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Protecting industrial policy space in low-income countries

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Of late, it has been increasingly recognized that space for pursuing the kind of industrial policies successfully used by the East Asian newly industrialized economies has been restricted for developing countries by trade rules enforced on signatories by the World Trade Organization (WTO) and by International Monetary Fund (IMF) conditionalities.[1] This note focuses on the impact of these trends on low income countries (LICs).[2]

Here, we review this debate in relation to the concept of industrial policy (that encapsulates related policies such as those pertaining to investment and technology) and report the results of some simple empirical exercises pertaining to the closing of policy space. Specifically, we explore the gap between bound non-agricultural tariff rates (the ostensible policy space in a trade context) and actual tariff rates (the effective policy space), and the possible impact of this on the manufacturing sectors in LICs.

Since UNCTAD XI in Sao Paulo in 2004, there has been growing attention given to the problem of closing policy space. Unlike its predecessor GATT, the WTO's "single undertaking" requirement since the completion of the Uruguay Round requires all members to comply with all agreements. The agreements have severely restricted the scope for industrial policy.[3]

The Agreement on Subsidies and Countervailing Measures (SCM) prohibits a wide range of fiscal, export and credit subsidies to support domestic industrialization. Copying and reverse engineering for technology acquisition are blocked by TRIPs (Trade Related Intellectual Property Rights) and more stringent constraints in regional and bi-lateral agreements. Most LICs also have limited capacity to exercise leverage with multinational corporations to ensure the contracts serve the long run goal of autonomous domestic industrialization. Thus, options open to and followed by most high and middle-income countries have been closed to others.

Many (Rodrik 2004, Amsden 2005, UNCTAD 2006, Chang 2006) argue that there is still some room for creative industrial policy and suggest methods and policy tools for attaining it. However, the leeway is limited in practice for many LICs. Consistent with their elevated aid dependence and limited public sector capabilities, the available policy space is threatened by the powerful policy leverage of LICs through free trade agreements and investment treaties as well as international financial institutions (IFIs) when they attach policy conditionalities to grants or loans from the IMF or World Bank.

Most poor countries have high tariff bindings and that, in principle, still allows them to pursue trade policies that could encourage domestic industrialization. The SDT (Special and Differential Treatment) for LICs allows more time for compliance, though many requests for extensions have been turned down by the WTO.[4]

Gallagher (2007) notes that "more than 25 percent of total WTO cases between 1995 and 2005

[1] See Jomo (2007) on the continuing constraining impact of IMF conditionalities and for a much broader take on policy space that includes restrictions on macro, trade, financial, investment, technology, and social policy.

[2] The use of LICs (low-income countries), MICs (middle-income countries), and HICs (high-income countries) for reference to country groups has been adopted because of the neutrality of these terms. Other terms can be pejorative (less-developed), or inaccurate (developing or South), or too narrow (poor – even for culturally or otherwise rich countries). While we refer to LICs in this brief, most of the arguments are also relevant for the various sub-categories of middle income countries (low, middle or high).

[3] Also refer to Rodrik (2004: Table 3) for a detailed documentation of international agreements, including those that are WTO-related, that have restricted industrial policy.

[4] Pakistan's request for an extension for compliance with TRIPS was turned down.

dealt with dismantling policy space in developing countries"; "in all cases the final ruling upheld the demand [for dismantling policy space]". Hence, these countries have been subject to pressure to liberalize trade policy.

One way of empirically assessing if policy space has shrunk is to compare the tariff bindings under the WTO Uruguay Round with the applied tariff rates. One can infer that the larger the gap, the greater the effective shrinking of trade-related policy space.[5] Table 1 shows the gaps between the bound and applied rates by country group.

Table 1. Mean gaps between bound and applied tariff rates by commodity types and country group

Country group	*Agri-culture*	*Non-agriculture*
LICs (31)	56.49 (38.63)	25.10 (30.53)
LMICs (28)	28.03 (23.94)	15.68 (11.03)
HMICs (14)	30.36 (27.02)	15.51 (13.19)
HIC (8)	24.74 (38.27)	15.31 (32.74)

Source: WTO on line database on tariff rates.
Note: Refer to Khan (2007) for details on country classification and country sample.

