

# Measuring the Cost of Lost Policy Space at the WTO

By Kevin P. Gallagher | March 20, 2007

This policy brief summarizes the key findings of a recent paper published in the *Journal of World Investment and Trade* that show how the shrinking of policy space is more than a theoretical concern at the World Trade Organization. Contrary to claims that nations can circumvent the WTO to promote development, new research finds that not only do many of the rules negotiated in the Uruguay Round constrict the ability of nations to put in place aggressive development policies, but these rules have been strictly enforced by WTO dispute panels. Indeed, more than 25% of all WTO cases between 1995 and 2005 dealt with dismantling policy space in developing countries. These findings imply that developing nations should exercise great caution in negotiating measures in the Doha Round that further restrict policy space, especially given the small gains projected to arise from a likely deal.

The need for developing nations to retain national policy space is grounded in both theoretical and empirical arguments. The persistence of market failures in the global economy, especially in developing countries, is cited as the theoretical justification for governments to play a supporting role in development. On the empirical level, the experience of many of the East Asian tigers such as Taiwan, South Korea, and contemporary China serves as testimony that state-facilitated development policy can be a success.

Economists have shown that liberalizing trade in one country that uses government policies to correct for market failures and another that does not correct for distortions can accentuate the distortions—both within the non-correcting country and between the two. Common market failures faced by developing countries in today's global economy are:

**Information externalities** where the private sector lacks the information about opportunities to make productive investments;

**Coordination externalities** where profitable new industries will not develop unless “upstream and downstream” industries are developed simultaneously;

**Imperfect competition** where highly concentrated sectors make entry into the industry and technological change extremely difficult; and

**Environmental externalities** where the environmental costs of production and consumption are not reflected

in prices and lead to the under or over production of certain goods and services

Table 1 displays the different policy tools used by developing countries to correct for market failures and also displays the extent to which such instruments are still permitted by the rules of the WTO. An “X” indicates that GATT/WTO rules prohibit the measure, a “\*” indicates that the measure is being considered for elimination in the Doha Round, and “o” indicates measures still permitted.

The nations that deployed such policies, mostly in East Asia, experienced per capita growth rates of 5% per year between 1980 and 2000. This experience is often contrasted with that of Latin America, a region of the world that deployed straight liberalization strategies, where growth rates during the same period were barely 1%.

In a new paper in the *Journal of World Investment and Trade* titled “The Shrinking of Development Space in the WTO: How Big is the Bite?”,<sup>2</sup> we analyze WTO case law related to these policies. The objective was to determine not only how development measures are theoretically restricted by WTO rules, but also to measure to what extent they have been enforced by binding dispute resolutions. To do this, we examined all WTO case law from 1995 to 2005, identifying cases in which the above policy instruments were subject to a panel and analyzing the outcome of the panels.



**TABLE 1: POLICY SPACE FOR DEVELOPMENT AND THE WTO**

| Policy Instrument                      | Permitted | Agreement   |
|--|-----------|-------------|
| <b>Goods trade</b>                     |           |             |
| Tariff sequencing                      | *         | GATT        |
| Tax drawbacks                          | o         |             |
| <b>Intellectual Property</b>           |           |             |
| Selective permission for patents       | X         | TRIPS       |
| Short patent timelines with exceptions | X         | TRIPS       |
| Compulsory licenses                    | o         |             |
| <b>Subsidies</b>                       |           |             |
| Export                                 | X         | SCM         |
| R&D                                    | *         | SCM         |
| Distribution                           | *         | SCM         |
| Environment                            | *         | SCM         |
| Cost of capital                        | o         |             |
| <b>FDI</b>                             |           |             |
| Local Content                          | X         | GATT, TRIMS |
| Trade Balancing                        | X         | TRIMS       |
| Joint Ventures                         | o         |             |
| Technology Transfer                    | o         |             |
| R&D                                    | o         |             |
| Employment of Local Personnel          | o         |             |
| Tax Concessions                        | o         |             |
| <b>Other</b>                           |           |             |
| Human Capital                          | o         |             |
| Administrative Guidance                | o         |             |
| Movement of People                     | *         | GATS        |
| Provision of Infrastructure            | o         |             |

