

# **TRADE-RELATED AGENDA, DEVELOPMENT AND EQUITY (T.R.A.D.E.)**

**WORKING PAPERS**

**25**

## **EXPANDING NATIONAL POLICY SPACE FOR DEVELOPMENT: WHY THE MULTILATERAL TRADING SYSTEM MUST CHANGE**

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## **PREFACE**

Paragraph 8 of the Sao Paulo Consensus adopted at UNCTAD XI held in Sao Paulo 13-18 June 2004, states: “The increasing interdependence of national economies in a globalizing world and the emergence of rule-based regimes for international economic relations have meant that the space for national economic policy, i.e. the scope for domestic policies, especially in the areas of trade, investment and industrial development, is now often framed by international disciplines, commitments and global market considerations. It is for each Government to evaluate the trade-off between the benefits of accepting international rules and commitments and the constraints posed by the loss of policy space. It is particularly important for developing countries, bearing in mind development goals and objectives, that all countries take into account the need for appropriate balance between national policy space and international disciplines and commitments.”

The Doha Plan of Action, adopted by the Second South Summit organized by the Group of 77, held in Doha, Qatar, 12-16 June 2005, requested UNCTAD and the South Centre to explore “through their research and analytical work ways and means to operationalize the concept of policy space in international economic relations including in all relevant international and multilateral forums”.

This brief study which focuses on the concept of “policy space for development” in relation to the multilateral trading system is an attempt to introduce some conceptual and methodological clarity into this matter. As such it should be of assistance to developing countries as they struggle to implement national policies that protect and support the development of their domestic industries and diversification of their economies, and to have these development priorities reflected in international agreements and global regimes, which are often asymmetrical and pay only lip service to development needs.

South Centre, September 2005



## TABLE OF CONTENTS

<b>EXECUTIVE SUMMARY .....</b>	<b>ix</b>
<b>I. NATIONAL POLICY SPACE: SMALL AND SHRINKING IN MANY DEVELOPING COUNTRIES.....</b>	<b>1</b>
<b>II. THE BOUNDARIES OF NATIONAL POLICY SPACE.....</b>	<b>3</b>
<b>III. MULTILATERAL AGREEMENTS AND THEIR EFFECTS ON NATIONAL POLICY SPACE .....</b>	<b>7</b>
A. International agreements on environmental and social issues .....	7
B. International trade agreements .....	9
C. The Multilateral Trading System .....	11
D. The International Financial System.....	18
<b>IV. WAYS TO BETTER UTILISE AND ENHANCE DEVELOPING COUNTRIES' POLICY SPACE .....</b>	<b>21</b>
A. Expanding endogenous policy space .....	21
B. Expanding exogenous policy space .....	22
C. Non-expansionary approaches .....	22
<b>V. POLICY SPACE GOALS FOR THE DOHA ROUND.....</b>	<b>24</b>
A. Protective policy space .....	24
B. Supportive policy space.....	25
<b>VI. CONCLUSION .....</b>	<b>27</b>
<b>REFERENCES .....</b>	<b>28</b>



## ACRONYMS

AoA	Agreement on Agriculture
ARIPO	African Regional Intellectual Property Organization
ACTRIPS	Advisory Council on Trade-Related Innovation Policies
CBD	Convention on Biological Diversity
CITES	Convention on International Trade in Endangered Species
ESM	Emergency Safeguard Measures
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
IFIs	International Financial Institutions
IGC	Intergovernmental Committee on Intellectual Property and Genetic Resources, Traditional Knowledge and Folklore
IIM	Inter-sessional Inter-governmental Meeting
INDECOPI	National Institute for the Defence of Competition and Intellectual Property
IP	Intellectual Property
IPRs	Intellectual Property Rights
LDC	Least Developed Country
MEAs	Multilateral Environmental Agreements
MTS	Multilateral Trading System
NGO	Non-Governmental Organization
OAPI	Organisation Africaine de la Propriete Intellectuelle
PCT	Patent Cooperation Treaty
S&DT	Special and Differential Treatment
SCCR	Standing Committee on Copyright and Related Rights
SCM	Agreement on Subsidies and Countervailing Measures
SCP	Standing Committee on the Law of Patents
SCT	Standing Committee on the Law of Trademarks, Industrial Designs and Geographical Indications
SDCs	Special and Differential Commitments
SMEs	Small and Medium Enterprises
SPLT	Substantive Patent Law Treaty
STOs	Specific Trade Obligations
TLT	Trademark Law Treaty
TRIMS	Agreement on Trade-Related Investment Measures
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
UPOV	International Union for the Protection of New Plant Varieties

## **Organizations**

ILO	International Labour Organization
ITU	International Telecommunications Union
FAO	United Nations Food and Agricultural Organization
OECD	Organization for Economic Cooperation and Development
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNFCCC	United Nations Framework Convention on Climate Change
UNEP	United Nations Environment Programme
UNESCO	United Nations Organization for Education, Science and Culture
WCO	World Customs Organization
WHO	World Health Organization
WIPO	World Intellectual Property Organization
WTO	World Trade Organization



## EXECUTIVE SUMMARY

With the increasing political and economic integration that accompanies globalisation, a growing number of international agreements now restrict the national ‘policy space’ of developed and developing countries alike. In order to assess the impact of international agreements on policy space, it is instructive to examine national policy space as a sub-space of the universe of policy options available to a country in an ideal world without policy constraints. From such an examination, this paper illustrates how domestic ‘endogenous’ constraints and international ‘exogenous’ constraints may significantly restrict a country’s access to national policy space for development. Sources of endogenous and exogenous constraints are reviewed, and ways that international environmental, social and economic agreements can both reduce and extend national policy space are outlined.

The paper demonstrates how developing countries’ national policy space is affected by agreements comprising the Multilateral Trading System (MTS) under the World Trade Organization (WTO). Focus is given to examining the narrowing range of policy options permissible under international trade and finance agreements, and the adverse effects this can have on countries in earlier stages of economic development. This contraction of policy space has recently been identified as a concern in international trade negotiations. In particular, agreements within the WTO contain provisions, and economic assistance arrangements of international financial institutions include conditionalities, that prohibit developing countries from implementing a range of policy interventions designed to stimulate the growth, industrial development and diversification of their national economies. These effects are reviewed with the finding that the playing field resulting from international trade agreements that have ostensibly equivalent rules for all contracting parties, may provide a much smaller policy space for developing than developed countries because of differences in initial conditions and national policy implementation capacities. Efforts to establish a level playing field for international trade must recognise and address this disparity.

After assessing the scope of policy space accessible to developing countries, the paper suggests what can be done at national and international levels to ensure that available policy space is effectively utilised, and when existing space is insufficient to advance national development objectives, it examines ways to expand policy space in a manner that is consistent with developing countries’ existing WTO commitments. It is argued that special and differential treatment (S&DT) for developing countries under the MTS needs to be enhanced and made more actionable and effective in order to provide developing countries with essential national policy space for development. Finally, general areas where improved S&DT is needed, and should be pursued by developing countries in the ongoing Doha Round of WTO negotiations, are summarised.



## **I. NATIONAL POLICY SPACE: SMALL AND SHRINKING IN MANY DEVELOPING COUNTRIES**

The development process of all countries is centred on increasing economic output to boost national income to higher levels so that national employment and consumption needs can be met. Within this process, the government plays a unique and central role in establishing a national policy framework designed to build human, technological and infrastructural capacities required to increase and diversify production and output; foster enterprise formation and growth; and manage the economic, social and environmental externalities of the development process as it proceeds.

As one of their primary functions, governments are therefore preoccupied with identifying, developing, implementing and assessing national policies to advance these development objectives. However, in a world with limited human and financial resources and growing democratic forces that support and reject policy choices, substantial national policy constraints arise. At the same time, national policy formulation takes place against a rich backdrop of interactions with other countries pursuing similar development objectives. With the march towards globalisation in recent decades, international agreements designed to manage these interactions between states have introduced a layer of ‘international’ policies – transmitted to the national level by commitments and obligations under international agreements – to be respected by the national policymaking process and thereby posing additional constraints on national policy choices.

The proliferation of international agreements during the past decades has evolved in step with the increasing globalisation of the world economy and a climate of improving cooperation and increased economic interdependence among nations. International agreements are viewed by adherents as necessary, because clear game rules are needed to ensure fair and equitable interactions between states, and desirable, because they provide various benefits, assurances and predictability that can only come from global cooperation. It is precisely for these reasons that they are subscribed to. However, as their scope deepens and numbers multiply, many countries are finding that they significantly constrain national policymaking.

In this era of increasing global governance, governments actively seek to secure a maxima of benefits in global agreements while at the same time maintaining as much policy space as possible in order to adopt, and adapt as needed, domestic policies that best serve national interests. Strategies to achieve these often conflicting objectives underlie national negotiating positions in the elaboration of international agreements. However, maximising national flexibility under multilateral agreements is not a simple exercise because global governance necessarily limits what states can and cannot do, sometimes in draconian ways. It is a complex process, simultaneously affecting interactions between countries across various institutional domains in ways that challenge concepts of national sovereignty and autonomy (Chayes and Handler Chayes, 1995; Mortensen, 2000). Global governance is thus prompting a redefinition of national political space wherein national sovereignty and autonomy are progressively displaced by global governance systems from their traditional placement within the national community and the territorially bounded nation-state (Held and McGrew, 1994).

The narrowing set of national policy options permissible under a growing array of international agreements is increasingly referred to in international debates as a major constraint on national policy space. In negotiations of the Eleventh United Nations Conference on Trade and Development in 2004, this issue, and the associated issue of building greater coherence between national and international policy regimes, were topics of considerable intergovernmental debate (UNCTAD, 2004). The success

of current World Trade Organization (WTO) negotiations also hinge on whether members perceive that their national policymaking abilities are sufficiently preserved.

Why is the trade-off between national policymaking autonomy and increased global governance necessary? What provisions have been made to account for the special needs and priorities of developing countries within international agreements? Do such provisions provide sufficient policy space required by developing countries to advance their development objectives? These are some of the questions this paper seeks to explore.

## II. THE BOUNDARIES OF NATIONAL POLICY SPACE

At both the national and international levels, the mechanics of policymaking are fairly straightforward. A problem or opportunity is identified and policies are designed to effect a response by stakeholders to resolve the problem, or share the opportunity, in an equitable manner reflecting their particular responsibilities, capacities and needs. What is less clear is how national and international policies should be designed in a mutually supportive way that does not overly restrict national policy space. In order to address this broad question of policy coherence, a conceptual overview of how national policy constraints manifest is useful.

