Review of Dani Rodrik's One Economics, Many Recipes (Princeton University Press, 2007)

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"The central economic paradox of our time is that 'development economics' is working while 'development policy' is not. On the one hand, the last quarter century has witnessed a tremendous and historically unprecedented improvement in the material conditions of hundreds of millions of people living in some of the poorest parts of the world. On the other hand, development policy as it is commonly understood and advocated by influential multilateral organizations, aid agencies, Northern academics, and Northern-trained technocrats has largely failed to live up to its promise." (p. 85). Thus begins one of the chapters of Dani Rodrik's new book, *One Economics, Many Recipes*. In exploring this paradox, Rodrik lays out a broad critique of prevailing approaches to development policy, offers fresh ideas for countries seeking to improve their economic performance, and argues for important reforms in the World Trade Organization (WTO) to make room for those ideas. The book is actually a collection of Rodrik's recent papers on growth, institutions, and globalization, but they constitute a remarkably coherent view of the development problem.

A unifying theme of the book is that "government has a positive role to play in stimulating economic development beyond enabling markets to function well… In the words of public policy, lots of $100 bills are left lying on the sidewalk. The role of

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economists is to point those out, while that of political leaders is to engineer the bargains that will allow them to be picked up." (p. 4). According to Rodrik, $100 bills are prevalent in stagnant countries, where a "limited range of (often unconventional) reforms" (p. 6) can kick-start economic growth, as in the recent experience of China, India, and Vietnam. Because of market failures (i.e., informational spillovers and coordination failures) that are inseparable from the process of structural transformation associated with economic development, these reforms entail more than getting the State out of the way or securing property rights; what is needed are proactive public strategies to kick-start growth and to maintain productive dynamism over time.

Rodrik insists that although there is a single economics, there is no single recipe for economic development. What are needed are "growth diagnostics" to identify each economy's "binding constraints" to growth. The methodology proposed entails going down a decision tree in which the analyst can identify major problems – inadequate social returns, low appropriability, or poor access to finance – and then move down the relevant branch to discover concrete constraints that are amenable to policy. Policy should attack these constraints rather than blindly follow a prepackaged list of reforms advocated for all countries (i.e., the Washington Consensus). Rodrik goes even further by arguing that even if two countries share a common binding constraint (e.g., limited access to credit for agents with good investment opportunities), differences in the countries' other distortions, political constraints, and informal institutions imply the need for different solutions.

The last chapters of the book are devoted to globalization, a topic on which Rodrik has taken a somewhat contrarian position. Indeed, while most economists seem to

think that eliminating restrictions on trade and foreign investment will by itself bring large gains, Rodrik argues that developing countries may sometimes want to pursue import protection or seek integration with the rest of the world through more heterodox policies such as export subsidies and export-processing zones. He argues that the deepening of economic integration that has been implemented over the last decades may damage poor countries by shrinking the "policy space" they need to follow these policies. Instead of continuing along this path, a development friendly WTO should strive for a "better mix of enhanced market access and maneuvering room to pursue appropriate development strategies." (p. 215). This flexibility should also be extended to rich countries: to deal with "divergence in national norms and preferences and for dealing with uncertainty and changing circumstances." (p. 205). Rodrik proposes an expansion of the Agreement on Safeguards in the WTO to allow for "escape clause" action "under a broader range of circumstances and in areas going beyond trade." (p. 215).

The different points made in the book form an enlightening perspective on development and globalization. This is the product of many years of serious, creative, and very influential academic research as well as on-the-ground experience advising multilateral institutions and governments throughout the world. The book presents the research at a simple and intuitive level, illustrating the arguments with recent development experiences. Together with clear and eloquent prose, the result is very compelling.

The call for an industrial policy will certainly raise many eyebrows, but this is much less controversial today than it was in the 1990s, thanks in no small part to Rodrik's work. Here the reader would have benefited from some discussion of the

evidence about the importance of information and coordination spillovers, which form the basis of Rodrik's view of industrial policy. Instead of dwelling on this, however, I turn my attention to two other issues that are likely to stir up some debate: the concept of growth diagnostics, and the proposals for making the WTO more flexible.

Development practitioners are likely to feel ambivalent regarding growth diagnostics. On the one hand, the presentation of this idea as a radical departure from a prevailing attitude of dispensing the same medicine to all developing countries will come as a surprise to most economists at multilateral institutions. In fact, the main task of these economists is precisely to identify the problems affecting particular countries and to propose specific solutions. On the other hand, by opening up this issue to formal analysis and debate, the proposal of a more disciplined framework for conducting diagnostics is already having an enormous impact and will continue to do so as the methodology is improved.

