Overseas Development Institute

Briefing Paper

January 2007

14

Policy space: Are WTO rules preventing development?

Do WTO rules restrict developing country 'policy space', limiting their development policies?

Key points

- Developing countries need 'policy space' to use policy to promote development, but international rules limit it.
- The principal areas where trade agreements do or may restrict countries are tariffs, TRIPs, and investment.
- The evidence is that while some 'space' has been closed, much remains, and space can cause problems as well as create opportunities.

Overseas Development Institute

ODI is the UK's leading independent think tank on international development and humanitarian issues.

Some NGOs and international observers worry that developing countries are losing 'policy space' because of new constraints from international rules which will prevent them from following the most effective development policies. If the policy instruments which made the East Asian countries and China successful (and perhaps the industrialised countries before them) are no longer permitted, are we 'kicking away the ladder' that we and others used to develop?

Concern about policy space emerged in negotiations about new obligations under the World Trade Organization (WTO), and an UNCTAD report in 2006 suggested that the risks were serious. This Briefing Paper* examines the evidence on existing and proposed new rules in relation to current developing country policies. There is no way to quantify some observers' concerns of restrictions to potential future policies that a developing country does not apply at present but might want to introduce in future.

'Space' for development

The term 'policy space' in its current meaning appeared in about 2002 in UNCTAD documents, and acquired its first official status in the São Paulo Consensus of 2004. This defined it as **'the scope for domestic policies, especially in the areas of trade, investment and industrial development' which might be 'framed by international disciplines, commitments and global market considerations'**. Perceived extensions to international rules and controls in the 1980s and 1990s included the new rules in the WTO: those on services; the new provisions on patents and copyright, under Trade Related Intellectual Property (TRIPS); and also the strengthened enforcement mechanism. But some of the most significant threats were seen in proposals for a Multilateral Agreement on Investment, the environmental conventions, bilateral and regional agreements, and, particularly for indebted developing countries, the increased financial power of the World Bank and IMF.

Trade rules allow room for manoeuvre.

All participants in the debate would agree that the issue is one of balance. International agreements on rules necessarily restrict states' freedom to manoeuvre – that is their intention. Countries choose between the advantages of constraints to other countries' policy freedom and the disadvantages of constraints on their own. The founding of GATT reflected a choice in favour of more limits: a view that there had been too much policy space for countries to take trade measures against others, as exemplified in the tariff wars of the 1930s.

The current debate asks if this move has gone

Box 1: Policy space for and from what?

Policy space is sought for both broad economic strategy and specific policies. UNCTAD documents consistently emphasise economic development, often specifically the type of policies followed by the East Asian countries, especially promoting industry and technology. Some countries have echoed this in their positions in the WTO. Others see it more as a general freedom from external constraints: the G77 gave the purpose of policy space as 'to enable national development strategies to be comprehensively nationally owned'.

The constraints directly relevant to the WTO from which freedom is sought are primarily legal ones, both those stemming from WTO commitments and those interacting with them, such as regional or financial agreements. But almost all discussion of policy space agrees with the UNCTAD São Paulo statement in including external, and sometimes internal, economic constraints. When specified, these include indebtedness, the ways in which markets work, for example in commodities, and the reactions of investors.

Regulatory and economic constraints can interact. If, for example, a country is too poor or too institutionally weak to have a policy of encouraging particular sectors through domestic subsidies or industrial policy, which are unconstrained, it may need to use tariff policy, so limits on this, which would not affect a country with other options, may constrain precisely those policies open to it.

too far. Some discussion of policy space in the development context also takes the view that developed countries are imposing their policies on all countries and that these limit the choices of developing countries. One strand argues that developed countries should accept more, and developing countries fewer, restrictions to their policy freedom.

It is clear that several elements of policy space have changed and that there is unlikely to be a single answer to the questions 'has it changed?' or 'is it too small?' A key argument advanced for more space is that because some developed and advanced developing countries used particular policies, including high and selective tariffs, these policies are necessary for development (see box 1). Before accepting this argument, however, it is necessary to demonstrate how these policies contributed to development, and whether this path will be the same for today's developing countries in today's economic conditions. Other analysts suggest that these policies were only a part of industrial strategies which relied strongly on domestic measures, that technology has changed development processes, and/or that different countries require different strategies.

