Fighting for Policy Space*

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Everyone recognises that erosion of the autonomy of national policy making (or briefly put, some loss of "policy space") has been among the important effects of various processes of economic globalisation and the institutional arrangements that have accompanied them. There are broadly two schools of thought in this regard. One sees this as both a necessary and a virtuous outcome of global integration, which forces governments to do what is "ultimately best" for them and for others, notwithstanding possible short term pain. The second view not only contests the notion of one-size-fits-all policy direction, but sees this as a significant loss of sovereignty and flexibility, and unfortunate reduction of the ability of governments to identify and pursue the most appropriate mix of economic and social policies to achieve equitable and sustainable development in their own national contexts, even as they remain parts of an interdependent global economy.

However one views the process, there is often too little discussion of how the trade-offs between national requirements and multinational commitments can be managed in a productive way in the current global context. This is what makes the latest Trade and Development Report from UNCTAD ("Global governance and policy space for development", UNCTAD Geneva 2014) particularly valuable. The Report highlights important dimensions in which policy space is affected: through the regimes that govern cross-border trade and affect the possibility of industrial policies; through the effects of capital movements in the form of both financial flows and foreign direct investment; through the limitations on fiscal policy and particularly taxation that are created by international interdependence.

What is even more important for policy makers in developing countries is that this Report goes beyond an identification and description of the mechanics of loss of policy space and associated problems. It also contains a fruitful consideration of how these challenges to national autonomy can be dealt with and managed in different contexts, and provides concrete examples of how this has been done in particular cases.

An interesting historical chapter notes that this is not really a new discussion: indeed it is has been debated extensively, and from many different angles, for almost two centuries. The crises of the interwar period of the first half of the 20th century, exposed the problems of allowing opportunistic national actions and damaging contagion of markets that could lead to both a breakdown of international trade and domestic depression or stagnation. The Bretton Woods architecture that was developed in the 1940s therefore explicitly sought to support the policy goals of rising incomes, full employment and social security in the developed economies, but some also struggled to place development issues on this multilateral agenda, specifically by expanding the policy space for state-led industrialisation and ensuring more financial support for this.

The Report notes that today's developed countries as well as the more successful emerging economies did not depend solely on "market forces" for their structural transformation; rather they adopted various country-specific forms of government intervention to mitigate the destructive tendencies of market operations and to guide private agents into more socially desired forms of investment and economic activity. This was enabled by the multilateral trade regime before the WTO, which consisted of a set of negotiated and enforceable rules and commitments, but with built-in flexibilities and permissible deviations.

But the era of globalisation has brought with it a combination of more intense multilateral commitments by governments and less power to deal with other cross border flows, particularly of finance and investment. This in turn has generated both more constraints on

such government actions as well as a greater sense of powerlessness among states and civil society alike in relation to apparently invincible market forces.

Consider just some of the constraints faced by developing countries today that prevent them from using strategies that were important tools for structural transformation in the past. Subsidies were a preferred instrument for incentivising certain types of investment and production, but these are now circumscribed by the WTO's Agreement on Subsidies and Countervailing Measures (SCM). Performance requirements on foreign investors for exports, domestic content and technology transfer that were important to create linkages between foreign investors and local manufacturers, are limited by TRIMS (the Agreement on Trade-Related Investment Measures). The Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) prevents countries from encouraging reverse engineering and imitation which were critical in all previous cases of successful industrialisation.

The surprising thing is that WTO restrictions are often less onerous than those demanded by Regional Trade Agreements (RTAs) and Economic Partnership Agreements (EPAs), which have become ever more comprehensive in recent times. Similarly, Bilateral Investment Treaties and investment chapters in RTAs play at best an ambiguous role in attracting more FDI. But the lack of transparency and perceived pro-investor bias of the tribunals associated with some of these agreements has made many countries more wary about their implications.

So why are developing countries still seeking to sign such agreements that severely constrain national policy autonomy? The desire for greater market access into developed markets and the fear of exclusion when other developing countries are also signing them are potent reasons, along with the hope of becoming more attractive destinations for foreign investment.