The traditional approach to growth diagnostics is to measure a country's performance in a series of key areas (e.g., credit, infrastructure, taxes) and compare them against a set of similar but more successful countries. To focus attention on variables that are indeed important for growth, there is usually some implicit or explicit appeal to cross-country growth regressions. There are serious shortcomings with this approach, both because of the well-known econometric problems affecting cross-section regressions and because of the implicit assumption of a common underlying structure across countries. Another popular approach is to rely on surveys of businesspeople to identify whether a country is performing relatively poorly in certain areas. The problem is that these surveys contain hundreds of questions, and there is no attempt to identify those areas that

businessmen see as the most serious impediments to growth. Moreover, as Ricardo Hausmann has said, “the fish can swim, but it doesn’t know it is in the water” – businessmen do not necessarily know why productivity is low; they just know how to deal with it.

To identify a country’s “binding constraints,” the methodology laid out in the book (from a collaboration with Ricardo Hausmann and Andres Velasco[2]) proposes looking at shadow prices and peculiar behaviors on the part of economic agents. If a country suffers from lack of credit, then interest rates should be high; if there is scarcity of human capital, then the skill premium should be high; if taxes are high, informality should be rampant. This makes a lot of sense but becomes very challenging in practice. One problem is that there are inputs for which the absence of markets makes it unfeasible to think of shadow prices (e.g., regulation, infrastructure). In fact, studies that have been conducted recently following the “Growth Diagnostics” methodology often end up considering quantitative measures and surveys of businessmen, precisely what the methodology was hoping to avoid. There are other reasons why binding constraints may not be reflected in high shadow prices. For example, if lack of credit is due to weak enforcement of credit contracts, interest rates may actually be low in equilibrium (see Aiyagari, 1994). Another problem arises because of complementarities. As an example, consider human capital and technology adoption. Barriers to the adoption of skill-intensive technologies reduce the return to schooling, and scarcity of human capital depresses the profitability of technology adoption. Improving conditions along one dimension may yield small benefits; large gains would only result from simultaneous

[2] Hausmann, Rodrik and Velasco (2005).

reforms (see Jones, 2008, and Rodríguez, 2006).[3] This does not mean that the Growth Diagnostics methodology is useless; on the contrary, by making these problems explicit, it suggests areas where research is urgently needed. In fact, this is already happening as the methodology is implemented in different countries (IADB, 2008).

The second issue deserving some discussion is about the role of trade in development and the associated proposals to make the WTO more flexible. One of Rodrik's major contributions over the last years has been to reveal many weaknesses in the empirical literature that purportedly established a large causal effect of trade on growth. He has also criticized the way in which the benefits of trade liberalization have often been exaggerated in policy circles. Of course, this skepticism regarding the role of trade in development does not mean that he favors protection as a general prescription for poor countries. In fact, he writes that "there is scant evidence from the last 50 years that inward-looking economies experience systematically faster economic growth than open ones." (p. 221). But he does seem to think that sometimes protection can play a positive role. For example, in the first chapter he argues that "a traditional import substituting industrialization (ISI) model was quite effective in stimulating growth in a large number of developing countries (e.g., Brazil, Mexico, Turkey)." (p. 50). This statement would not survive the kind of critique that Rodrik has lobbed at those arguing for trade liberalization as a key reform for developing countries. It is clearly true that many countries at different times experienced fast growth while applying ISI, but is that evidence for success of ISI?

[3] Another problem with the methodology is that if the tests for this or that particular constraint are rejected (i.e., the cost of finance is not high, implicit and explicit taxes are moderate, and there are no reasons for why social returns to investment would be low) then the conclusion will be that the binding constraint is associated with market failures, either information or coordination externalities. But it is hard to verify whether such externalities are indeed binding constraints.

What is the counterfactual? Where is the evidence for the mechanisms that supposedly would be behind ISI's success? Should not we require the same kind of rigorous evidence for this as we do for the link between trade liberalization and growth? There is even reasonable and well researched skepticism about the importance of import substitution and other forms of industrial policy (e.g., easy credit and export subsidies targeted at certain industries) in East-Asian countries.[4] The view that high tariffs were important for the onset of industrialization in today's rich countries has also been questioned by careful research (Irwin, 2002).