Access to development enhancing policy options varies considerably among countries due to their own national policy constraints. These constraints result from inadequate financial, human, institutional and infrastructural resources needed to implement desirable development objectives. In many developing countries, the sustainability of policies vis-à-vis these resource bases cannot be ensured over the time period of implementation needed to achieve policy objectives. Financial and infrastructure constraints are prevalent in developing countries with high debt servicing requirements that leave limited funds available for government expenditures (UNDP, 1999). Furthermore, in many developing countries, particularly LDCs, human and institutional resources remain insufficient to satisfy policy implementation, monitoring and assessment requirements.

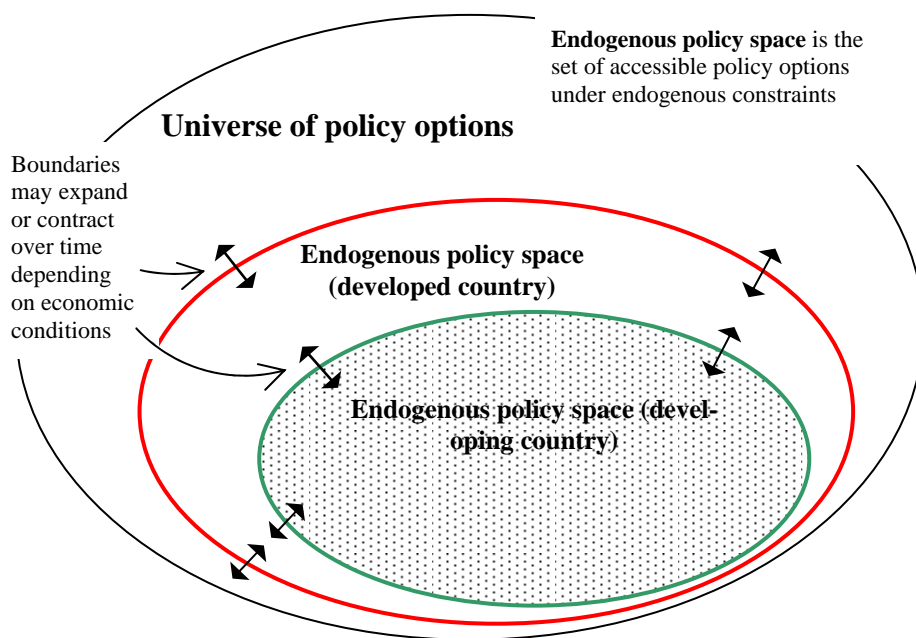
National policy constraints also arise from limits to policy acceptability by national stakeholders. For example, the latter may oppose policies that raise taxes, strengthen environmental regulations or liberalise trade in sensitive sectors. But even in cases where national capacities and acceptability by a vast majority of stakeholders are sufficient to introduce and implement welfare improving policies, the latter may never be realised due to unresponsive political leadership, resource diversion to vested interest groups, or a simple lack of political commitment to reform. Such situations remain as persistent problems in many developing countries where democratic political systems are absent or newly emerging (Van de Walle, 1999; Hyden, 2002; Acemoglu and Robinson, 2002). As shown in Figure 1, these national, or *endogenous* constraints, form a boundary limiting the extent of '*endogenous policy space*' within a larger universe of possible policy options. And because the 'size' of this endogenous policy space is proportional to the magnitude of available resources, i.e., the level of a country's economic development, developed countries possess a considerably larger endogenous policy space than developing countries.

In addition to domestic or endogenous constraints, various international or *exogenous* constraints limit a country's '*exogenous policy space*'. Foremost among these is the requirement that domestic policies do not conflict with national commitments and obligations assumed under various multilateral agreements – global, regional, sub-regional, and bilateral – on economic, social and environmental issues. There are many instances of exogenous policy constraints resulting from international agreements. For example, to meet agreed commitments to limit emissions of greenhouse gases under the United Nations Framework Convention on Climate Change (UNFCCC), developed countries' national energy policy options are restricted to a subset of options within a larger set of otherwise nationally acceptable options.<sup>1</sup> Or, in conformance with WTO Agreement on Agriculture (AoA), mem-

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<sup>1</sup> Under the Convention, only developed countries have accepted commitments to limit their emissions to numeric targets. Because few met these targets, which were not legally binding, Parties to the UNFCCC elaborated a protocol to the convention – the Kyoto Protocol – to strengthen developed countries commitments and make them legally binding. Adopted in 1997, the Protocol has yet to secure sufficient ratification for its entry into force.

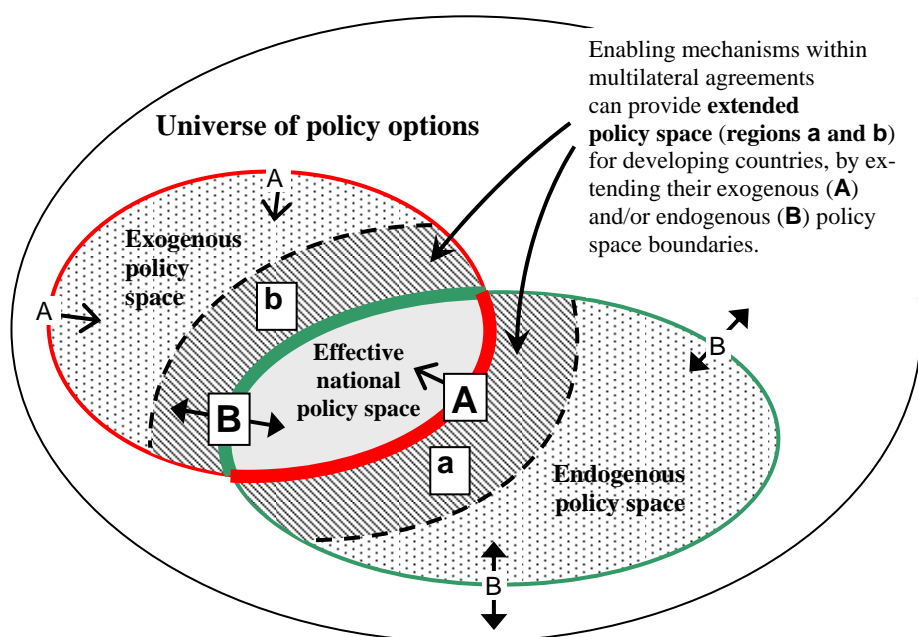
bers' national policies options to subsidise agricultural producers are reduced, while under the Agreement on Subsidies and Countervailing Measures (SCM), national policies to subsidise industrial producers are restricted. The affect of these agreements on national policy space will be further examined below.



**Figure 1 :** Countries' endogenous policy space as subset of possible policies in the policy universe. The size of this space, which depends on the availability of domestic resources and the level of the country's economic development, is larger for developed countries and smaller for developing countries.

Together, endogenous and exogenous constraints define the size of a country's '*effective national policy space*' which is shown conceptually in Figure 2 as the grey region of overlap of permitted 'endogenous' and 'exogenous' policy space. Specifically, as shown in Figure 2, international agreements (i.e., exogenous constraints) define one boundary (boundary A) of governments' national policy space, while national conditions (i.e., endogenous constraints) define the other (boundary B). Figure 2 also illustrates how the size of countries' effective national policy space can vary over time as endogenous conditions change. For instance, as a country's level of development increases, or as economic activity steps up, the endogenous policy space boundary (B) often expands, augmenting the size effective national policy space. Alternatively, declining economic performance usually forces this boundary to contract, reducing the size effective national policy space. In contrast, exogenous policy space boundaries (A) delineated by international agreements generally do not expand. Rather they tend to contract as the scope of international agreements widens and/or their number increases over time. The net result for most developing countries is that the extent of their effective national policy space shrinks over time.

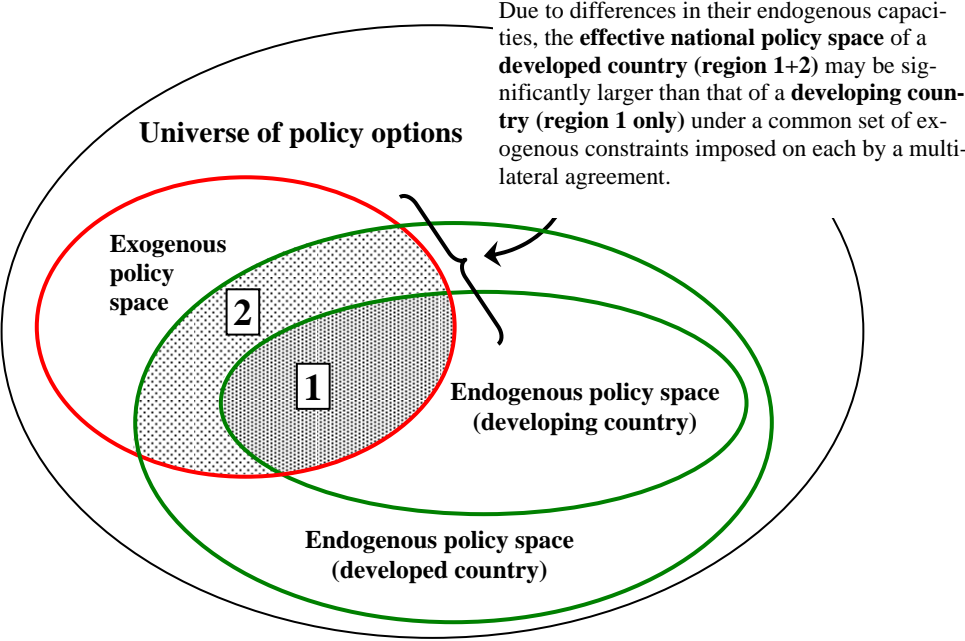
Although under the application of a multilateral agreement all countries may be subject to act within an equivalent exogenous policy space<sup>2</sup>, developing countries may not have sufficiently extended endogenous policy space to access much of the allowed exogenous space. As a result, their effective national policy space may be considerably smaller than that of developed countries. This is shown schematically in Figure 3. An agreement's provision of extended policy space for developing countries may thus be essential to ensure their economic competitiveness and attainment of national development goals vis-à-vis developed countries. When adequate policy space extensions (regions a and b in Figure 2) are provided through '*enabling mechanisms*', developing countries in need of retaining access to certain policy spaces may be able to do so.



