign direct investment, (especially seen in the experience of latecomers to industrialization beyond the East Asian countries such as Thailand, Philippines and Malaysia) it would provide an additional channel to raise growth through technology that is protected by licensing arrangements. Fourth, expanded international trade increases the number of specialized inputs and allows even a greater division of labor to realize higher gains from trade. Developing countries can participate in the international division of labor by participating in value adding processes (producing components) and do not have to wait until they develop the ability to produce final goods. In any case, international production and trade today are a disintegrated process, where final good production by a developing country is the exception rather than the norm. Finally, the recognition of transaction costs implies that firms that trade are subject to additional but indirect channels that influence their behavior and orientation and could act as conduits to bring about transformation towards democracy.

But even as the new models can accommodate technological change, externalities and greater gains from specialization, there are still other channels by which trade can raise growth and lead to prosperity. This is perhaps why, in empirical tests of both neoclassical and endogenous growth models, actual growth performance of fast growing economies is actually understated.

4. The transition from restricted trade to free trade: Developing Country Antecedents

The ideology of planning that followed independence in many former colonies provided much of the rationale for trade restrictions in the 1960's and 1970's, and the eventual failure of restricted trade provided an objective lesson that restricted trade is neither a path to prosperity or freedom.

In South Asia there was a close connection between those who were impressed by the Soviet experience of planning and a suspicion of the market as a vestige of colonial rule. Prime Minister Jawaharlal Nehru of India was a strong believer in planning and following independence India became a highly protected country.[20] And other countries introduced restrictions on trade due to the false belief that restricted trade could remedy unsustainable balance of payment situations. For example, Sri Lanka's Prime Minister (1970-77) Srimavo Bandaranaike formed a coalition government in 1970 with Marxist parties that promoted restricted trade and hoped that it would improve his country's balance of payment situation. Prime Minister S.W.R.D Bandaranaike (1956-59), influenced by the Indian independence movement, was also not a free trader. In a similar fashion, Bangladesh moved towards restricted trade following its independence from Pakistan. Nepal, influenced by the Indian lead, also adopted restricted trade during this time. In one sense Nepal did not have a choice in the matter, since all its surface trade has to pass through India.

African countries followed suit after their independence in the 1960s, although their shift to restricted trade was not so much due to ideology but to the poor economic outcomes (appreciated exchange rates and unsustainable balance of payments situations) which arose from bad economic policies. Such poor economic outcomes provided much of the rationale for the imposition of trade restrictions, due to the mistaken belief that restricted trade would be a solution to these problems. Presidents Nyerere of Tanzania, Kaunda of Zambia and Kenyatta of Kenya may have espoused a more anti-capitalist ideology than other African leaders of their time, but their protectionism was also somewhat convenient since it helped them centralize power, extend patronage to their supporters and share rents from restricted trade.

[20] It should be recalled that the Indian independence movement led by Mohandas Gandhi extolled the virtues of self sufficiency rather than free trade. Hence the Gandhian movement advocated the weaving of cloth as a cottage industry rather than import factory produced textiles from Lancashire.

Latin American countries who won independence in the 19th century led the movement towards restricted trade based on the views of the "Structuralist School" led by Raul Prebisch (1958). Partly as a reaction to the tremendous decline in primary commodity prices that these countries experienced during the Great Depression, they accepted the inward oriented trade strategy proposed by the Structuralists to industrialize behind high trade barriers. Thus, in the past fifty years, the developing countries that eschewed free trade did so either for default ideological reasons or to address unsustainable balance of payments outcomes that arose from poor macroeconomic management. In Addition, many of the poor countries signed bilateral payments agreements with the Soviet Block and established an external commitment to restricted trade.

