Rethinking developmental policy space in a fragmented trade regime

Shamel Azmeh and Ken Shadlen explore the concerning rule breaking threatening the future of the multilateral trade regime.

Research has examined the role of the multilateral trade regime in limiting the abilities of developing countries to design and implement trade and industrial strategies, i.e. their "policy space". In this piece, we argue that such analyses need to be incorporated in a broader understanding of the relationship between trade governance and development, and that an exclusive focus on policy space can lead to caricaturised and apolitical versions of this relationship. These concerns, we argue, are particularly important in the context of ongoing shifts in the global economy, and the increased inclination of some of the countries that designed and promoted the multilateral trade regime, namely the United States, to ignore the set of rules that they largely wrote in the first place, threatening the future of the multilateral trade regime.

In recent decades, a common approach to analysing the relationship between the multilateral trade regime and development has been to assess "policy space," which refers to the extent to which countries retain opportunities for the autonomous design and implementation of trade (and broader economic) policies and strategies. This approach tends to feature two related contentions, the first being the importance of interventionist trade and industrial policies for late developing countries to achieve upward mobility in the global economy, and the second that that the multilateral trade regime greatly restricts developing countries' abilities to use such policies. Thus, the expansion of the multilateral trade regime in recent decades, according to some analysts, has reduced developing countries' policy space and limited their prospects of upward mobility, thereby locking in advanced economies' position at the top of the global economic order; what some scholars have referred to as "kicking away the ladder" of development.

The policy space approach remains highly influential. Many academics and activists engaging with trade policy at the World Trade Organisation (WTO) often analyse issues through this perspective, and WTO member states often cite the notion of policy space to object the expansion of multilateral rules into new areas. While not always stated explicitly, the conclusion of this perspective is that the WTO is harmful for development, and that its decline should not necessarily be an issue of concern for developing countries.

That the WTO imposes restrictions on the ability of developing countries to adopt the trade and industrial policies that they might otherwise select is undeniable (though it is important to be careful not to overstate the extent of these restrictions). The expansion of multilateral trade rules to include disciplines on countries policies with regard to intellectual property rights, foreign investment, trade in services, subsidies, and many other areas certainly limit the options that are available to developing countries' governments to intervene in economic activities and structure their countries' integration with the global economy.

Focusing exclusively on WTO policy space, however, risks ignoring the multiple ways that power asymmetries shape the global economy and affect developing countries' policy trajectories. As indicated, WTO rules unquestionably restrict the policy space of developing countries, but the decay or absence of multilateral rules does not mean that developing countries will benefit from enlarged space to implement interventionist policies of their choosing, as developed countries have myriad instruments to influence the policies and practices of smaller countries. Developed countries often use the carrot of preferential market access to their larger markets to shape the behaviour of other countries, for example. This disciplining can take place through regional and bilateral trade agreements, such as those negotiated by the European Union, the United States, or, more recently, China. As many trade negotiators acknowledge, negotiating agreements with large countries involve far more asymmetrical power relationships in comparison to multilateral negotiations. While it is true that developing countries could in principle decide to stay outside such agreements, the decision is often more difficult as concerns about trade and investment diversion, compounded by the decisions made by other countries with similar export profiles, present countries with challenging dilemmas.

Even if some developing countries decide to remain out of these bilateral/regional regimes, trade dependence on the markets of major economies could leave those countries in a more precarious and unpredictable position as the unilateral policies of major powers can have significant economic implications for the smaller economies. In these cases, the existence of a functioning multilateral regime provides developing countries with a minimum predictable baseline of their relationships with the larger economies which can allow them more leverage when navigating bilateral and regional relations with those powers. The question, thus, is not if a certain set of rules, such as those of the WTO, are “good” or “bad” for development in a hypothetical world of full autonomy and policy space, but how these rules compare with alternative, explicit or implicit, rules that could be imposed by powerful countries often through more asymmetrical processes than the multilateral trade regime.

The resurgence of industrial policy in advanced economies forces a further rethink of the policy space perspective. Under the administration of Donald Trump, for example, the US displayed open hostility to the multilateral trade regime and unabashedly adopted trade and industrial policies to protect import-competing sectors from international competition. Though the rhetoric has toned down the central thrust has continued under President Biden: a central part of the 2022 Inflation Reduction Act (IRA) is to condition economic support on the location of production. Companies can receive of tax credits when using inputs produced in the US, for example, and consumers buying electric vehicles are eligible for substantial tax credits for vehicles assembled in North America. To be sure, the US never abandoned industrial policy, actively subsidizing and shaping the trajectory of technological development and diffusion, and indeed the WTO rules were written to allow the sorts of industrial policies that are more common in wealthier countries, but policies of the sort advanced by the US in the last decade are precisely the sorts of measures that the WTO rules attempted to restrict. Traditional industrial policy is back!

Not surprisingly, these measures have generated conflicts between the United States and other advanced economies, particularly the European Union. Volkswagen for example has paused a new battery project in east Europe awaiting an EU response to the IRA after estimating that the project could receive subsidies and loans of around 10 billion Euros if moved to the US. In comments made to the US treasury in 2022, the EU argued that the IRA “contains provisions with clearly discriminatory domestic content requirements, in breach of WTO rules” and “could lead to reciprocal or retaliatory measures”. These complaints, however, alongside others by countries such as South Korea, were largely dismissed by U.S officials who argued that other countries should follow suit.

This competition, which some have called a “race to the top”, illustrate how, in a “no rules world” where all countries have full policy space and autonomy, it is precisely those at the top who have access to the power and resources needed to boost their position and to benefit economically at the expense of others. It is those same more powerful countries who are also likely to have the tools to shape the behaviour of other weaker actors. While larger developing countries might have sufficient leverage to negotiate with the large advanced economies, smaller and poorer developing countries are more likely be left exposed to the whims of the trade and economic policies of the powerful, including large developing countries. Indeed, in recent years we have seen some of the larger developing countries such as India and Brazil responding to this changing trade landscape by adopting retaliatory trade measures and by adopting export bans to promote domestic industrialisation.

While the restrictions that the WTO imposes on developing countries’ policy space should be a key area of analysing the relationship between the multilateral trade regime and development, this issue should not be examined as a stand-alone issue but as part of more nuanced analysis of development policies and how they interact with multiple layers of trade governance. While we should be critical of the asymmetrical restrictions that the multilateral trade regime places on poorer countries, we should be careful not to jump to the conclusion that the ongoing marginalisation of this regime by the advanced economies is not an issue of concern for developing countries and development processes. Moving towards a “no rules world” might liberate developing countries from multilateral policy constraints, but it might also result in a far more unpredictable and asymmetrical global trade regime. Developing countries, as a result, might find themselves in a difficult position today. As powerful countries move to ignore WTO rules and adopt industrial policies that are explicitly of the sort that are prohibited, developing countries are left to ponder the implications of the decline of this regime for their economies and if they will have to defend a regime they played little role in constructing.

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