Source: Gallagher, 2005<sup>1</sup>

**TABLE 2: PANEL CASES INVOLVING PROHIBITED INDUSTRIAL POLICIES 1995-2005**

| Defendant                   | Local Content Requirements    | Import Controls   | Export/production subsidies <sup>3</sup>  | Tax manipulation                                    | Weak IPR enforcement                                      |
|-----------------------------|-------------------------------|---|---|---|---|
| <b>Developing Countries</b> | 11 (Brazil, India, Indonesia) | 19 (Argentina, Brazil, India, Korea, Malaysia, Mexico, Philippines) | 3 (Brazil, Korea, Philippines,)   | 10 (Chile, Dominican Republic, Korea, Mexico, Peru) | 5 (Argentina, India, Pakistan)                            |
| <b>Industrial countries</b> | 0                             | 4 (EC)  | 18 (Australia, Belgium, Canada, EC, France, Greece, Ireland, Japan, Netherlands, US,) | 4 (Japan, EC)                                       | 10 (Canada, Denmark, EC, Greece, Japan, Portugal, Sweden) |
| <b>Total cases</b>          | 11 (3%)                       | 23 (7%)   | 21 (6%)   | 14 (4%)   | 15 (4.5%)   |

Source: WTO chronology of cases in the dispute settlement mechanism, printed in DiCaprio and Gallagher, 2007.

Two important findings emerged. First, the many cases brought before the panel indicate that policies prohibited under WTO rules have remained in practice in both developing countries and industrial countries. Second, the Dispute Settlement Mechanism (DSM) has spent a large proportion of its time adjudicating industrial policies. Cases in the DSM that deal with prohibited industrial policies make up 25% of total cases. This means that more than 25% of the 90 cases in the WTO dealt with a demand to eliminate an industrial promotion tool used by developing countries, and in all of the cases the final ruling upheld the demand. Below we present a general analysis of how these cases affected the developing countries in each category.

### Long-Term Losses for Little Gain

In many ways, this analysis should come as no surprise—WTO rules are strictly enforced. What the study underscores, however, is that once nations negotiate away certain tools that have been successfully deployed for development purposes, they will not be able to regain them. These long-term “costs” of the negotiations should be taken into consideration with costs in form of tariff revenue losses and juxtaposed against the benefits of various liberalization proposals.

Table 3 compares the projected benefits of the Doha Round with estimates of projected tariff revenue losses. The World Bank and other models of trade liberalization make the assumption that nations’ fiscal balances are fixed—in other words, any losses in tariff revenue are offset by lump-sum taxes.

In the real world, however, such taxation schemes are difficult to pass and face stiff resistance. UNCTAD has published data on projected tariff revenue losses under the Doha Round, based on a scenario of the most likely outcome of current negotiations. Table 3 shows tariff revenue losses against World Bank benefit projections for the world and selected regions and countries. In some ways, it's true that this table compares apples and oranges by juxtaposing economic welfare gains (or losses) with losses in government revenue. Nevertheless, negotiating countries want to know both the extent to which their country's private sector stands to gain and the amount of revenues that may be lost from government coffers.

The "likely" Doha benefits projected by the World Bank are exhibited in the first column. Under this scenario, which states gains projected for 2015, global gains are \$96 billion, with only \$16 billion of that going to the entire developing world. The developing country benefits amount to a mere 0.16% of GDP for that year. In per capita terms, that comes to \$3.13 or less than a penny-a-day per capita for those living in developing countries.

Although most attention in WTO negotiations has been focused on agriculture, developing country gains from "likely" agricultural reforms amount to less than 0.1% of GDP—just \$9 billion. Likely gains from northern subsidy reduction are projected at barely \$1 billion.<sup>4</sup> Gains from projected services liberalization for all developing countries are estimated to reach only an additional \$6.9 billion.<sup>5</sup>

### TABLE 3: DOHA BENEFITS VS. NAMA TARIFF LOSSES

Source: Wise and Gallagher, 2006<sup>6</sup>

As Table 3 reveals, the tariff revenue losses can be significant. Total tariff losses for developing countries under the "Non-agricultural market access" or manufactured goods part of the negotiations, could be \$63.4 billion—almost four times the benefit.<sup>7</sup>

For many developing countries, slashing tariffs not only restricts their ability to foster new industries so they may integrate into the world economy, but it also eliminates an important source of funds for industrial

promotion and social programs for the poor. Most developing countries rely on tariffs for more than one quarter of their tax revenue. For smaller nations with little diversification in their economies, tariff revenues provide the core of government budgets.

According to the South Centre, the Dominican Republic, Guinea, Madagascar, Sierra Leone, Swaziland, and Uganda all depend on tariffs for more than 40% of all tax revenue. In a recent issue of *Foreign Affairs*, Jagdish Bhagwati commented: "If poor countries that are dependent on tariff revenues for social spending risk losing those revenues by cutting tariffs, international agencies such as the World Bank should stand ready to make up the difference until their tax systems can be fixed to raise revenues in other, more appropriate, ways."<sup>8</sup> While there is indeed evidence that consumption taxes are superior forms of generating welfare, economists have shown that tariffs may be preferable in developing countries with large informal sectors that cannot be taxed efficiently.