It is not surprising that restricted trade led to further immiserization of these countries since the allocation of domestic resources was administratively determined. Such a strategy not only ignored relative prices and comparative advantage, but also discouraged foreign capital inflows and the associated transfer of technology from the advanced to the poor countries. It was not understood at that time that trade restrictions were not a solution to an unsustainable balance of payments situation. Such restrictions only postponed the inevitable need to adjust the exchange rate, reduce the bias against exports and discourage rent seeking activities. Given the distortions that trade restrictions created and the nature of the economic organization in planned systems, it is not surprising that standards of living in these countries stagnated in the 1960s and 1970s.

We note that the corollary to the proposition that free trade could lead to prosperity is that restricted trade leads to the absence of prosperity.

But the high costs incurred by planned economies as a result of restricted trade eventually required the developing countries to liberalize their trade regimes. Hence, the movement towards free trade among the developing countries in the 1980s and 1990s can be ascribed to several reasons.

First, the failure of the economies that had adopted restricted trade provided an objective lesson to developing countries. Nearly all the countries that adopted restricted trade experienced economic stagnancy.

Second, no group of developing countries other than the East Asian countries had succeeded in growing rapidly and moving towards prosperity and free trade was an important factor in their success, beginning in the mid 1960s. They did run into crisis in 1997-98, but it was the result of poor macroeconomic policies that led to the appreciation of their currencies and huge accumulation of contingent liabilities due to poor supervision of their banking systems in the presence of moral hazard. In other words, trade policy was not implicated in the crisis. These countries have been on a path of strong recovery since 2000 and have in fact reduced their remaining trade barriers and moved towards even greater free trade than before. While some have argued that it was authoritarian nature of these governments that led to their success, this is not a well established claim.

It is made by those who cannot contemplate that individuals, when left to themselves, make good decisions in economics as in other areas of human endeavor.[21]

Third, the developing country leaders that moved these countries into restricted trade either lost power due to their failed economic policies or died, and a new wave of democracy (what Huntington called the Third Wave of the 1970s and 1980s) led to more representative governments.[22] In fact, as Milner and Kubota (2003) have argued (see above), the "rush to free trade" (a phrase coined by Rodrik (1994)) was supported by the widening of the selectorate. Consequently, the leadership responded to the wishes of the median voter who in a labor abundant economy moves to freer trade policies over restricted trade policies which favor capitalists and land owners. By 1989, the collapse of the Soviet Union provided an additional lesson that planned economies cannot lead to prosperity and that political rights and civil liberties have intrinsic value for persons wherever they live. Thus the movement towards democracy supports free trade, but did not cause it.

Fourth, the movement to free trade was also supported by economic crises that beset the non-oil exporting developing countries in the mid 1980s.[23] By that time the second oil crisis (1979-81) had occurred and the world economy was in a recession. This was followed by the Debt crisis (1982-88) that began with the default by Mexico. The borrowing capacity of developing countries had reached its limits and these countries

[21] Wade (1990), Amsden (1989) among others have famously argued that going against the market was the reason for the success of the East Asian countries. No mainstream economists support this view and it has been discredited by further work by Lawrence and Wienstein (2001) among others.

[22] The leadership that spearheaded the movement towards independence turned out to authoritarian but also corrupt as it was seen in the case of Kenya, Uganda, Zambia, Pakistan, Indonesia, , Venezuela, Nicaragua, Panama and Nigeria to name few of the leading contenders for most corrupt countries.

[23] Little, Cooper, Corden and Rajapatirana (1993)

were forced to adjust their economies, which implied the need to move towards free trade. Some have argued that pressure from international financial institutions led these countries to move towards freer trade, but this cannot be well established by evidence.[24] The majority of countries that adopted strong trade reforms and moved towards prosperity did so without the World Bank's structural adjustment loans or the IMF's Stand-by arrangements. Actually, a number of countries (Chile 1974, Sri Lanka 1977, Bolivia 1995, and the four Tigers (Hong Kong, South Korea, Singapore and Taiwan) in the mid 1960s liberalized their trade regimes without assistance or pressure from these institutions. Conversely, many countries that received a large number of structural adjustment loans did not adopt free trade policies as much as those that did not borrow from these institutions. They moved towards free trade on their own. Mexico, Turkey, Indonesia, Cote d'Ivoire and Nigeria are examples of countries that borrowed much and reformed little. Until the early 1980s, the World Bank did not even attach policy conditions to its loans. Both the IMF and the World Bank acquiesced in the prevailing ethos of restricted trade. In the 1950s and 1960s, the World Bank merely requested the borrowing countries to prepare "development plans" to enhance their eligibility to receive loans!