The principal argument for allowing developing countries more policy space than others is that they are more likely to need to take the policies which may be constrained. This is clearest where specific policies are mentioned, in particular those to implement an industrial strategy. The Small and Vulnerable Economies, for example, have argued that their characteristics give them a particularly strong need to use subsidies. There is also the possibility that developing countries are more likely to want to change their policies in the future. This would support the case for more general policy freedom. The recent changes of government in some Latin American countries are a current example.

Policy space in the current WTO negotiations

As an expression, 'policy space' was most often used in the Doha context around 2003–4, when UNCTAD first discussed it. In the WTO 2003 Ministerial Conference there were references in speeches by, among others, Zambia, Solomon Islands, Guyana, Dominica, Jamaica, Lao, and Mauritius. In contrast, there were very few mentions at the Hong Kong Ministerial Conference in 2005. This was partly because the WTO negotiations had by then moved on to specific rules and constraints, so that general positions and objections were less relevant. It was also because a primary focus of concern – the 'Singapore issues' – were no longer at issue in WTO negotiations (although they are still proposed in regional agreements). They proposed an expansion of the WTO to cover new areas such as government spending, competition policy, and (most feared) investment, and were seen as particular threats to policy space.

A third reason is that the major arguments in the Doha Round have been about 'traditional' WTO subjects: tariffs, agricultural subsidies, etc., not about the introduction of new forms of agreement. Therefore, in contrast to the Uruguay Round, which brought new areas like services and intellectual property into the WTO, there is little encroachment on new 'policy spaces' in the original sense of the term. Moreover, some of the conflicts evident in Hong Kong are among developing countries and therefore cannot be interpreted as developed countries' attempts to restrict the space of developing ones (see box 2).

Policy space in relation to specific Doha commitments could be an issue in six areas: tariffs, agricultural policy, services, TRIPs, investment and Aid for Trade. For the first two, the arguments are clearly about the choice between constraints and policy space. For the rest, controlling damage to others is one major driver, but there is also a fear in some countries that developed members of the WTO are trying to impose what they consider to be good internal policies on all members, i.e. a conflict over the right level at which to design rules and policies.

Tariffs

Arguably, the single largest loss of policy space takes place when each country joins GATT or the WTO: it is the loss of freedom to vary a major domestic tax. Import tariffs can be an important policy instrument if countries want to follow an industrial development policy, and both Asian and Latin American

Box 2: Policy space and trade between developing countries

It is sometimes argued that developing countries, especially the small or poor, should have more freedom from international rules because the effects of their actions are less likely to be large enough to damage other countries. If, however, an action is sufficiently large relative to a country's own economy to be an effective tool of industrial policy, it may be large relative to a sector in one of its trading partners, especially if the partner is also small. Most WTO prohibitions are enforced by challenges by another country which needs to prove damage from the action complained of, so there is already a de facto exemption for any action which genuinely does not affect any other country.

countries used selectively high tariffs to encourage specific industries. But the moves by most developing countries, outside WTO agreements, to reduce their tariffs below what the WTO permits ('applied' tariffs are often half the level of 'bound' tariffs) and to flatten their tariff structures, as well as their policy statements, suggest that most do not want to use tariffs for this at present. The major 'loss' of potential policy space has thus already happened. There does not appear to be a current actual constraint. And there is no current threat to tariffs for most countries, even if the Doha Round of negotiations revives. Most countries did not need to make significant cuts in the Uruguay Round, and for most commodities in most countries (India and Pakistan may be exceptions), the likely Doha formula would not require significant cuts. Most countries still have the space to use tariffs to undertake industrial policy, and would still have it after a Doha agreement.

Countries which are members of regional groups or have bilateral trading arrangements may have accepted constraints on at least some of their tariffs, so for each country the net effect of the WTO on policy space in tariffs must be calculated relative to other commitments. Financial institutions and aid agencies may also impose constraints on some countries' tariffs, but the argument that this reduces policy space is less strong, as the evidence is that conditionality is in practice weak.

Agricultural policy

The cost to the rest of the world of developed countries' use of freedom to impose their own agricultural policies has been high; this may be one reason that policy space arguments are less often used in agriculture. The specific policy for which 'space' might be wanted in agriculture is usually specified as some form of 'food security', i.e. it is not the traditional argument for policy space, that countries should have the 'space' to follow the Asian (or Japanese or German) example. Actual and likely constraints are again small.