Although the net benefits for many countries are projected to be positive (again, not figuring in tariff losses), such benefits will be the result of significant structural changes away from the development of knowledge-based assets and back toward primary commodities and low-technology manufacturing. Primary commodities have seen a temporary upswing in prices, but the long-term trends are not encouraging. According to the Food and Agriculture Organization, non-energy commodities have

|                                    | "Likely" Benefits    | NAMA Tariff Losses |
|------------------------------------|----------------------|--------------------|
|                                    | (U.S. 2001 Billions) |                    |
| <b>Developed</b>                   | 79.9                 | 38.0               |
| <b>Developing</b>                  | 16.1                 | 63.4               |
| <b>Selected developing regions</b> |                      |                    |
| Middle East and North Africa       | -0.6                 | 7.0                |
| Sub-Saharan Africa                 | 0.4                  | 1.7                |
| Latin America and the Caribbean    | 7.9                  | 10.7               |
| <b>Selected countries</b>          |                      |                    |
| Brazil                             | 3.6                  | 3.1                |
| India                              | 2.2                  | 7.9                |
| Mexico                             | -0.9                 | 0.4                |
| Bangladesh                         | -0.1                 | 0.04               |

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declined in price by 30% between 1980 and 2005, and will likely to continue to decline. What's more, the terms of trade (the average prices of agricultural commodities sold by developing countries relative to the price of manufactured goods purchased from developed countries) have fallen by close to 70% during the period 1961 to 2001.<sup>9</sup>

When commodity prices go down again, there may not be much industry left to pick up the slack in some developing countries. In countries like Brazil and Argentina, economists predict that almost all employment gain will be in agriculture or in apparel. The structural changes caused by liberalization will hurt manufacturing industries such as machinery, non-ferrous metals, electronics, and motor vehicles. This translates into job losses in cities and expansion sectors with less potential for job growth in the countryside.

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**By the World Bank's own estimates, a person in a developing country would gain less than a penny a day in benefits from Doha-round trade liberalization measures projected for 2015.**

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In Asia there will be a movement of people out of higher technology manufacturing and into apparel jobs. Both adjustments underscore the slide in wages and level of technological sophistication that will occur under a liberalization scenario that does not devote significant attention to paying adjustment costs.

## **A Way Forward**

There had been a sense of urgency to complete the Doha Round talks in 2006, before the U.S. Trade Promotion Authority (TPA) expires on June 30. The U.S. Constitution grants decision-making powers on international commerce to Congress, but the TPA—also called “fast track”—allows the President to negotiate trade deals and

submit them to Congress for an up or down vote. Over the past decade, TPA, and trade deals themselves have faced contentious battles in Congress, and when passed have passed by a mere handful of votes—in the case of the Central American Free Trade Agreement vote last year, by a single vote.

The outcome of the 2006 U.S. congressional elections put the Democrats in the majority and made it unlikely that TPA will be renewed in 2007 unless major agreements are reached to compensate workers in the United States who lose their jobs to trade, and on labor and environmental conditions in developing countries. The larger question of facilitating more equitable development for poor countries will also need to be given at least some lip service. In addition to concerns over the Iraq War, constituents elected Democrats based on concerns about the perceived threat recent trade deals pose to U.S. workers and the environment. If TPA fails to pass in 2007, it has an even slimmer chance in 2008—a presidential election year.

A two-year break is not necessarily a bad thing. Developed countries should rethink the full impacts of their current negotiating positions. At the moment the benefits will be concentrated among just a handful of industries but the costs are dissipated across the nation as a whole. Developing nations need to carefully rethink the structure of current trade negotiations and how to put them back on track, with development as their cornerstone.