Finally, beginning in the 1970s and well into the 1980s and even later, convincing evidence based on sound empirical studies showed that restricted trade was not a viable path to prosperity. The studies of Little, Scitovsky and Scott (1970), Bhagwati (1978) Krueger (1978), Michaely (1977), Feder (1983) , Dollar (1992) Edwards (1993), Sachs

[24] Krueger and Rajapatirana (1999)

and Warner (1995), Harrison (1996) and Frankel and Romer (1999) provided convincing evidence that movement towards free trade or what some have called outward oriented policies (including competitive exchange rates, lower levels and variance in protection based only on tariffs) were associated with better economic performance and prosperity.[25] This view was not without critics. Those who favored intervention argued that the success of countries that moved towards free trade was subject to many qualifications.[26] These included (i) the difficulty of attributing success to trade policy when there were other accompanying policies. (ii) the use of the trade ratio (the ratio of exports and imports to GDP) as an argument in the growth equation was flawed because the trade balance is endogenously determined. (iii) in the case of the East Asian countries some argued that clever bureaucrats directed resources to the most profitable activities when the market may not have done it due to informational problems and incomplete markets and (iv) the simultaneous growth of trade and income was merely fortuitous and had more to do with the state of the world economy than with trade liberalization.

In the event, these arguments have been more than adequately met by further empirical work that has demonstrated that free trade was the best policy to achieve prosperity. In this genre, the work of Frankel and Romer (1999) provide a clear answer and antidote to the critics of free trade. They get around the problem of the endogeneity

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[25] World Bank (1987), World Development Report

[26] The most well known recent criticism was by Rodriguez and Rodrik (1999) who argued that the relationship between free trade and economic growth was far from a settled question due to the problems associated with the attribution of growth success to trade when there were a host of factors that could account for improved economic performance. They were particularly critical of cross country studies and challenged the econometric evidence that was put forward by the studies that favored free trade. Bhagwati and Srinivasan (2000) accepted the criticism regarding cross country studies but challenged the conclusions of Rodriguez and Rodrik citing cases of success with free trade established by individual country studies.

of trade and income by using a gravity model of trade that employs time invariant country characteristics independent of income and trade policy (geographic data and colonial legacy among others). They construct instrumental variables to isolate the effects of trade and on growth and find that a one percent rise in the ratio of trade to GDP increases income per person by at least one half percent. While this relationship appears small at first blush, cumulating growth by half a percent can lead to substantially higher GDP levels over time by raising the rate of accumulation of physical and human capital and increasing output for given levels of capital. Their other significant finding is that the Ordinary Least Squares (OLS) regression approach used in earlier work to establish the connection between free trade and income actually understates the positive effect of trade on income.

5. Indirect Channels between Trade and Freedom.

There are much less appreciated and not yet formally modeled indirect channels through which trade also contributes to freedom. We note that trade contributes to prosperity through similar indirect channels which are not yet fully accounted for by neo-classical or endogenous growth models. Moreover, since the existing body of literature supports the proposition that prosperity tends towards freedom, we acknowledge that trade also supports the move towards freedom to the extent that trade promotes prosperity indirectly. We will discuss such channels in this section where relevant, but we will focus our attention on the indirect channels through which trade promotes freedom, with particular attention to the role of information, transaction costs, and institutions.