Services

The approach adopted for services in the WTO is that countries specify what they want to include, rather than the approach used for goods which presumes that everything is included. This was explicitly supported as a way of preserving policy space by some developing countries. Since the commitments made in the Uruguay Round by both developed and developing countries simply reflected existing policies, they did not require any change and left countries free to target assistance either to encourage particular services or to use services to assist industrial development. Even critics of the WTO accept that there has so far been no reduction of policy space. There were fears that the current negotiations would adopt a different pattern of liberalisation, but this is now unlikely.

Trade Related Intellectual Property (TRIPs)

The introduction of rules on patents and copyright in the Uruguay Round was probably one of the most important sources of concern over policy space (and certainly was one of the first subjects where the words were used). It was argued not only that the new rules would impose costs on net importers of technology (this was its purpose: the aim of reducing the losses to the providers), but that the possibility of using national policy to make technology readily available would end (because the agreement would control internal laws as well as external payments). Policy space was indeed reduced: countries needed to change their rules, although the extent to which TRIPS reduced actual, as opposed to potential, space depended on the intellectual property protection already available in each country and on countries' different interests. (Some developing countries are actual or potential exporters of technology and entertainment.)

The introduction of TRIPS into the WTO may have had a more profound restrictive effect on potential policy freedom by suggesting that all economic activities were potentially subject to being brought into the WTO. Regional agreements have taken some restrictions further.

Investment

This was the third major area of concern in the Uruguay Round, with TRIPS and services, but the result did little more than confirm the restrictions agreed in 1947 on imposing trade rules on investors. It did introduce an alternative way of implementing rules on treatment of services investment. Concern remained after the Round, however, because of the attempt first to negotiate a Multilateral Agreement on Investment (MAI) in the OECD, and then to include investment in the Doha Round. But countries' positions evolved as all, including the developed countries, started to make judgements about the balance between what they wanted for their own investors and what they did not want to give to others. (Those who fear constraints on developing countries may forget that developed countries will also oppose restrictions which they find unacceptable.) The only result of the Doha Round so far is to reduce even further the application of restrictions to LDCs.

The fact that countries, including the Asian NICs, were not constrained by the restrictions in GATT which already existed in the 1970s when they were using industrial policies suggests either that the rules are not too restrictive for countries to find suitable policies or that the nature of FDI makes rules unlikely to be an insurmountable problem because they will not be consistently enforced: after all an investor (and his home government) would hesitate to start a WTO dispute action in a country in which it needs to continue to operate. As with tariffs, regional and bilateral arrangements impose additional rules, so that measuring any additional effect from the WTO has to take account of these.

Aid for Trade

If lack of external or internal resources restricts policy space then arguably the proposed new flows of aid for trade will increase it by giving governments more opportunity to encourage production for trade. If countries lack the technical ability to devise and

Box 3: The UNCTAD Trade and Development Report 2006

In spite of its headline claim that policy space has been lost, the report does not show that WTO rules have significantly restricted countries' ability to use policies on foreign investment, subsidies, and tariffs to implement industrial policy or that the changes proposed in the Doha Round would have a significant effect.

In fact, it finds that many tools of industrial policy remain open to developing countries, and that the restrictions that do exist come from regional agreements or non-trade agreements, not from the WTO. The WTO investment rules do 'not restrict the provision of incentives to attract FDI. Regional and bilateral investment agreements can be considerably more restrictive.' (p. 169)

The Report notes correctly that the Subsidies Agreement is 'a significant tightening of disciplines', but finds that development subsidies have been tacitly allowed with neither developed nor developing countries challenging them (p. 171). Although it argues, in contrast to other observers, that the remaining permitted subsidies are not sufficient to allow an East Asian strategy for industrial development, it accepts that cost is a major constraint on any developing country use of subsidies.