**Figure 2 :** Determinants of effective national policy space under multilateral agreements. Both contractions and extensions of effective national policy space are possible (see text).

To maintain simplicity and broad applicability, international agreements necessarily generate policy constraints related more to the conditions within a standard model of the '*generic*' state contracting to an international agreement, than to the national conditions particular to any one state. However, to address the particular conditions of developing countries, most multilateral agreements contain special provisions for enabling mechanisms which take into account their specific needs, development priorities and limited implementation capacities. How useful such provisions are varies from one agreement to another and ultimately depends on the effectiveness of developing countries in advancing their negotiating objectives during the elaboration of any given agreement.

<sup>2</sup> This is not always the case. Some WTO agreements provide a larger exogenous policy space to developed countries than developing countries. Box 1 provides details on how the WTO Agreement on Agriculture provides developed countries with a significantly larger exogenous policy space than developing countries in the agriculture sector.



**Figure 3 :** Developed and developing countries’ effective national policy space under a uniformly applied exogenous constraint.

Many multilateral agreements include enabling mechanisms that provide developing countries with enhanced endogenous and/or exogenous policy space. In order to allow developing countries to advance development objectives, agreements may allow them to benefit from an exogenous policy space boundary that extends beyond the limits placed on developed country parties (region **a** in Figure 2). While through technical and financial assistance programs, agreements may extend endogenous policy boundaries to permit countries with limited capacities, to implement policies and corresponding measures and actions that would otherwise be beyond their national capacities (region **b** in Figure 2). Special and Differential Treatment within the Multilateral Trading System (MTS) is example of an enabling mechanism that extends, to a defined extent, both exogenous and endogenous policy space for developing countries.



### **III. MULTILATERAL AGREEMENTS AND THEIR EFFECTS ON NATIONAL POLICY SPACE**

Which multilateral agreements restrict national policy space and which extend it? Agreements designed to resolve social, political and environmental problems call on parties to adopt specific policies and timetables with the objective of promoting actions needed to obtain agreed goals. Under many such agreements, through integral enabling mechanisms, technical and financial assistance is provided to developing countries to address associated capacity constraints. Their policy space is often extended within these agreements. On the other hand, agreements designed to share economic opportunities, in areas such as trade, finance and investment, usually incorporate prohibitions against various ‘non-competitive’ national policies and actions of parties. The policy space of developing countries can be constrained by these agreements when enabling mechanisms do not provide adequate extensions.

The dissimilarity between agreements on social, political and environmental issues, on the one hand, and agreements on economic issues, on the other, arises from differences in the fundamental nature of these agreements: the former aim to share responsibilities among parties to address a common problem whereas the latter seek to share an opportunity between parties (Stilwell and Tarasofsky, 2001). Reflecting this underlying difference, social, political and environmental agreements tend to specify what countries ‘can do’ based on their respective responsibilities relating to their role in causing a problem and their capacities to address it. In contrast, economic agreements tend to draw up game rules that specify what countries ‘cannot do’ in order that an opportunity is equitably shared between parties.

An attempt to classify multilateral agreements according to their effect of limiting or enhancing national policy space for development is not clear-cut. As noted above, some multilateral agreements constrain national policy space, others extend it, and some may constrain it in certain areas while extending it in others. The strength of mechanisms to enforce compliance with commitments and obligations is also an important consideration. If an agreement’s policy space limiting commitments are not enforceable and go un-respected, the agreement cannot truly be considered to constrain national policy space. Whether compliance with commitments is governed by a set of benefits (carrots) and penalties (sticks) is thus a relevant issue when considering how effectively an international agreement may actually constrain national policy space.

#### ***A. International agreements on environmental and social issues***

Multilateral environmental agreements (MEAs) are an example of agreements that usually have the effect of extending developing countries’ national policy space for development. MEAs identify a shared environmental problem of a regional or global nature to be addressed multilaterally through a concerted international effort. It is not only the transnational scale of these problems that necessitates a multilateral response, but economic considerations as well. As environmental problems are economic externalities, costs are associated with their internalisation, and thus few countries are willing to address them unilaterally for fear of reducing their international competitiveness relative to countries taking no similar action yet benefiting from actions taken by others (free riders). The MEA, therefore, is an instrument through which all parties agree to establish and implement environmental policies based on an assurance that other parties will engage in like commitments and thus incur similar costs. Moreover, MEAs designed to protect ‘global commons’, often take the form of a Coasian contract between parties wherein developing countries’ willingness to accept engagements is predicated on the

provision of financial assistance, often to cover full incremental costs associated with implementation, from developed countries (Congleton, 2001).

Rather than prohibiting countries from adopting and implementing certain policies, MEAs set general obligations to be implemented by parties to redress environmental problems – usually through new national environmental policies. National policies pursuant to MEAs usually complement parties' developmental objectives by improving the efficiency of natural resource management and thereby enhancing the sustainability of economic activities based on their use. Given the resources-intensive nature of many developing country economies, the prospect of obtaining international assistance for enhanced resource efficiency represents a primary motivation for developing countries to adopt and ratify MEAs.

Importantly, as an integral component, most MEAs provide a framework to coordinate technical and financial cooperation to assist developing countries with limited institutional and financial capacities to implement their obligations.<sup>3</sup> Such frameworks were elaborated during negotiations to address developing countries' concerns that their ability to undertake national actions to achieve MEA goals is limited and that 'new and additional' financial and technical assistance would be required for their implementation of MEAs (i.e., extending their endogenous policy space).<sup>4</sup> In addition, reflecting their limited capacities for implementation, commitments of developing countries in many MEAs are usually designed to be less resource intensive than those of developed countries (i.e., providing them with an extended exogenous policy space under the MEA relative to developed countries). Such is the case under the Climate Convention (UNFCCC) which specifically recognises parties' common but differentiated responsibilities, taking into account their specific national and regional development priorities, objectives and circumstances, and in the Montreal Protocol of the Vienna Convention to protect the Earth's Ozone Layer, which takes into account technical and economic considerations and the developmental needs of developing countries.

Despite their non-binding nature, MEAs with specific trade obligations (STOs) may affect national policy space for development in certain export sectors for specific chemicals and natural resources, although by and large, developing countries have relatively minor exports of goods affected by such STOs. Only about one-tenth of the over 200 MEAs in existence contain STOs (UNEP-IISD, 2000). STO provisions in the major MEAs restrict<sup>5</sup> or ban trade in: hazardous wastes (Basel Convention), endangered species of animals (Convention on International Trade in Endangered Species – CITES), ozone-depleting substances (Montreal Protocol), hazardous chemicals and pesticides (Rotterdam Convention), and living genetically modified organisms (Biodiversity Convention). To date, import restrictions placed on these goods by WTO members have not been formally challenged by other members. As such, MEAs have never resulted in a formally contended market access issue in the WTO Dispute Settlement Body.

This notwithstanding, some countries fear that a current trend to expand WTO application to within-the-border issues might eventually result in the use of trade sanctions to enforce MEAs (Bagwell and Staiger, 2001). A role for MEA governance by the WTO might not only apply to enforcing STOs, but more generally to justifying various non-specific trade measures implemented by parties

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<sup>3</sup> For example, considerable technical and financial assistance is provided to developing countries under the United Nations Framework Convention on Climate Change (UNFCCC), the United Nations Convention on Desertification (UNCCD) and the United Nations Convention on Biodiversity (UNCBD), among numerous others. The Global Environment Facility, implemented by the UNDP, World Bank and UNEP was created in 1991 to finance developing countries' participation in achieving global MEA objectives.

<sup>4</sup> The common negotiating positions of developing countries in MEA negotiations are expressed by the Group of 77 and China. The G-77, currently comprising over 130 members, was established in 1964 in the context of the UNCTAD negotiations and now functions throughout the UN system.

<sup>5</sup> Aside from outright bans, other restrictions on imports prescribed by STOs include export/import licenses, notification requirements and packaging/labeling requirements.

to advance their national commitments under MEAs, including for MEAs without STOs. This could further result in some WTO members' use of trade remedies against other members, positing that the latter's lower environmental standards and correspondingly lower production costs constitute a form of dumping. The heretofore un-approached Pandora's box of trade restrictions based on non-product related process and production methods could thus be opened.<sup>6</sup>

Many multilateral agreements on social issues are closely associated with the concept of universal human rights that is integrated into the Charter of the United Nations itself through Articles 55 and 56. No state has ever made reservations against these articles, and most adhere to the United Nations Universal Declaration of Human Rights and its supplemental treaties. However, the extent to which parties respect their commitments by implementing international human rights instruments is varied (Forsythe, 2000). This is largely due to the legal status of multilateral agreements on human rights. They are not based on contractual or constitutive law – as are some MEAs and most trade and economic integration agreements – and thus they do not provide parties with either a clear incentive or means to enforce the terms of these agreements on other parties (Rabkin, 2000). In other words, these agreements have neither 'carrots' nor 'sticks'. In the event of non-compliance, the most parties can do is publicly admonish non-compliant parties during formal conferences of the parties in an effort to morally persuade the latter to respect their commitments.

In instances wherein parties perceive that multilateral agreements on social issues may constrain national policy options, they may choose to not effectively enforce national policies adopted pursuant to these agreements without encountering economic consequences. Examples of such breaches of commitments are not uncommon in developed and developing countries alike. For example, enforcement of national policies to support the International Covenant on Economic, Social and Cultural Rights – designed to ensure fair wages and equal remuneration for work of equal value without distinction of any kind – or basic employment standards governed by International Labour Office (ILO) Agreements – such as freedom of association and the right to collective bargaining – confront considerable imperfections in implementation. In this connection, it is noted that the majority of the countries in the world still fail to comply with basic ILO conventions on fundamental labour issues (Dølvik and Tørres, 2002). Compliance failure may occur intentionally, to reduce labour costs for national firms, or due to a lack of government resources needed for effective monitoring and enforcement.