LICs have the highest gaps between bound and applied tariffs, and being a LIC significantly explains the size of the gap. Further, aid is positively and significantly associated with the size of the gaps for LICs, and a review of IMF letters of intent showed that the countries in our sample have been subject to trade liberalization pressures beyond WTO commitments as part of IMF-led structural adjustments.[6] Table 2 below shows that the LICs sampled have, for the most part, experienced stagnation or a substantial decline in manufacturing activity since the completion of the Uruguay Round.[7]

Table 2. Manufacturing value added as a % of GDP for LICs

Bangladesh	15.29	16.13	Moldova	30.90	16.82
Benin	8.74	7.63	Mongolia	11.64[c]	5.15
Burkina Faso	11.95	13.53	Nepal	9.55	7.98
Burundi	10.74	8.48	Nicaragua	18.88	20.45
Cameroon	9.91	7.44	Niger	6.31	6.56[d]
Central African Rep.	10.00[a]	9.39	Nigeria	4.94	3.99[d]
Congo, Dem. Rep.	6.89[b]	5.34	Pakistan	16.78	17.56
Ghana	9.11	8.54	Rwanda	17.25	10.04
Guinea	4.18	4.08	Tanzania	7.41	7.01
Kenya	10.69	11.11	Togo	9.12	9.44
Madagascar	8.02	14.19	Uganda	6.52	9.16
Malawi	17.39	11.40	Zambia	11.24	11.91
Mali	7.72	3.37			

Source: *World Development Indicators*, World Bank
Notes: [a]1998; [b]1993; [c]1995; [d]2003

It is difficult to anticipate the impact of future trade rounds on policy space. There is much concern that the bulk of policy space was conceded by low and middle income countries in the Uruguay Round. In the Doha Round, NAMA negotiations threaten to drastically reduce tariff bindings across all product lines for developing countries[8]. As this outcome would have severe long-term consequences for the capability of LICs to undertake industrial policy in the future, low and middle income countries should seek a NAMA outcome that strongly differentiates between HICs and developing countries.

LICs are more likely than other country groupings to be recent WTO accession countries in which it is well-known that some powerful existing members have imposed severe entry conditions that they themselves do not implement (such as caps on agricultural subsidies). However, continued attempts by countries like Russia to accede to the WTO

[5] Another way of measuring the closing of trade-related policy space would be by tracking changes in gaps within one country over time. Unfortunately, the WTO was unable to respond to a request for historical data.

[6] Khan (2007) documents in an appendix table the commitments to aggressively reduce tariff and non-tariff barriers far below bound rates in IMF letters of intent. A related debate is the extent to which these commitments are voluntary.

[7] Causality is not implied here as might be inferred from cross-country regression analysis. Nonetheless, that this de-industrialization followed the post-UR shrinking of trade-related policy space for these countries is suggestive.

[8] The current proposal is to exempt LDCs from NAMA for the Doha round. Hence, they have informally supported NAMA in WTO negotiations to improve their access to other developing country markets. Meanwhile, the middle income countries are resisting NAMA, but may give in if an agricultural deal can be reached. The Swiss formula approach to NAMA was originally supported by a range of developing countries to remove tariff peaks on textiles and clothing in HICs.

suggest that the multilateral trade regime embodied by the WTO continues to be attractive, and that countries, on balance, consider the positives to outweigh the negatives. The absence of exit from the WTO suggests the same.

Thus, the real issues are protecting existing policy space and making the most of what exists within the multilateral framework. Bypassing this framework via bi-lateral accords due to the current impasse at the WTO is tempting, but given the asymmetrical power of high and low income countries, the latter concede much more policy space through such agreements than when they are engaged in collective action within a multilateral framework. Competing for relative access among low and middle income countries by acceding to bilateral treaties has resulted in a beggar-thy-neighbor race to the bottom.

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