(a) *Information*

First, trade is an important conduit for the exchange of information between economies. In fact, there is a deep body of literature that explores how trade and FDI promote the transfer of best business practices, managerial solutions, and research and development innovations between trading partners. But economic information is often indivisible from political information, since it is highly unlikely that economic and business concepts exist completely separate from the political notions which gave rise to those concepts in the first instance. The ultimate efficiency of dispersed resources and knowledge, power sharing among competing interests, and checks and balances on institutional powers has been shown in both the political and economic spheres.

Perhaps the most important features of the transfer of economic information between trading partners is that it is completely incentive based. For example, profit maximizing exporters from one country must learn about the demand curve for their products in the importing country (which requires knowledge of habits, fashions, and economic organizations in detail and with increasing accuracy), as well as the type of marketing needed to increase penetration. Also, importing countries must learn about the sources of cheap imports that serve as inputs in domestic production, which is an incentive to observe the quality, design and prices that prevail in rich democracies.

Simply reading about what other countries consume or produce without the trade connection does not provide the incentive to learn and profit from that learning.

Trade-related travel from developing countries to more developed countries and training programs for local staff in multinational corporations provide additional channels for the transfer of information. Trade delegations from highly restricted countries visiting foreign capitals carry back knowledge and ideas how countries that enjoy freedom organize themselves, select their leaders and conduct themselves without a central command. They will see that high living standards or prosperity enjoyed by countries that are free (e.g. countries that score 1 and 2 in the Freedom House index) provide living proof that prosperity and freedom are related. This must send a powerful message to those that aspire for freedom themselves. Thus, we argue that imbedded in the incentive-driven transfers of economic knowledge lie deep-seated political notions. Hence, wherever economic knowledge changes hands between trading partners, political concepts are sure to follow.

Moreover, both economic and political information are not acquired without costs. Although the demand for prosperity is demonstrably universal, and the demand for freedom is presumptively so, much of the world does not have the resources and information that would allow for the enjoyment of both prosperity and freedom. Geography and lack of access to telecommunications are two impediments for the flow of economic know-how (read: human capital) and political knowledge (read: freedom). Often, barriers to trade act a similar obstacle to the diffusion of democracy from rich democracies to poor, un-free countries. In poor, un-free countries, the reduction of barriers to trade serves to decentralize knowledge of the external environment, and induces potential traders to research potential trading partners, the most luring of which are most often rich democracies.

It may well be that having the knowledge of other countries that enjoy high living standards and enjoy freedom may be necessary but not sufficient to move towards democracy. It must be combined with opportunities to bring about change. Such opportunities arise during crises when many developing countries transformed themselves from dictatorships to democracies. Brazil, Argentina, Uruguay in Latin America in the early 1990s, South Korea, Taiwan and Indonesia in the late 1990s, Lesotho, Botswana, and Zambia in early 2000 are examples. Different patterns emerge here. Latin American countries moved towards free trade following the transitions to democracy. But South Korea and Taiwan moved to free trade before moving to democracy. African countries noted here ended up with the Latin American pattern by moving to free trade after enjoying a measure of freedom. Lipset's factors may hold namely not only income, but culture, leadership, nature of executive and colonial experience influence transitions.

(b) *Transaction Costs*

To approach a preliminary model of the indirect effects of trade on democracy, it is useful to frame the diffusion of liberty in the context of transaction cost minimization. The general microeconomic model for this particular transaction cost minimization is merely a means of achieving a broader social welfare maximization which includes prosperity and freedom. We take the transaction cost approach due to the special importance of information and institutions in the transfer of democracy through free trade. Also, our assumption that people everywhere have a preference for freedom over tyranny leads to our methodological inclination towards a scheme that is able to evaluate, qualitatively, the merits of alternative institutional frameworks to achieve such freedom. This type of evaluation between institutional frameworks is a hallmark of Coasean and transaction cost economics, and it is quite applicable in this instance. We conclude that high levels of trade openness minimize transaction costs, and what is important is that this is incentive compatible for consumers, firms, and States over the long run.