These dynamics suggest that although in principle national policy space on labour issues may be constrained following the adoption of national policies pursuant to human rights and labour agreements, in practice they are constrained relatively little. However, should governance of labour standards be introduced into the WTO, members' use of trade remedies as a means to enforce other members' compliance with agreements on labour-related social issues could arise (Bhagwati, 1995; Bagwell and Staiger, 2001). Similar to the case for MEAs, a role for WTO governance of multilateral agreements on labour issues would likely result in trade disputes over non-product related process and production methods based on the argument that non-observance of internationally agreed labour standards is being used by foreign firms as an illegitimate means to lower costs and thus constitutes a form of dumping.

## ***B. International trade agreements***

The introduction of modern transport, information and communication technologies have accelerated the modern globalisation process. On both regional and global scales, supranational economies have emerged allowing producers to access vast foreign consumption markets and thereby achieve higher economies of scale needed to reduce production costs and improve profit margins. On the demand side, consumers' consumption frontiers have extended significantly through access to cheaper im-

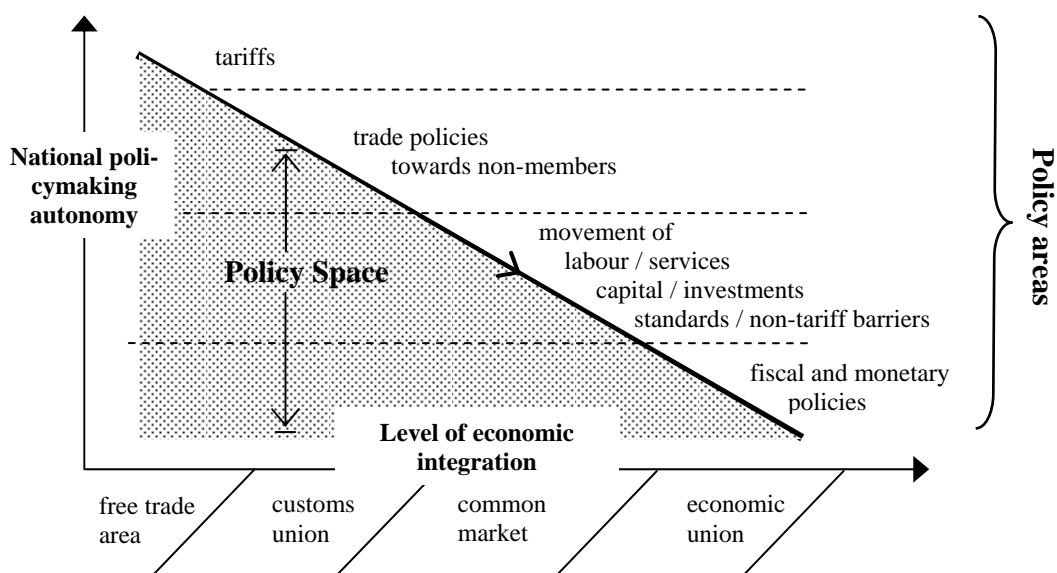
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<sup>6</sup> GATT Article III on National Treatment prohibits discrimination of imported products on basis of process and production methods (PPMs).

ported goods and services, resulting in significantly enhanced social welfare. Attracted by the benefits offered by integration into supranational economies, developed and developing countries alike have elaborated and entered into the WTO Multilateral Trading System (MTS) and over 200 bilateral and regional trade agreements of a South-South, North-North and North-South nature (UNCTAD, 2003). This activity occurred mostly during the past two decades in step with accelerated globalisation processes.

Bilateral and multilateral trade and economic integration agreements are the cornerstone of supranational economies. To integrate national economies they necessarily comprise provisions affecting the movement of goods, labour and capital – the basic elements of an economy – and contact with consumers – market access. In order of increasing integration between members, trade and economic integration agreements include free trade areas, customs unions, common markets, and economic unions. At a minimum, all of these arrangements seek to facilitate trade in goods between member states by reducing tariffs applied to imports from other members in an agreed way. Therefore, at the very least, a nation’s adherence to any integration arrangement restricts national autonomy to freely set tariff levels on goods imported from other member states. However, in return, countries benefit from expanded market access in other member’s economies.

Participation in deeper integration arrangements, such as common markets and economic unions, requires that members agree to liberalise exchanges not only in goods, but also in services and capital. These agreements require member states to implement agreed measures at the national level to facilitate the free exchange of labour and investments across national borders. Furthermore, they also seek to reduce non-tariff barriers to trade in goods between members. Participation in a common market or economic union thus restricts national autonomy to make certain types of policy interventions in services and financial markets, and to impose non-tariff barriers on imports of goods from other members. When monetary union is also covered by an integration arrangement, national autonomy to freely adopt monetary and fiscal policies, maintain fiscal deficits or intervene on interest and exchanges rates are also restricted. Generally, therefore, reductions in national policy space vary in proportion to the depth of economic integration pursued as shown in Figure 4.



**Figure 4 :** Economic integration and policy space

The European Union (EU) is the foremost example of states conferring national policymaking autonomy – and to some extent, national sovereignty itself – to a supranational economic system. While it

began with a regional agreement for coal and steel trade among European states, the EU has evolved into a formal governance system covering a broad range of policy domains (Duina, 2001). Member states have retained little of the national policy space they possessed before their entry into the EU. They now share a single market, currency, competition policy, voice in international trade negotiations, and common environmental, labour and health policies (Schmidt, 2003).

As integration has advanced, however, there have been increasing calls by EU member states for increased policy flexibility to adopt and pursue policies to meet country-specific priorities, conditions and needs. Their ability to do this has recently become possible through 'flexibility' provisions in the EU's Amsterdam Treaty which entered into force in May 1999. The Treaty is the first EU Agreement to explicitly acknowledge the principle of flexibility. Also referred to as enhanced cooperation, flexibility is used to describe the situation wherein several EU member states pursue a new EU policy while the others stay outside the terms of this policy but remain EU members (Philippart and Sie Dhian Ho, 2003). While flexibility is a recent term, the mechanism had been exercised earlier; for example, both the UK and Denmark negotiated 'opt-outs' from the European Monetary Union (EMU) during the mid-1990s.

### ***C. The Multilateral Trading System***

The Multilateral Trading System (MTS) governed by WTO Agreements represents a unique type of supranational economic system. It is neither a free trade area, customs union, common market nor an economic union, although increasingly over time has assumed qualities of each of these supranational economic systems. Although prior to the Uruguay Round (UR) the MTS infringed in a limited way on national policy autonomy – limiting its application to tariff policy – through its recent evolution since the UR it has increasingly infringed on national policy space. Through a number of new UR '*within-the-border*' agreements on subsidies, investment, services and intellectual property, the extent of this infringement is similar to that observed in common markets and economic unions.

Do the market access benefits of the MTS outweigh its encroachment on national policy space? This is a question of serious debate. There is growing consensus among developing countries that any further loss of national policy space may seriously deprive them, particularly those with small less diversified economies, of access to essential development pathways. At the same time developing countries recognise the need to enhance their access to foreign markets – in both the North and South – in order to sustain and enhance the phenomenon of trade-led growth.

The effect of MTS infringement on developing countries' national policy space must be considered within the context of the development process itself. This process is centred upon increasing national output to raise its national income level and thereby enhance social welfare by extending the national consumption frontier for goods and services. Within this process, the national government plays a unique and central role in establishing a national policy framework capable of: building national human, technological and infrastructural capacities required to increase and diversify production and output; fostering enterprise formation and growth; and managing the economic, social and environmental externalities. And only the national government has the mandate to serve these overarching economic functions – no other sub-national or super-national entity possesses the authority or interest to fulfil these responsibilities systematically at the countrywide level.

In addition, it should be emphasised that development cannot be left to laissez-faire markets and international trade and financial systems. History has shown that market forces alone are incapable of promoting broad-based and systemic national economic development (Stiglitz, 2002). Therefore, quite simply but dramatically, if a government fails to advance national development objectives, its national economy may fail to develop. This fundamental reality underscores the importance of governments' preservation and active use of national policy space for development.

Government's access to essential development policy options hinges critically on the evolution of effective national policy space over time against the background of the country's economic

development path (UNDP, 2003). Development optimising policies need to be accessible within a country's effective national policy space at the appropriate points in time as a country develops. Whether or not they are accessible depends upon the timing of the introduction of exogenous constraints through international agreements. Therefore, if the MTS, or any other international agreement, overly restricts national policy space during a country's early developmental stages, it may prohibit that country's access to, and implementation of, essential development policies.

Limiting government support to the agriculture by reducing permitted levels of domestic support (i.e., input, output and investment subsidies) and export subsidies under the MTS provides an illustrative example of how national policy space to foster development of the sector may be constrained. The sector is particularly important for developing countries as it provides employment to over 40 percent of their labour force, 1 billion workers, and sustains the nearly 60 percent of their population that resides in rural areas, 3 billion people, or nearly half of the world's population (World Bank, 2004). Moreover, because most of developing countries' rural population lives in poverty, rural development and food security remain modern-day priorities for them.

At lower levels of development, most governments do not have sufficient financial resources to provide domestic and export subsidy support to their agricultural sector; i.e., they remain policy options that lie outside of the country's endogenous policy space. However, as a country develops, government revenue grows sufficiently to place it in a position to provide this support. Generally, the more developed a country is, the greater the level of agricultural support it is able to provide to the sector. In the early 1900's when developed countries initiated domestic and export subsidy support programmes, exogenous constraints were not present, and they proceeded to provide substantial support to agriculture. Then, a decade ago, as exogenous constraints emerged through the WTO Agreement on Agriculture (AoA), developed countries locked-in or 'grandfathered' their continued provision of agricultural subsidies through commitments to marginally reduce support from their 'established' or base levels. In contrast, most developing countries which notified relatively low levels of domestic support in their original schedules are not permitted to subsequently raise them above their negotiated *de minimis* levels. Additionally, developing countries, who as a group reported virtually no use of export subsidies, are prohibited from later introducing them.

Today, as many developing countries are now reaching a level of development where they are in a position to provide greater levels of domestic support and some measure of export subsidy support to agriculture, exogenous constraints deriving from the AoA are in place, substantially restricting this option for them. Moreover, options available to developing countries under the AoA are much more limited than those available to developed countries since the AoA was concluded at a time when developing countries had comparatively insignificant established levels of agricultural support from which not only increases are prohibited, but moreover, reductions must be made.