The passage quoted above about a positive role of protection in some instances is consistent with other points made in the book. Already in the Introduction we read that "a desirable trade regime would be one that provided much greater policy space to developing countries to pursue domestically crafted growth strategies, possibly including 'unorthodox' policies such as export subsidies, trade protection, weak patent rules, and investment performance requirements." (p. 9). And part C of the book advocates making the WTO more development friendly, particularly by providing increased flexibility for developing countries to institute more interventionist trade regimes. This proposal is somewhat surprising in light of the arguments laid out earlier in the book, where Rodrik advocates an industrial policy that eschews protection, leading him to conclude that "what constrains sensible industrial policy today is largely the willingness to adopt it, not the ability to do so." (p. 122).

There are, of course, conditions under which protection can boost growth and welfare in developing countries. For example, according to the standard argument for ISI, if an industry exhibits economies of scale that are external to the firm but internal to the

[4] See Beason and Weinstein (1996), Lee (1996), and Noland and Pack (2003).

country (Marshallian externalities), then temporary protection may allow the country to move to an "industrialized" equilibrium with a higher wage. But the conditions that are needed for this are very stringent (Rodríguez-Clare, 2007). In particular, the industry needs to be viable without protection once the Marshallian externalities have been fully exploited. This makes it hard to justify tariffs for advanced industries in poor countries. Moreover, Marshallian externalities are not an intrinsic characteristic of an industry: the same industry may benefit from such externalities in one location but not in another. In particular, protection may fail to boost industry productivity in certain countries because of the absence of some complementary inputs, infrastructure or regulation.

Regarding export subsidies, Rodrik laments that "among existing international [WTO] disciplines, probably the most significant is the one that constrains the use of export subsidies." (p. 148). He acknowledges that "there is nothing in the empirical literature to suggest that exports generate the kind of positive externalities that would justify their subsidization as a general rule," but then says that "conditioning subsidies on exports has the valuable feature that it ensures the incentives are reaped by winners (i.e., those that are able to compete in international markets) rather than the losers." (p. 149). Although appealing, this argument is not entirely sound. There is no reason why subsidies should be directed at "winners" rather than "losers." Demidova and Rodríguez-Clare (2008) explore this in a model with heterogeneous firms and find that export subsidies do benefit highly productive firms, which expand and thereby increase aggregate productivity. Still, their overall effect is to decrease welfare because of a more than compensatory decline in variety available for domestic consumers. The bottom line

is that the idea that export subsidies are good because they fall on highly productive firms is only valid if one can show that such firms are the ones generating positive externalities.

The book's proposal that the WTO should be more flexible goes beyond expanding developing countries' policy space. Rodrik argues that "countries may legitimately wish to restrict trade or suspend existing WTO obligations for reasons going beyond competitive threats to their industries." (p. 230). For rich countries, those reasons include "distributional concerns or conflicts with domestic norms or social arrangements in the industrial countries." (p. 230). "Trade rules should not force Americans to consume shrimp caught in ways that most Americans find unacceptable." (p. 232). This would logically extend to goods produced by workers treated in ways that Americans find unacceptable: "advanced countries might seek temporary protection against imports originating from countries with weak enforcement of labor rights when such imports worsen working conditions at home." (p. 230). The goal would be to make the trading system more resilient and resistant to ad hoc protectionism while allowing for diversity in national institutions and standards. To reduce the risk that this would be abused, leading to widespread protectionism, any proposed social safeguard "must demonstrate broad domestic support, among all concerned parties." (p. 231).

Ideally, broad domestic support for a safeguard entails the maximization of a country's social welfare while disregarding any improvement in its terms of trade (Bagwell and Staiger, 2002). In reality, however, it seems difficult to organize this kind of public consultation. How do we know how consumers feel? If there is disagreement among different groups, how do we aggregate to what the country wants? Would majority voting be appropriate? Another problem with this proposal of expanded

safeguards is that it would weaken one of the benefits of international agreements, namely, allowing governments to commit to certain policies (Maggi and Rodríguez-Clare, 2007).

To avoid the dangers associated with collective action of this sort, one approach is to rely on labels or certificates so that concerned consumers can make informed private decisions. Another possibility is to agree on minimum common environmental, labor, and consumer safety standards. Countries could impose social safeguards against imports that fail to meet these standards.

Growth diagnostics and the role of trade policy in development are just two among many issues raised in the book. The argument that countries should adopt an experimental and creative approach to institutional reform, the reasoning for why industrial policy should be an important part of development strategies, and the concerns raised about the clash between globalization and democracy are all important points that deserve much attention. The book should have a deep and lasting effect on the way we think about economic development.

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