Using the transaction cost approach, we look at three actors: consumers, firms and the State. Consumers try to maximize utility including freedom which we can see as a luxury good for which the income elasiticity of demand increases as income rises. Firms organized by definition to minimize transaction costs will have incentives to search out for new organizational forms to maximize returns. Firms may realize that they cannot compete with the straight jacket of state ownership. But state run firms are not keen to privatize or undertake meaures that will reduce their income and power. I have not seen state enterprises clamoring for privatization. Where state firms have privatized, it gives us the revealed preferences of who won and perhaps tells us why. We need a transformational government that is prepared to bite the bullet and liberalize the economy, but the state tries to preserve its own power. State will only cede power under two circumstances: when transaction costs are so high that the status quo is unsustainable, states go for reform. Also, even without a crisis, certain leaders can emerge that are true visionary leaders.

(c) *Institutions*

Implicit in the previous discussion of transaction cost minimization is an important indirect channel for learning through trade that emerges through the type of organization required to be successful in trade. Successful, sustainable trade is impossible without built-in incentives of private profit. State trading has proven not to be incentive compatible, and in a world of increasing competition cannot survive without continuous intervention. Thus, in India until recently, state trading enterprises were given monopoly to import goods they produced (called "import channeling"), thereby stifling competition and perpetuating high cost production. In the case of Sri Lanka, state trading companies once practiced content protection. To buy one type of imported door lock, one had to buy another domestically produced door lock![27]

In addition to accelerating the transition between state trading and free trading, the reduction of barriers to trade also has a more widespread impact on the institutional framework between trading partners. Namely, trade openness improves the adaptive efficiency of a domestic economy, which speaks to the ability to learn and benefit from new ideas and demands from the external environment. Restricted trade severely undermines an economy's adaptive efficiency, which is possibly why revisionists have been lured into citing adverse terms of trade as one factor for the failure of trade liberalization to generate larger export receipts. In reality, adverse terms of trade were not the root cause of trading failures, but were symptomatic of the protectionist developing countries' inability to adapt their production structure as commodity prices fell, as was the case in Latin America. Conversely, the East Asian countries' success in exports was at least partly due to the fact that it was conducted by private agents responding to market

[27] The other extreme example from Sri Lanka is that the State Hardware Corporation sent mechanics to check whether a the customer really needed a clutch when he wanted to buy one from the corporation. Never mind that the customer was prepared to pay hard cash for it.

signals, rather than deliberate effort led by the bureaucracy through industrial policy and picking winners. In fact, the East Asian experience is best described as winners picking support from the Government, even though in many cases this support was not necessary. And where the "support" was provided by interventions in the financial market, it contributed to the East Asian financial crises.

Another indirect effect of trade on democratic reform relates to the institutional effects of the improved income distribution in developing countries that follows from trade liberalization, since the allocation of resources based on comparative advantage favors labor which is the abundant factor in most developing countries. Increased resources and widening of the selectorate can and has been used to raise levels of education, which has a feedback on prosperity by raising the level of human capital, and on freedom, by improving the adaptive efficiency and dynamism of a country.

Finally, trade is an efficient conduit to diffuse knowledge that is generated in the more advanced countries due to the reason that global production processes are organized like a single firm. This induces the creation of closely knit organizations across borders. In particular, developing countries can and do benefit from participating in the organizational changes that lead to more efficient use of knowledge than ever before and the advances in communications and information technology makes these channels more important than ever before. For example, the Sri Lankan experience of export-oriented FDI inflows following its 1977 liberalization episode led to a dramatic increase in light manufacturing goods more as a result of the international production location decisions of foreign firms, which are governed by the availability of required inputs such as labor and are not due to domestic incentive structures.[28] Nevertheless, as of yet, the changes in organizations and institutions that the interaction among global firms bring about may not be related to R&D as usually conceptualized or measured (Pack 1994).