Taking these considerations into account, the policy space dynamics of the AoA result in a much more limited national policy space for developing countries relative to developed countries in the agriculture sector. The magnitude of the difference in domestic support – as a percentage of total value added in the agriculture sector – between developed and developing countries is dramatic: the median level was only 5 per cent for over 40 developing countries notifying support to the WTO, whereas in developed countries it was significantly higher, climbing to levels over 60 per cent (Roberts et al., 2002). Even in 2000, some six years into AoA implementation, domestic support for the sector in developed countries remains high. As a percentage of total value added in the sector, domestic support levels in the EU, Japan and US were respectively 51, 62 and 36 per cent, levels considerably higher than the developing country average which was less than 5 per cent (USDA, 2000). It should be emphasised that these high levels of domestic support in developed countries are entirely consistent with the AoA since they fall below reduction-adjusted target levels. At the same time, however, if developing countries were to raise their support to a level only slightly exceeding their *de minimis* level of 10 per cent of total production, many would be in violation of the AoA, even though this revised level would be substantially lower than those of developed countries.

Implementation of the AoA demonstrates how a specific trade agreement under the MTS, although applied uniformly to all members, can affect countries differently according to the level and timing of their economic development (see Box 1 for further details). Other WTO agreements, including the Subsidy and Countervailing Measures (SCM) Agreement and the Agreement on Trade-Related Investment Measures (TRIMS), also produce differential effects on members depending on their level of development.

The SCM Agreement permits subsidies to industry for some purposes but prohibits them for others.<sup>7</sup> A subsidy to industry can take many forms, including through direct transfers of funds, tax reductions or government provision of goods and services to firms, as well as through income or price support provided to firms for their production of goods. The SCM defines prohibited subsidies as a financial contribution by a government that 1) confers a 'benefit' to a recipient and 2) is 'specific' to an enterprise, industry or region. Furthermore, it prohibits governments from implementing national policies to subsidise industries contingent on their export performance (export subsidy) or upon their use of domestic inputs to production (local-content subsidy). However, many developing countries view the use of export and production-related local-content subsidies as fundamental to their economic diversification and development, while on the other hand, developed countries have argued that such subsidies are trade distorting. But although export and domestic content subsidies have been prohibited for decades under the GATT and the Tokyo Round Agreement on Subsidies, prior to 1995 both were successfully utilised in developed countries, as well as in many East Asian developing economies, because these rules were not effectively enforceable until the establishment of the WTO and entry into force of the SCM (Steger, 2003).<sup>8</sup>

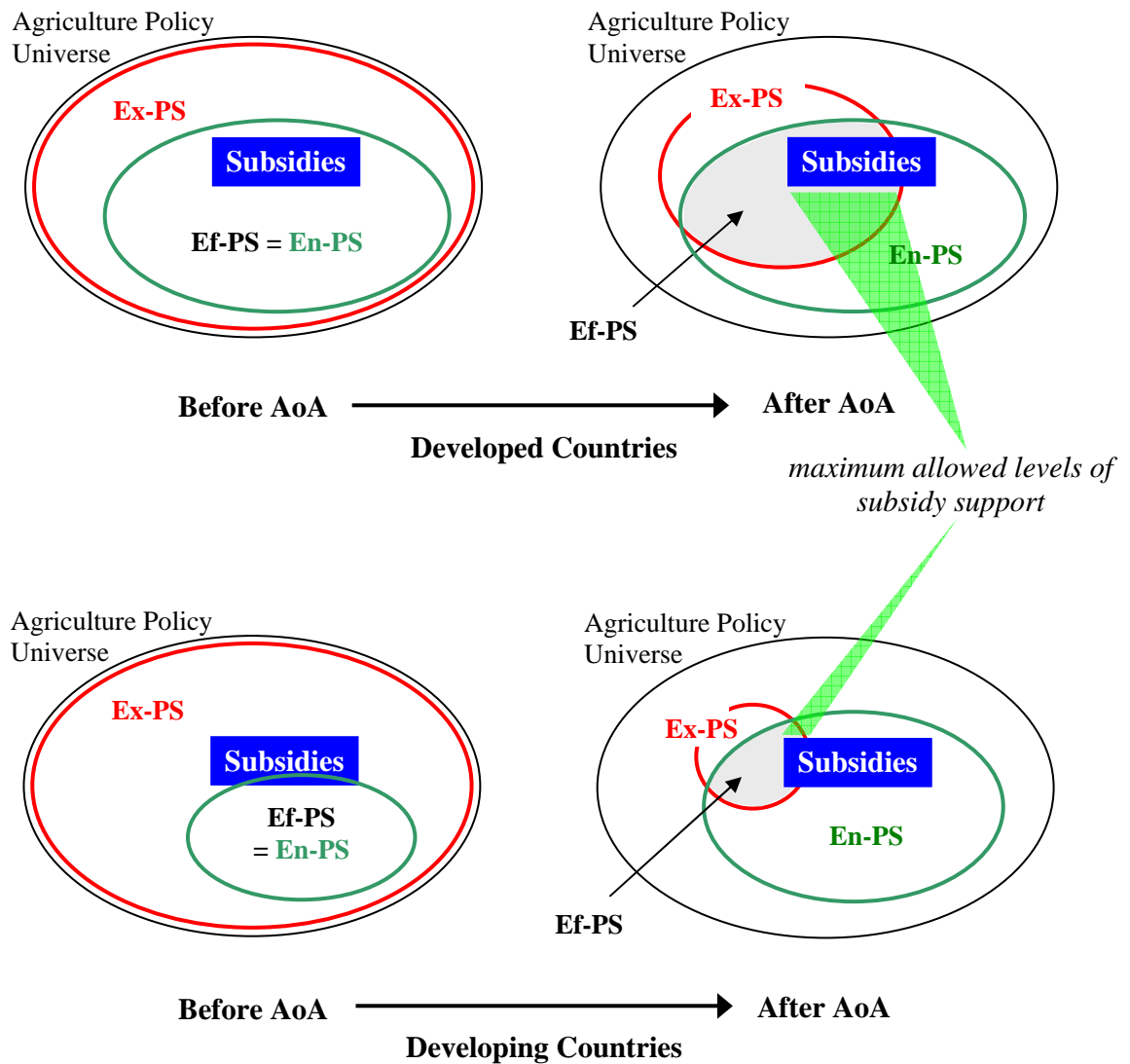
Non-specific subsidies provided for research, regional development, or adaptation to environmental requirements, are permitted under the SCM. However, despite a scope for permitted subsidies under the SCM, rulings by dispute settlement panels suggest that any subsidy may be brought into dispute if it has the effect of supporting exports. This presents a particular problem to developing countries wherein many of industries with the greatest potential for growth and employment are export-oriented due to small, immature or saturated domestic markets. Developing countries may also have difficulties providing 'non-actionable' subsidies for regional development, since beneficiaries are often active in only one economic sector or a single geographical region, and thus such subsidy support may be challenged as being 'specific'. By contrast, in larger developed countries the need for 'export-supporting' subsidies is less critical since domestic markets are dynamic and sufficiently large relative to scale economies, allowing developed countries' subsidy-recipient firms to develop substantially within a domestic market envelope.

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<sup>7</sup> Subsidy disciplines under the SCM apply to all goods except agricultural goods. The latter are covered separately under the WTO Agreement on Agriculture.

<sup>8</sup> Since export and production subsidies are largely prohibited under the SCM, many developing countries remain reluctant to reduce tariffs and tariff bindings since these remain as the only means to provide 'support', albeit indirect and less effective than direct subsidy support, to strategic industries. As a result, the SCM has had the perverse effect of impeding progress in trade liberalisation negotiations.

**Box 1: Effective national policy space under the WTO Agreement on Agriculture**



The WTO Agreement on Agriculture (AoA) has a differential effect on members' effective national policy space in the agriculture sector. **Prior to introduction of the AoA**, exogenous constraints were absent so the effective national policy space (Ef-PS) and endogenous policy space (En-PS) for agriculture were identical. Providing subsidies (i.e., domestic support and export subsidies) to the agriculture sector was within developed countries' Ef-PS but largely outside of developing countries' Ef-PS. Developed countries provided significant subsidy support to the sector but developing countries did not. **During the period of AoA implementation**, developing countries' endogenous capacities increased and so En-PS has expanded to include their potential to provide subsidy support. However, their exogenous policy space (Ex-PS) was reduced substantially by the AoA since imposed subsidy reduction commitments were set relative to the low levels of support they provided before introduction of the AoA. As a result, developing countries are only permitted to provide limited subsidy support to the sector *ex-post*. For developed countries the situation is markedly different. Ex-PS was also reduced by the AoA, but relatively little since AoA subsidy reduction commitments were set relative to the high levels of subsidies they provided before AoA implementation. As a result, developed countries are permitted to continue providing substantial subsidy support to the sector *ex-post*. The AoA therefore generates a larger effective national policy space, and establishes higher maximum allowed levels of subsidy support, for developed countries than developing countries.

Developing countries are also at a relative disadvantage because non-actionable subsidies for R&D and environmental adaptation permitted under the SCM are generally important requirements for



firms' competitiveness in advanced industrial sectors which prevail in developed countries. For instance, R&D is important for the computer software, aerospace, chemical and pharmaceutical industries where developed country firms are major global players, and relatively unimportant in sectors such as textiles and clothing and basic commodities where developing countries have comparative advantages. Moreover, in sectors where R&D is important, it leads to patents, which guarantee developed country firms a price setting ability for downstream products, allowing them to lock-in significant earnings when products are eventually produced and exported, with intellectual property protected by the WTO TRIPS Agreement

Apart from subsidies, government policies can also use non-subsidy means of supporting national economic development. Investment policies, which can be used in this regard, place performance requirements on foreign investment. Prior to the Uruguay Round Agreements, these requirements included local-content and export value-added requirements that enhance national development through linkages and spillover with domestic firms and through skill and technology transfer. Performance requirements also required foreign investors to export a certain percentage of their production and thus contribute to a country's foreign exchange earnings. However, since 1994, the WTO Agreement on Trade-Related Investment Measures (TRIMS) prevents such performance requirements, and a number of others, from being placed on foreign investments, leaving little room for developing countries to design national investment policies that can help ensure positive development linkages and spillovers from foreign investment.