The possibility of domestic firms becoming integrated into global value chains that reflect international production networks is undoubtedly a major instigating factor for many developing countries. But the TDR 2014 notes that this is not always a win-win situation: it runs the risk of generating adverse terms of trade effects on countries, particularly those at the lower ends of production chains, and it creates few domestic linkages and technology spillovers. Indeed, a country can even get locked into low-value-added activities, as competition drives a race to the bottom and lead firms' control over intellectual property and branding prevent them from moving up the value chain. A telling example is China, which is now a dominant producer of many electronic items. There are still very few Chinese firms that control the different parts of the electronics chain, and one recent estimate suggests that Chinese firms account for just 3 per cent of total profits in this sector.

This is not to say that nothing is possible anymore. There are still some flexibilities in tariff policy, so differences between actual and bound tariffs can be exploited to some extent to orient domestic production in certain directions. Some subsidies that promote research and development and innovation are still allowed by the WTO. In the TRIPS, compulsory licensing (whereby governments can allow companies other than the patent owner to use the rights to a patent) and parallel imports still provide some flexibilities, despite recent attempts to limit them.

Given the recent revival of interest in industrial policy in both developed and developing countries, it is worth noting that even within these constraints various measures are still possible. Developed countries like the US and developing countries like Brazil and Vietnam have shown how it is possible to use measures like sector-specific modulation of applied tariffs, preferential import duties, tax incentives, providing long-term investment financing through national development banks and using government procurement to support local suppliers to support and encourage domestic industry.

Fiscal space has clearly been hit by globalisation, which has affected the ability of governments to mobilise domestic revenues. Trade tax collections have come down because of trade liberalisation, while greater capital mobility has generated tax competition between countries, leading to reduced direct taxation. At the same time there has been more blatant use of tax havens by multinational firms and wealthy individuals. TDR 2014 contains a fascinating description of the proliferation of off-shore financial centres, tax havens and secrecy jurisdictions that enable tax avoidance or evasion of billions, if not trillions, of dollars. Further, trade mispricing, including through transfer pricing (involving cross border transactions by various constituents of multinational companies) has become the evasion mechanism of choice for many companies. In addition to this, "thin capitalisation", allows a company to mix and matches intra-group debts and interest payments across its subsidiaries to minimise tax payments and generate higher overall profits.

It is clear that the main obstacle to doing something about this at the international level is political. The report notes that the major providers of financial secrecy are to be found in some of the world's biggest and wealthiest countries, or in specific areas within these countries. In fact, offshore financial centres and the secrecy jurisdictions that host are not just small outlaws (like the frequently mentioned island states) but are fully integrated into the global financial system and responsible for handling substantial shares of global trade and capital movements, including FDI. Despite a number of recent initiatives by G20 and OECD to improve transparency and exchange of information for tax purposes, implementation has been very slow. Further, because these initiatives are mostly led by the developed economies (which are also the main homes of TNCs and some secrecy jurisdictions) the debate has not fully taken into account the needs and views of developing and transition economies.

Here too, while a multilateral approach to dealing with this is essential, there are still some steps that national governments can take. For example, "aggressive" tax schemes can be declared illegal when challenged in courts. Transfer mispricing in trade can be controlled by using reference pricing for a number of homogeneous traded goods.

In many developing countries, the financing of development could rely heavily on rents from natural resources, especially from the extractive industries. But thus far public gains from resource rents have lagged far behind their potential. This can only partly be blamed on corruption: the main reason has been overly generous royalty policies and taxation regimes that were established at a time of low prices, typically with the hope of attracting foreign investment to these sectors. But now many governments – both from developed and developing countries – have begun to revise their policies relating to the extractive industries. There have been measures like renegotiation or cancellation of existing contracts, increases in tax or royalty rates, introduction of new taxes and changes in the degree of State ownership of the extractive projects. There is no doubt that the emergence of new players (from emerging nations in particular) has also increased the bargaining power of host countries in this regard.

This means that it is now more possible to think of a comprehensive policy aimed at improving public revenues from natural resources. The right of government to review the tax regimes and ownership structures whenever deemed necessary for the economic and development interests of the country and to control transfer pricing manoeuvres and underreporting of export volumes should not be inhibited by the threat of legal retribution through existing investment dispute mechanisms. So while measures can be taken at the national level, multilateral cooperation in this area is clearly of the essence.

This suggests that there is a role for the international community that goes beyond the simple framing of development goals and targets, to providing the enabling conditions for

development in the first place. The ensuring of national policy space, including fiscal space, should clearly become prominent elements of the post-2015 development agenda.

* This article was originally published in the Frontline, Print edition: October 3, 2014.