It does not follow that a certain level of income must be reached that automatically brings about freedom. Saudi Arabia and India were cited below in this vein. India's case has been described as "the only complete, highly differentiated civilization which throughout history has maintained its cultural identity without being tied to a political framework" (Eisendstadt (1968) quoted by Lipset (1994)). Saudi Arabia's case is exceptional, given its power structure, culture, its single commodity based economy, lack of education among the female population and the very narrow selectorate. By one definition it has free trade because it exchanges oil exports for a host of imports that are non-competing with its meager domestic non-oil production structure.

Finally, the wave of democracy that is sweeping through the world cannot leave even the most non-free governments unaffected. The tremendous increase in informal, people to people communications through the Internet and trade links cannot but spillover to domestic institutions, politics and provide a strong demonstration effect that

[28] For a thorough account of the role of FDI in Sri Lanka's post liberalization export-oriented economic success, see Athukorala and Rajapatirana (2000). The Sri Lankan example is even more important to note here because the 1977 market-oriented reforms occurred in light of a longstanding civil war, which speaks to the robustness of such reforms, which can succeed despite political risk and policy uncertainty which discourages investment.

freedom and prosperity can be both be had at the same time.[29] But the process will differ according the particular economic , cultural, social , political and historical contours.

8. Conclusions

The paper explored the ways in which the movement towards free trade and freedom in the last few decades could be related and the channels through which the relationship holds. We found that such channels exist in an incentive compatible framework. There is a direct channel that links free trade to prosperity, and prosperity leads to freedom. There is also an indirect channel between free trade and freedom that operates due to the nature of free trade as a conduit for information about the state of economic well being among trading partners. Trade is a conveyor belt that influences political, institutional and organizational characteristics among the trading partners due to the role of information, transaction costs, and institutions in free trade.

The process of transformation from restricted trade to free trade and from less free to more free political states will differ according the particular economic, cultural, social political and historical contours of the country in question. What can be surely said is that the third wave shows no sign of abatement. It may not always be smooth. But a change in direction is simply unthinkable. As time passes, more countries will move towards free trade and more are bound to seek more freedom. We could then well observe stronger links between free trade and freedom.

[29] Jadish Bhagwati once quipped that-“ The PC (personal computer) killed the CP (the communist party)!

Econometric Framework:

To account for the possible endogeneity between democracy and trade, we employ the gravity model of trade as developed by Frankel and Romer (1999) and Rose (2003), constructing an instrumental variable for trade openness to control for bilateral trade flows that result from mere geographic reasons or colonial legacy among other factors. We use panel data for 32 countries between 1970 and 2000. The general specification for the model is the following:

$$\ln(X_{ijt}) = \beta_0 + \beta_1 \ln D_{ij} + \beta_2 \ln(Y_i Y_j)_t + \beta_3 \ln(Y_i Y_j/Pop_i Pop_j)_t + \beta_4 Cont_{ij} + \beta_5 Landl_{ij} +$$
$$\beta_6 Island_{ij} + \beta_7 \ln(Area_i Area_j) + \beta 8 ComCol_{ij} + \varepsilon ij$$

Where i and j indicate trading partners, t indicates time, and the variables are the following:

X_{ijt} = Openness, which is exports plus imports over PPP-adjusted GDP
D_{ij} = Bilateral distance between country i and country j
$Y_i Y_j$ = Product of country i and country j's PPP-adjusted GDPs
$Y_i Y_j/Pop_i Pop_j$ = Product of PPP-adjusted GDP's divided by product of populations
$Cont_{ij}$ = Dummy variable for contiguity equal to one if there is a shared border
$Landl_{ij}$ = Dummy variable equal to one if at least one of the two countries is landlocked.
$Island_{ij}$ = Dummy variable equal to one if at least one of the countries is an island.
$Area_i Area_j$ = Product of the land areas of country i and country j.
$ComCol_{ij}$ = Dummy variable equal to one if country i and j share the same colonial legacy.
εij = Country pair specific error term