This brief discussion of the AoA, SCM and TRIMS agreements demonstrates that even though a trade agreement's rules may apply equally to all parties, the constraints they impose on national policy space will affect the development prospects of countries very differently depending on their level of economic development. While there is no universal prescription for economic development, the experience of many developed countries indicates that many national policies that are now branded as trade-distorting policies by developed countries, and prohibited by WTO rules, have played a critical role in fostering capital accumulation, building sectoral comparative advantages, and stimulating economic diversification and sustainable growth in the developed world (Chang, 2002; Baldwin, 2003; Rodrik, 2003). Moreover, once these results have been achieved, many of these national policies can be safely abandoned. Thus, while developed countries may no longer require the use of such policies to sustain their economic growth, they remain essential to catalyse economic diversification and growth and development in many developing countries.

At higher stages of development, developed countries no longer need the extended policy space that they required in the past. They may thus seek to lock in their gains through a negotiated trade agreement that limits other similarly developed countries from maintaining so called 'trade-distorting' policies (UNDP, 2003). Unfortunately – intentionally or unintentionally – uniformly applied policy space restrictions imposed by new multilateral trade agreements necessarily have the effect of preventing developing countries from pursuing many growth-critical policies used earlier by developed countries, thus locking-out developing countries prospects for growth, not only by reducing their capacity to participate in global export markets but in their own national markets as well (Chang, 2002).

If an equitable trading system is to be achieved, these considerations suggest that the timing and sequencing of trade liberalisation must be carefully matched to a country's level of economic development, and that a one-size and one-time fits all approach to trade liberalisation cannot serve the development aspirations of developing countries (Rodrik 2001; UNCTAD, 2003; UNDP, 2003). Reflecting this view, negotiators of developed and developing countries alike have suggested that WTO members should recognise that members' national policy preferences differ, and to promote more open and rule-based trade, emphasis should be placed on a balanced articulation of policy choices rather than on an imposition of a single standard. Moreover, referring to the development aspirations of developing countries, the EU has officially stated that "developing countries should maintain their right and policy space to pursue their policies and that no international agreement should prevent them from doing so" (EU, 2003).

What are some of the growth-critical national policies that developing countries require to support economic development? They are policies that provide support to national industries, over limited periods of time, to stimulate investment, production, build competitive export capacity and promote economic diversification. In broad terms they may include policies to:

- ◆ subsidise specific agricultural and industrial sectors, particularly for small and medium size enterprises (SMEs), including through production and export subsidies and grants, wherein governments seek to build national comparative advantages, and to advance economic diversification;
- ◆ provide financial support to national industries in economic difficulty, or to those undertaking major capital investments;
- ◆ maintain higher import tariffs and impose import limitations (through quotas and temporary bans) on goods whose production provides significant levels of national employment and/or is required to pursue poverty reduction efforts and sub-national regional development objectives;
- ◆ mandate the procurement of nationally produced goods and services, when available, by foreign multinationals and national government entities in order to promote SME development;
- ◆ recognise and protect traditional knowledge to encourage entrepreneurship in rural communities;
- ◆ ensure high levels of local content and domestic participation in foreign investment projects, not only to ensure related national employment, but more so, to build national human capacities;
- ◆ ensure minimum levels of technology transfer in foreign investment projects to build national human and technological capacities,
- ◆ ensure minimum levels of service are provided to poor and minority groups by foreign service providers establishing themselves in national markets;
- ◆ restrict large and abrupt movements of investment capital to prevent economic instability;
- ◆ maintain government-supported domestic pricing schemes on essential goods and services consumed by the poor.

These are just examples of the many growth-critical national policies that have been, or risk being, placed outside of the policy space boundaries of developing countries by international trade and investment agreements.

### **Special and Differential Treatment within the MTS**

Special and Differential Treatment (S&DT), a fundamental principle that all WTO agreements are built upon, serves to accommodate members' development needs within the trading system (Youssef, 1999). Lacking comparable economic, structural and institutional endowments in trade and trade related areas, developing countries require less policy-restrictive WTO obligations than their developed country counterparts. S&DT allows developing countries greater flexibility to implement national development policies that enhance the supply capacity and competitiveness of domestic enterprises. Furthermore, not yet having achieved substantial and sustained growth of their share in world exports, particularly for value-added goods and services, developing countries require greater special and differentiated rights that provide them with capacity building assistance and more favourable terms for exporting their goods and services to global markets.

Special and Differential Treatment within the MTS remains developing countries' preferred mechanism to improve and restore national policy space for development. S&DT is an established principle in WTO – dating back to provisions provided under the 1947 General Agreement on Tariffs and Trade (GATT 1947) – conceived to accommodate developing countries' development needs

within the MTS. Until the Uruguay Round of negotiations in 1994 the MTS trade agenda was confined to trade in goods, and S&DT under GATT 1947 provided developing countries with flexibility in the use of tariffs, quotas and other import measures to shelter specific domestic industries from import competition, and to discourage a broad range of imports when confronted by large trade deficits and balance of payment difficulties.

As an integral part of the MTS, Articles XVIII, XXVIII bis of GATT 1947 provided developing countries with flexibility to derogate from GATT commitments and obligations for limited time periods in order to support development objectives. Article XVIII provided developing countries with a wide range of options to support national industries, including through implementing tariff protection and government assistance initiatives required for the establishment of a particular industry; and quantitative restrictions on imports for balance of payments purposes. Article XXVIII bis of GATT 1947 recognises that the success of multilateral negotiations depends on the participation of all contracting parties, and that negotiations shall take into account the needs of less-developed countries for a more flexible use of tariff protection to assist their economic development and meet the special needs of these countries to maintain tariffs for revenue purposes.

Largely through efforts initiated by developing countries during UNCTAD I in 1964 (South Centre, 2004 A), Part IV of the GATT on Trade and Development was elaborated in 1965 introducing the principle of non-reciprocity for developing countries in MTS negotiations in order to address difficulties they experience in integrating into international markets. And later, in 1979, resulting from the Tokyo Round of GATT negotiations, the Enabling Clause established a framework to provide developing countries with differential and more favourable treatment through the members' introduction of trade preferences for developing countries, including through preferential market access provided by developed countries under the Generalised System of Preferences.

During the pre-1994 period, when the scope of the MTS was largely limited to border measures affecting trade in goods, national policy space for development was not significantly restricted by the MTS, and the above S&DT provisions were largely viewed as providing sufficient flexibility in the area of import restrictions and related policies, although serious concerns were raised over the difficulty in effectively implementing these S&DT provisions due to cumbersome rules of procedure and the need to secure approval from, and in some cases compensate, other trading partners.

More recently, however, the MTS regime has expanded dramatically in scope. As discussed above, an array of new WTO Agreements, such as the AoA, SCM, TRIMs and GATS, among others, adopted following the conclusion of the Uruguay Round in 1994, and 'New Understandings' of the GATT 1947 provisions accompanying the establishment of the WTO, extended the influence of WTO measures from members' borders to their national economic policy regimes. This transformation, however, was largely asymmetric as the Uruguay Round did little to extend the offering S&DT provisions into new within-the-border areas governed by the WTO regime (Tortora, 2003). At the same time, with the formation of the WTO, the formal and legally binding Dispute Settlement Agreement curtailed the ability of developing countries to interpret and apply GATT S&DT provisions in a flexible manner to support their implementation of pro-development policies (Stevens, 2003).

With the conclusion of the Uruguay Round and the *de-jure mis-en-place* of a single undertaking approach to the WTO Agreements through the Final Act and the emergence of a formal dispute settlement system, the principle and practical applicability of S&DT was significantly eroded and transformed. The wide scope and integrated nature of S&DT in GATT 1947 was not replicated in the Uruguay Round Agreements. Appearing only as an 'add-ons' in these agreements, S&DT has largely taken the form of a transitional device providing developing countries with longer timeframes to implement their commitments and only slightly reduced obligations vis-à-vis developed countries. Moreover, the technical assistance measures designed to respond to developing countries capacity building needs for a 'single undertaking' implementation of all of the Uruguay Round agreements are only accorded on a best-endeavour basis by developed countries.

Because S&DT has not evolved in parallel with new far-reaching within-the-border commitments under this transition, most developing countries are demanding that S&DT assume an integral role in all WTO Agreements similar to the one it has in GATT 1947 by substantially upgrading it to restore much of the national policy space for development that has been lost since the conclusion of the Uruguay Round and establishment of the WTO (Corrales-Leal et al., 2003).

Certainly the MTS transition to within-the-border domains has greatly reduced the exogenous policy space of developing countries, severely restricting their ability to provide support to their industries, build domestic supply capacity, and promote economic diversification through active policy interventions. For the majority of developing countries, therefore, more effective S&DT provisions to reopen and extend their policy space are of critical and essential value.

#### ***D. The International Financial System***

Loan and grant agreements with international finance institutions (IFI) such as the World Bank and IMF are ostensibly designed to promote development in recipient developing countries. IFI aid programmes (often in the form of structural adjustment programmes) provide developing countries with useful assistance in building national institutional and infrastructural resources needed to overcome endogenous constraints that limit national policy space. However, at the same time, these programmes often impose significant exogenous policy constraints on recipient developing countries through privatisation and trade and investment liberalisation conditionalities.

The debt crisis of the early 1980s provided a major motivation for the World Bank and the IMF to require trade policy reform as a conditionality for developing country loans. IFI conditionalities were and remain largely based on policy recommendations known as the ‘Washington Consensus’ (UNDP, 2003). These conditionalities – requiring ambitious privatisation and liberalisation of capital accounts and trade in developing countries that leave a very limited role for government intervention in markets – have often met mixed results (Stiglitz, 2002) and a comprehensive assessment of IFI conditionalities shows their extensive intrusiveness into borrowing governments’ ability to use industrial policy as a tool for development (Dreher, 2002).<sup>9</sup>

According to adherents of the Washington Consensus, there are many arguments against the state playing a role in the economy. They argue that government is harmful, ineffective, and unnecessary (Stiglitz, 1997). However, history portrays a different picture. Rather than impeding growth in Korea, Thailand, Singapore and other East Asian economies, governments’ active intervention through industrial policy, primarily export promotion, played a central role in catalysing rapid economic growth in East Asia over the past two decades (World Bank, 1993). More recently, China and India – where government intervention is particularly strong – have joined their ranks. In stark contrast, the market-based *laissez faire* approach prescribed by the IMF, World Bank and WTO for many African and Latin American countries over the same period, was followed with disastrous results. Broad-based liberalisation resulted in severe import surges, drastic declines in domestic production and high levels of unemployment (Buffie, 2001). In summary, most developing countries followed the doctors’ prescription and, in many cases, did not feel better (Stiglitz, 1997). Now these same countries seek to re-

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<sup>9</sup> Of the 156 developing countries (low and middle income countries in the World Bank classification system), 136 (87 per cent of them) were extended credit by the World Bank Group through IBRD loans, structural adjustment lending programs and IDA credit. According to the World Bank, loan conditionalities related to international trade account for almost 16 percent of all conditionalities and were included in 79 percent of World Bank programs between 1980-88. Where assistance from the IMF is concerned, 118 developing countries (76 per cent) received assistance from the IMF between 1980 and 2000, including through trust fund loans and credit provided under the IMF’s structural adjustment and enhanced structural adjustment facilities. For the IMF’s programs, between 1987 and 2000, about 15 per cent of all loan conditionalities were trade-related (for further details, see Dreher, 2002).

assert their own self-care approach to economic management, largely based on the positive experiences of their Asian counterparts. Not surprisingly, they thus seek policy space, and lots of it.