Even in TRIPS where, like all critics, it finds that the agreement severely restricts the traditional forms of developing country access to technology, it notes that 'regional and bilateral trade agreements with developed countries...often foreclose part of the autonomy left open to developing countries by TRIPs.' (p. 173)

In its discussion of tariffs, it tries to find a path between the welfare advantages of low uniform tariffs and the industrial policy tool of flexible and differentiated tariffs (p. 175). It argues that developed countries benefited more when they were developing from the 'additional protection of natural trade barriers in the form of transportation and information costs', as the differential between transport costs of efficient and inefficient systems may be greater than in the past. It does not answer the question of whether any developing countries would find themselves with a seriously weakened possibility of using tariffs as part of an industrial policy given the proposed exemption of LDCs and lower cuts for other developing countries in the most recent Doha Round proposals.

implement development policies, technical assistance may increase their ability to use the policy space available to them.

Space has been lost and gained

Some of the changes resulting from negotiations outside the WTO may affect the impact of rules agreed within the WTO. Some of the effects may be substantially more important than the changes as a result of the WTO. Hence the discussion on the WTO needs to be seen in its broader context.

There are many factors which affect policy space. New non-trade international obligations (Kyoto, etc.), for example, may have already reduced space for economic policy. If environmental conditions are given legal force in WTO agreements, as is being suggested in the proposals in the Doha Round for fish, or if there is a more general move towards mutual recognition among the conventions, this would intensify the effect. Regional and bilateral agreements, whether for trade or investment, have also reduced space.

Impacts on policy space come from a variety of agreements, and for a particular country the net effect of each will depend on its other obligations (for example in regional agreements) and on the other characteristics of its economy (such as its dependence on aid). Some rules may reduce potential freedom, but do not restrict current policies; it is impossible to measure their effect. Any rules or changes in them also affect the policy space of a country's trading or investing partners or competitors. This may in turn increase its own 'space' (a bound tariff or a prohibition on export subsidies affecting another country increases the returns to its own trade policy). Except for the impact of TRIPS on technology transfer to and within developing countries, there is little evidence that WTO rules are constraining countries' ability to follow developmental paths, including those followed by the newly industrialised countries (NICs).

For changes in the WTO and outside it, the effects on policy space are much less certain than the stark assertion by UNCTAD that 'the rules and commitments of the international trading regime restrict the de jure ability of developing nations to adopt national development policy (UNCTAD 2006: 167, see box 3).

Even when international agreements limit a country's ability to follow its chosen development strategy the costs (which must always be calculated) do not always outweigh the benefits. This is partly because it is the net effect of all relevant rules that is important rather than that of any one, and partly because some gains are seen to flow precisely from a limitation to policy space.

A loss of policy space is one of the arguments made for the existence of international regulations and in particular those of the WTO: they provide an international commitment ('lock in') which is more stable than domestic legislation. From that point of view, restricting policy space, or at least defining it precisely, is the objective for some countries, not a problem.

To the extent that WTO agreements move in the direction of imposing multilaterally agreed policies, rather than simply regulating the interaction of countries' national policies, the debate becomes more complicated. What is the appropriate level to make policy? And what is the right policy? TRIPs was one move towards centralised policy-making which clearly restricted policy space. But applying a 'development' objective to the WTO might be another. It would be difficult to argue both that the WTO should promote development and that preserving countries' policy space is always more important than multilateral agreements.

Written by ODI Senior Research Associate, Sheila Page (s.page@odi.org.uk).

Note and further reading

* An earlier draft of this note was supported by funding from the Inter-American Development Bank in its support for Latin American countries in international negotiations. We are grateful for the financial support and for the comments on that draft, but they are not responsible for any errors that remain or for the views expressed.

Chang, Ha-Joon (2005) 'Policy Space in Historical Perspective' Queen Elizabeth House 50th Anniversary Conference: *The Development Threats and Promises*, University of Oxford, 4-5 July, 2005.
UNCTAD (2002) *Trade and Development Report, 2002*.
UNCTAD (2003) Notes on the concept of economic policy space, internal document.
UNCTAD (2004) *São Paolo Consensus*, UNCTAD TD/410.
UNCTAD (2006) *Trade and Development Report, 2006*.
WTO (2003) Ministerial speeches at Cancún Ministerial WT/MIN(03)/ST/*.

Photo credit: http://en.wikipedia.org/

odi

Overseas Development Institute

111 Westminster Bridge Road, London SE1 7JD

Tel: +44 (0)20 7922 0300

Fax: +44 (0)20 7922 0399

Email: publications@odi.org.uk

ISSN 0140-8682