Once we construct an instrument for bilateral trade between two given countries, we will be able to predict the openness of a country even if we are given only right side geographic variables (plus colonial legacy as do Córdova et al). We need to expect that the predicted trade openness from our geographic data is uncorrelatied with the residuals from the regression and therefore only incorporates the geographic determinants of trade (see below for my comments on this condition). Once we have an IV for trade openness, we should regress actual openness onto predicted openness, to verify that geography accounts for about ½ of trade, which is what most of the other studies have found. If so, then we then carry out the probit estimates of the effect of trade openness on the freedom house index for 6 five year average periods, as follows:

$$Pr(FHI_t > FHI_{t-k}) = \beta_0 + \beta_1 \ln(X_{ijt}) + \beta_2 \ln(Y_iY_j/Pop_iPop_j)_t + \beta 4 Landl_{ij} + \beta_5 FHI_{t-k} + \beta_6 BCM + \varepsilon ij$$

Where k is the number of lags, t is the period in question. FHI is the freedom house index, and BCM = a binary control matrix, with a variety of control variables to capture the regional effects on democracy (Latin America, East Asia, etc.)

This step of the econometrics will be performed on both the IV for trade openness and the actual measure of trade openness. It will be performed in a pooled data model, a fixed effects model, a random effects model, and a GMM model.

Econometrics: Difficulties and Possible Solutions

The main difficulty lies in the inclusion of the colonial legacy variable in building our instrument, because colonial legacy is highly likely to be correlated to other determinants of democracy besides geography. For example, the democratic ideology left behind by British would be an extra-geographic determinant of democracy, which would render our IV of trade openness somewhat invalid (it would be correlated with a determinant of democracy this is not trade openness). My recommendation is to exclude colonial legacy from our instrumental variable construction, and to instead merely include the colonial legacy as a control binary variable in the regression of freedom house index onto trade openness.

I tried to employ both an OLS univariate specification of the effect of trade openness on the FHI scores, and lagged the trade openness data by as much as three years. However, the basic correlation between FHI and trade openness is just not statistically significant.

In the excel table below I put the correlation between trade openness and FHI for our 32 countries. Unfortunately, the linear relationship is not very close to holding… This renders the instrumental variable approach unnecessary for right now. I have highlighted the countries for which there is a high negative correlation between FHI and trade openness. None of the univariate OLS attempts yielded a significant relationship.

Country	corr in t	corr in t-1	corr in t-2	corr in t-3
ARG	0.268	0.304	0.287	0.192
BOL	-0.735	-0.823	-0.707	-0.634
BRA	0.020	0.134	0.158	0.142
CHL	0.074	0.115	0.248	0.467
COL	-0.736	-0.736	-0.717	-0.678
CRI	-0.745	-0.714	-0.675	-0.624
ECU	-0.056	0.014	0.196	0.238
EGY	0.300	0.297	0.344	0.281
ETH	0.485	0.380	0.218	0.088
IDN	0.427	0.392	0.296	0.018
IND	-0.230	-0.198	-0.121	-0.050
KEN	-0.033	-0.014	0.096	0.199
KHM	na	na	na	na
KOR	0.126	0.147	0.217	0.190
LKA	-0.234	-0.305	-0.295	-0.284
MAR	-0.147	0.015	0.290	0.562
MDG	0.670	0.641	0.630	0.567
MEX	0.506	0.514	0.469	0.464
MYS	-0.870	-0.858	-0.846	-0.852
NGA	-0.207	-0.204	-0.198	-0.170
NPL	0.600	0.605	0.622	0.615
PAK	0.143	0.027	-0.060	-0.021
PHL	0.651	0.621	0.600	0.588
SGP	0.510	0.542	0.507	0.405
THA	0.526	0.524	0.470	0.441
TUR	-0.616	-0.479	-0.391	-0.360
TWN	-0.123	-0.039	0.081	0.082
TZA	0.511	0.614	0.693	0.756
URY	0.451	0.521	0.574	0.651
VEN	-0.039	-0.119	-0.314	-0.374
VNM	na	na	na	na
YEM	na	na	na	na
AVERAGES	0.052	0.066	0.092	0.100

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