This is not to suggest that developing countries advocate a return to their state-run or state-dominated economies of the past. Rather they seek to restore government's ability work in partnership with private enterprise to promote diversification and build national export capacities, not only as in successful Asian economies, but also as in the EU, Japan, US and other developed countries.

In developed countries, this partnership is particularly advanced. Developed country governments run trade seminars, provide export finance and tax incentives, conduct market studies, and deliver technical assistance to companies that wish to enter foreign markets (Schweke, 1999). More significantly, developed country governments are actively involved in extending export guarantees and credits for goods and services exported by their firms. In 2000, developed country export credit agencies had a total stock of 500 \$b in outstanding guarantees to their firms operating in developing countries, and issued 58 \$b worth of new export credits for goods and services exported by their firms (World Bank, 2002; OECD, 2002).

From a strategic perspective also, developed country governments actively support their firms through research and development (R&D) support aimed at maintaining leadership in key goods and services exports. In the US alone, research and development R&D grants and subsidies totalled 117 \$b in 2003 (AAAS, 2003), much of which, either directly or indirectly, supports the activities of US firms (Edwards and DeHaven, 2002). R&D support also drives much of the innovation and generates much of the intellectual property that US state-of-the-art technologies – sold throughout the world – are based upon.

The above figures illustrate the substantial amount of support provided to developed country firms through financial support mechanisms that are instrumental in facilitating and sustaining developed country exports. It should be noted that neither export guarantees and credits nor R&D support are classified as production or export subsidies, and that governments' use of each of these policy instruments is entirely consistent with WTO disciplines.

There is an abundance of other examples of governments playing a central role in 'industry building' in developed countries. For instance, in the aerospace sector, the European Airbus Consortium was launched with considerable and sustained financial support from several EU countries (France, Germany, Spain and the United Kingdom) to make it the world's largest aerospace company today. The Airbus story not only demonstrates how governments can work with the private sector to build an infant industry and help it enter global markets, but moreover, it shows how several countries' policymakers and private sectors can work together in a multi-country consortium – an approach largely unexploited by, but offering considerable potential to developing countries.

The World Bank has emphasised that a government that encourages and complements the activities of private businesses is an essential ingredient in economic development. An effective state is vital for sustainable development, both economic and social. Experience shows that the state is central to economic and social development, not as a direct provider of growth, but as its partner, catalyst, and facilitator (World Bank, 1997; Rodrik, 2004; Tabellini, 2004). For developing countries in particular, a recent communiqué of the World Bank and IMF Development Committee has stated that sustainable and inclusive growth needs to be accelerated in many developing countries, and that specific priorities must be determined at the country level in the context of country-owned and monitored development strategies (World Bank / IMF, 2004).

Most governments recognise the need to implement policies and actions that support national industries as an important government function. Through grants, subsidies, preferential loans and tariff barriers on certain goods, developed country governments have and continue to provide support to industry as one of their primary functions. Without the means to provide financial support, many developing countries have relied on tariff protection as an indirect means to support their industries.

Now, however, as some are approaching levels of economic development where they are beginning to attain levels of national income that permit them to form durable partnerships with their industries, including by providing them with financial support, MTS rules and IFI conditionalities are increasingly limiting their ability to do so, while at the same time impelling them to reduce protective tariffs applied to imports which may be needed to protect sensitive industries by establishing economies of scale, and to generate government revenue. Approaches to ensure adequate national policy space for development remain essential if developing countries are to move beyond this impasse.

#### **IV. WAYS TO BETTER UTILISE AND ENHANCE DEVELOPING COUNTRIES' POLICY SPACE**

When developing countries' development objectives are being considered, it is important to assess how much national policy space is currently available to them. Is it adequate to advance development objectives? Does it permit governments to work in partnership with national industries, including through national policy instruments that confer economic support to firms? What needs to be done at the national and international levels to ensure that it is effectively utilised? Finally, if national policy space is overly constrained, blocking many essential national policy options, what can be done to enhance it?

In assessing the scope and extent of national policy space, both endogenous and exogenous constraints need to be evaluated within the context of specific policy options that a government desires to implement. Once endogenous and exogenous constraints are mapped-out and possible enabling measures, including S&DT within the MTS,<sup>10</sup> are accounted for, how much of the policy universe remains accessible to policymakers? Are effective national policy options accessible within a government's effective national policy space? If they are, policy space constraints may not be at issue, and national governments need to use available space more effectively. However, if they are not, policymakers need to identify the source of constraints and ways to overcome them. Several approaches can be considered:

##### ***A. Expanding endogenous policy space***

In many cases, it is endogenous, rather than exogenous, constraints that render desirable policy options inaccessible. In such instances, international agreements do not restrict access to the policies under consideration. For example, the national budget may be insufficient to implement a policy option, or institutional and infrastructural resources may be insufficient to support effective policy implementation. Alternatively, the government may lack knowledge of, or commitment to, new development schemes and appropriate policies to advance them. Whatever their source, endogenous constraints need to be addressed by a long-term national development plan.

Development partners – namely the IFIs, regional development banks, international organisations and both bi- and multi-lateral assistance agencies – have a significant capacity building role to play in assisting developing country governments address endogenous policy space constraints. Although a great deal of capacity building assistance is already being provided by the WTO, IFIs and UN organisations in this area, much more remains to be done. New and improved S&DT under the WTO should also be developed to help address trade-related endogenous constraints wherever appropriate, particularly in the areas where developing countries with limited institutional resources to implement and comply with WTO agreements need greater assistance. Such areas include simplifying rules of origin; increasing channels for the transfer of technology; and, assisting developing countries to comply with product standards.

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<sup>10</sup> In 2000, a total of 145 Special and Differential Treatment provisions were included in the WTO Agreements. For comprehensive compilation and discussion of these provisions, see WTO, 2000. An additional 27 S&DT provisions were adopted in 2003 during the 5<sup>th</sup> WTO Ministerial Conference.

### ***B. Expanding exogenous policy space***

When endogenous policy space is adequate, exogenous policy constraints that block access to desirable policy options are often identified as limiting national policy space, even when existing enabling mechanisms, such as S&DT, are taken into account. When an exogenous constraint has its origin in IFI conditionalities, lender governments should relax their loan requirements. The IFIs are now listening closely to client countries and are more open to modifying conditionalities to ensure country ownership of IFI assistance packages. When the exogenous constraint has its origin in WTO rules, existing S&DT provisions need to be re-examined and improved.

As WTO members agreed in the Doha Declaration, “concerns expressed regarding their operation in addressing specific constraints faced by developing countries, particularly least-developed countries, need to be addressed by members, and therefore all S&DT provisions should be reviewed with a view to strengthening them and making them more precise, effective and operational.”

Key areas where improved S&DT would be beneficial are: expanding the scope of non-actionable subsidies in production and export-related areas; permitting broader application of performance requirements for trade-related investment; permitting the designation of ‘special products’ – essential for economic diversification, food and livelihood security, and rural development – on which lower than average tariff reductions can be applied; and, liberalizing the use of special safeguard measures to temporarily increase tariffs to protect domestic producers from abrupt import surges of nationally sensitive goods and services. Moreover, the Doha Declaration also emphasises that current Round negotiations “shall take fully into account the special needs and interests of developing and least developed country participants, including through less than full reciprocity in reduction commitments,” setting the basis to provide additional exogenous policy space to developing countries as an integral and automatic component of the commitment process and outside of any resort to S&DT provisions that only come into effect following an application to them by developing countries under special prescribed circumstances. For their part, developing countries maintain that ongoing trade negotiations must respond substantively to the above mandates of the Doha Declaration if the Round is to reach a successful outcome (TWN, 2004).

It is important to stress that removing exogenous policy constraints does not imply developing countries will fall out of compliance with their IFI loan commitments, or call for a roll-back of WTO agreements and rules which they have accepted and seek to implement and comply with. Rather, more flexible IFI conditionalities and more effective S&DT are in fact approaches to ensure that developing countries can comply with IFI conditionalities and WTO rules. They also enhance policy coherence among IFI and WTO agreements which are, *a priori*, established upon a fundamental premise of advancing global economic development.

### ***C. Non-expansionary approaches***

In instances when the underlying situation prompting their need for greater national policy space can be resolved through actions taken by developed countries, developing countries may not require any expansion of their policy space at all. Addressing certain developing countries’ outstanding WTO implementation issues can contribute significantly to eliminating their need for additional policy space. Many of these issues, currently under negotiation, involve problems encountered as a result of developed countries’ implementation of their own commitments, or lack thereof. Among these issues are: unremitting domestic support for agriculture; growing indiscriminate use of antidumping measures to restrict imports from developing countries; the persistence of peak and escalating tariffs on goods of significant export interest to developing countries; limited commitments to open services markets of export interest to developing countries; and, failure to effectively implement existing S&DT provisions of the WTO agreements. Progress in resolving these issues could significantly reduce the scope and degree of exogenous policy space requested by developing countries through additional S&DT.



Finally, another option may be for WTO members to consider, in addition to S&DT for developing countries, special and differential commitments (SDC) for developed countries. Through SDCs, developed countries would voluntarily assume commitments to promote imports from developing countries by providing special and more favourable conditions for developing country exports on a non-, or less than full, reciprocity basis.