The following five reforms are critical for a more development-oriented trade regime:

- 1) Honor existing agreements. For example, the United States and Europe should agree to honor WTO rulings that have deemed their subsidies for cotton and sugar to be in violation of existing trade rules that forbid exporting products at prices lower than what it cost to make them. This would give a real boost to farmers in West Africa and Latin America and send a strong signal to developing countries that developed nations are willing to honor the rules of the WTO. Developed nations have not yet complied with these rulings and in the case of cotton, Brazil has begun to explore compensatory measures. Further cases are on the horizon, with Canada, Brazil, and other nations considering filing a claim against U.S. corn subsidies.
- 2) Western nations should take seriously the proposal by many African nations to regulate global businesses

that demand unfair prices for resources used in farm production and reap billions in profits on the sale of final products. African nations made numerous proposals during the round to this end, specifically to make room for international supply-management schemes to raise prices and to curb the oligopolistic behavior of large foreign commodity firms, but were ignored by the developed nations.<sup>10</sup>

- 3) Negotiators should recognize the long-standing WTO principle of “special and differentiated treatment” for poorer nations. Developed nations should roll back patent laws that impede poorer nations from manufacturing cheaper generic drugs, and they should allow poorer countries to exempt staples of their local economy such as corn, rice, and wheat from deregulation.
4. International institutions such as the IMF and World Bank should step in and help developing nations cover the costs of adjustment for measures already agreed on, such as tariff losses and job retraining, until the proper policies can be put in place on the ground. The IMF’s Trade Integration Mechanism exists for such a task but is not ambitious enough and should not come with additional conditionality. The IMF plan also leaves little room for incorporating costs of adjustment and the Fund is often criticized for tying funds to even further reforms.

Developed countries have a right and obligation to compensate their “losers” as well, and will need international support to do so.

- 5) There should be a moratorium on regional and bilateral trade deals. These deals exploit the asymmetric nature of bargaining power between developed and developing nations, divert trade away from nations with true comparative advantage, and curtail the ability of developing countries to deploy effective policies for development.

Helping the world’s poor is not just about charity—it can lead to mutual benefit. In 2005, more than half of U.S. exports went to nations outside Canada, Japan, and Europe. The more developing countries grow, the more markets the developed world will have for its products. The less they grow, the less the developed world grows.

## END NOTES

- <sup>1</sup> Kevin P. Gallagher, (2005), *Putting Development First: The Importance of Policy Space in the WTO and IFIs* (London: Zed).
- <sup>2</sup> Alisa Dicaprio and Kevin P. Gallagher (2006), “The Shrinking of Development Space: How Big is the Bite?” *Journal of World Investment and Trade*, October, v7, n5.
- <sup>3</sup> Non-agriculture only
- <sup>4</sup> All projections of the benefits of the Doha Round in this paper are from the following: Kym Anderson and William Martin et al. (eds) (2005a), *Agriculture Trade Reform and the Doha Development Agenda*, Washington, DC: World Bank; and K. Anderson, W. J. Martin, and D. van der Mensbrugghe (2005b), Global impacts of the Doha Scenarios on poverty; *Putting Development Back into the Doha Agenda: Poverty Impacts of a WTO Agreement*, T. W. Hertel and L. A. Winters, Washington, DC, the World Bank: Chapter 17. For a critical review of these estimates see Frank Ackerman (2005), “The Shrinking Gains From Trade: A Critical Assessment of the Doha Projections,” Global Development and Environment Institute Working Paper 05-06, Tufts University, Medford, MA. New research by the Carnegie Endowment for International Peace using similar modeling exercises puts the potential gains to developing countries at \$21.5 billion. See Sandra Polaski (2006), *Winners and Losers: Impact of the Doha Round on Developing Countries*, Washington: Carnegie Endowment for International Peace.
- <sup>5</sup> Estimates of services benefits can be found at J. Francois, H. van Meijl, and F. van Tongeren (2003), Trade Liberalization and Developing Countries Under the Doha Round, Tinbergen Institute Discussion Paper 2003-060/2, Rotterdam and Amsterdam, Tinbergen Institute.
- <sup>6</sup> Timothy Wise and Kevin P. Gallagher (2006), Doha Round and Developing Countries: Will the Doha deal do more harm than good? RIS Policy Brief No. 22, April 2006.
- <sup>7</sup> “Likely” benefits from Anderson (2005) cited above. Tariff losses from De Cordoba, Santiago Fernandez, and David Vanzetti (2005), Now What? Searching for a Solution in WTO Industrial Tariff Negotiations, *Coping with Trade Reforms*, (Pgrave-MacMillian).
- <sup>8</sup> See Jagdish Bhagwati (2005), “From Seattle to Hong Kong,” *Foreign Affairs*, December.
- <sup>9</sup> FAO (2004) The State of Agricultural Commodities Markets 2004 Rome, FAO, World Bank (2006), World Development Indicators, Table 6.5: Primary Commodity Prices, available at <http://devdata.worldbank.org/wdi2006/contents/Section6.htm>.
- <sup>10</sup> Peter Gibbon (2007), “Africa, Tropical Commodity Policy and the WTO Doha Round,” *Development Policy Review*, 25(1), 43-70.

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