While SDCs would represent a new mechanism within the WTO, as noted earlier, the principle of such a mechanism is now solidly based in international law. Precedents include both the UNFCCC's principle of 'common but differentiated responsibilities' and the EU Amsterdam Convention's principle of 'flexibility' or enhanced cooperation. SDCs within the WTO would allow developed countries (or a subset of them) to make special commitments on a voluntary basis to facilitate access of developing countries to their markets by reducing not only tariff barriers, but a wide range of non-tariff barriers as well.

Because SDCs would be an integral part of WTO Agreements to which all members are parties, they would be differentiated from plurilateral agreements and extra-WTO bilateral and multilateral free trade agreements. This would allow all developing country WTO members to benefit from SDCs, rather than restricting benefits to members that are parties to separate plurilateral or extra-WTO free trade agreements. SDCs would also be distinguished from generalised systems of preferences (GSP) schemes by addressing, in addition to tariffs, a number of within-the-border issues. From a practical perspective, integrating SDCs into WTO Agreements could reduce motivations for additional North-South bilateral and regional trade agreements, and lead to a strengthened central role of the MTS within the wider international trading system.

## V. POLICY SPACE GOALS FOR THE DOHA ROUND

The strength and sustainability of the global economy depends on mutually beneficial economic partnerships between increasingly interdependent nations. These must be partnerships through which the needs and interests of all partners are served, and through which the economic welfare all partners are improved. To guide the development of such partnerships, the 2000 United Nations Millennium Development Declaration call for a ‘Global Partnership for Development’ supported by “an open, equitable, rule-based, predictable and non-discriminatory multilateral trading system”. This is precisely the type of trading system the majority of WTO members are working to strengthen through the ongoing Doha Round of trade negotiations.

The WTO Ministerial Declaration, adopted in Doha in November 2001, represents an important step forward to bring development issues to the fore in WTO negotiations. In Doha, WTO members agreed to make positive efforts designed to ensure that developing countries secure a share in the growth of world trade commensurate with the needs of their economic development, including through enhanced market access for their exports, and that negotiations shall take fully into account the special needs and interests of developing and least developed countries, including through less than full reciprocity in reduction commitments. By integrating the development dimension into multilateral trade negotiations, the Doha Round provides a unique opportunity to help build a ‘Global Partnership for Development’. But to seize this opportunity, all those engaged in negotiations need to work cooperatively to integrate members’ development needs into the agreements and provisions that will ultimately be adopted.

At UNCTAD XI in July 2004, following two and a half years of protracted Doha Round negotiations that saw little progress in achieving consensual results, developing countries argued that negotiating progress can best be achieved by responding to their need for expanded policy space (South Centre, 2004 B). By definition, trade liberalisation requires countries to reduce barriers to trade, and for trade in goods, this often implies that participants reduce tariffs. Tariff reduction is, therefore, a central element of market access negotiations on agricultural and non-agricultural goods. But this is where the problem begins.

In a world free of market distortions in which all trading partners share comparable endowments of technological, human and financial capital and possess sufficient comparative advantage in tradable goods needed to achieve balanced trade in global markets, tariff reduction, *voir* tariff elimination, benefits all. Unfortunately, the world is not so utopian, and many developing countries have learned that appropriately set tariffs remain necessary; not only achieve economic growth in an open global economy, but for many of them, to merely survive.

### A. *Protective policy space*

In the real world of unequal partners, fair trade rules are critical to ensure developing countries of their ability to protect their economies if things go wrong. This does not imply that trade liberalisation cannot proceed, but only that it must be accompanied by trade rules that allow developing countries to protect national industries when they find themselves on the wrong side of global market equilibria. As was clearly recognised almost 60 years ago by the drafters of the GATT, when sharp tariff reductions result in unmanageable import surges, sharp increases in unemployment and balance of payment difficulties, governments need to act to restore economic stability to national economies. This reality points to the need for emergency safeguards. S&DT provisions must be integrated into the Doha

Round market access negotiations on both agricultural and non-agricultural goods to provide developing countries with confidence that they will be legally empowered to sufficiently raise tariffs in times of trouble. While negotiations aimed at broad-based reductions of tariff bindings have included proposals for emergency safeguard mechanisms, expectations for their scope remain divergent. Negotiations might thus consider not only bound and applied tariff rates for all traded goods, but also a potentially new category of emergency-bindings that developing countries can maintain at levels above liberalised bound rates and resort to under negotiated conditions clearly specified in relevant S&DT safeguard provisions.

Moreover, to avoid even finding themselves on the wrong side of global market equilibria, developing countries should retain the option to selectively exclude a sizable portion of goods from broad-based tariff reductions in the first place. This is precisely the rationale behind 'special products' of national production and export interest as introduced in both agricultural and non-agricultural market access negotiations. S&DT provisions must provide developing countries to have a free hand in independently selecting a fair number of special products which they can exclude from tariff reduction. Such a provision should not trouble trading partners, because governments will logically only select as special products those goods that they have production and export capacities in, and they will certainly reduce tariffs on a wide range of goods that they seek to import more efficiently. And because there is significant production and export specialisation in the global marketplace, all participants will inevitably find significant new export destinations in liberalised markets, even after an exclusion of special products is discounted. The risk of pursuing a comprehensive and nearly all inclusive approach to tariff liberalisation, allowing few and limited special product exceptions, is that negotiations are likely to fail. Developed country *demandeurs* should recognise that such an 'all or nothing' approach holds every possibility to result in 'nothing'. As the Seattle and Cancun Ministerials have clearly demonstrated, developing countries prefer no deal to a bad deal, and they will be entirely content to return home from Hong Kong with a null result rather than one which deprives them of sufficient policy space to protect their national industries.

Liberalisation of trade in services is also a major focus of the Doha negotiations. As with goods, developing countries will seek selective liberalisation of trade in services. However, unlike market access negotiations based on the AoA and GATT, market access negotiations in services permit, *a priori*, developing countries to limit the sectoral scope of liberalisation by virtue of the flexible structure of the GATS (Gibbs, 1998). Under Article XIX of the GATS, market access and national treatment can be limited to selected service sector or sub-sector and thus permit developing countries to pursue a gradual approach to liberalisation. The GATS further provides developing countries with the option of restricting liberalisation to a limited number of sectors and modes of supply and, when providing enhanced market access available to foreign service suppliers, to attach conditions aimed at achieving development objectives such as strengthening their domestic services capacity, efficiency and competitiveness and improving their access to technology, distribution channels and information networks.

By providing developing countries with the flexibility to advance their services liberalisation in a phased and selective manner, the GATS continues to be viewed by most as a development friendly agreement. Notwithstanding this viewpoint, many remain concerned that in bilateral request and offer negotiations with developed countries that they will be pressured into opening their services markets so extensively that the viability of their nascent domestic industries may be put at risk.

Developing countries also seek a safety valve against unexpectedly high services imports surges through an emergency safeguard mechanism (ESM). Because an ESM would provide them with access to protective policy space, it would raise their confidence level to assume aggressive services liberalisation commitments. As with trade in goods, developing countries are thus clearly signalling that they are willing to engage in services liberalisation negotiations provided that the flexibilities under the GATS are respected and they are allowed to have recourse to protective policy space if things go wrong *ex post* to any services liberalisation commitments.

## ***B. Supportive policy space***

Protective policy space alone constitutes only half of developing countries' recipe for success in the global economy. In a world of unequal trading partners, fair trade rules are needed not only to provide developing countries with the ability to protect their national industries if things go wrong, but also to support their national industries so that things might go right in the first place. As all developed countries have learned, the provision of government assistance to domestic industries – particularly small and medium size enterprises (SMEs) – through public-private partnerships is crucial to ensure their competitiveness, not only in global markets, but in domestic markets as well.

The emphasis on providing government support to SMEs is important. In developed and developing countries alike, relative to large firms, SMEs face similar challenges due to their small size, lack of financial and technological capital, and limited access to information, distribution and marketing resources. In developed countries, governments provide substantial assistance to SMEs to enhance their international competitiveness (OECD, 2000). Certainly in developing countries where SMEs account for a significantly higher share of national employment and export earnings (Van Houtte, 1997) the case for government assistance is even more critical. Without it, developing countries' continued export diversification into higher added value manufactures may falter. Yet as this support is beginning to materialise in some developing countries, including through the provision of subsidies, the question arises whether developed countries will resort to trade remedies or challenge such support in the WTO as developing countries' SMEs' competitiveness increases in the future.

Clear and operational provisions permitting developing countries to provide support, including through subsidies, to their enterprises (small, medium, or large) are needed. S&DT provisions must be improved to ensure developing countries' access to sufficient policy space for industry support. Unlike S&DT provisions needed to provide developing countries with protective policy space which can be placed directly in the market access agreements currently under negotiation (e.g. on agriculture, non-agricultural goods, and services), S&DT provisions designed to provide supportive policy space will likely need to be developed in the SCM, TRIMS, and TRIPS (and potentially the Anti-Dumping) Agreements. Developing countries will thus need to continue to engage proactively in the WTO Rules negotiations and the more general S&DT negotiations underway in the Special Sessions of the WTO Committee on Trade and Development, in order to ensure that S&DT provisions resulting from the current WTO negotiations will be sufficient to guarantee access to needed supportive policy space.

## VI. CONCLUSION

Development optimising policies need to be accessible within a country's effective national policy space at appropriate points in time to stimulate and reinforce national economic development. In particular, adequate policy space is needed for developing countries to implement national policies that protect and support the development of domestic industries and greater diversification of the economy.

The growing perception that international trade and economic agreements may overly restrict national policy space options for developing countries should be more seriously considered by the international community, and additional policy space should be provided within the framework of existing multilateral commitments and obligations. As called for in the Doha Declaration, greater emphasis should be placed within the MTS on addressing specific constraints faced by developing countries through S&DT provisions by strengthening them and making them more precise, effective and operational.

WTO members should also recognise that their national policy needs and preferences differ, and to promote more open and rule-based trade, agreements could offer a balanced array of policy options for developing countries to choose from rather than imposing a single, often developed country, standard. At the same time, when negotiating new multilateral agreements, developing countries should carefully assess the policy space implications of all provisions under negotiations and refrain from accepting development-restrictive commitments. They should also demand supplementary enabling mechanisms and/or S&DT provisions permitting exceptions from restrictive disciplines based on agreed development priorities and needs.

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