Incentives, Capabilities, and Space

– The Evolution of World Trading System and the Future of Developing Countries

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1. Introduction

In the past two and half decades, the world trading system has gone through enormous changes, especially for developing countries. The Third World debt crisis of 1982 has put an end to the so-called Import Substitution Industrialisation (ISI) in developing countries, leading to widespread and often deep trade liberalization. In the Uruguay Round of the GATT talks started in 1986, the rich countries aimed at no less that a complete overhaul of the world trading system. Its conclusion in 1994 led not only to tariff reduction, near-abolition of quantitative restrictions, and banning of most subsidies, it has brought new areas into the arena of multilateral trade politics – especially patents and other intellectual property rights (through TRIPs), regulation of foreign investment (through TRIMs), trade in services (through GATS). Moreover, the principle of single undertaking was adopted to make it virtually impossible for developing countries to opt out of agreements that did not suit them. The GATT was upgraded to a more powerful WTO, now presiding over a much expanded territory.

Throughout this process of radical transformation of the world trading system, it has been constantly argued that the transformation has brought, and will further bring, unprecedented economic benefits to everyone. The benefits are argued to be particularly large for developing countries, as they have had higher trade barriers and thus greater potential benefits from lowering them.

Unfortunately, as I will show shortly, such benefits have not materialized. On the contrary, economic performance markedly deteriorated in most developing countries following trade liberalization the adoption of other neo-liberal policies. This makes it necessary to question the outlook that underlies the current world trading system. In this paper, I will try to do this by critically anlaysing orthodox trade theory in relation to its understanding of the roles that incentives, capabilities, and space play in determining the conduct and the outcome of international trade in developing countries

2. Free Trade Isn't Working: The Disappointing Outcomes

In the orthodox discourse, the economic "disasters" of import substitution industrialization (ISI) in the 1960s and the 1970s is used as the most compelling "proof" that developing countries need to liberalise their trade (Bhagwati, 1985, and Sachs & Warner, 1995, are the best examples).

The problem with this position is that the "bad old days" in the developing countries weren't so bad at all. During the 1960s and the 1970s, when they were pursuing the "wrong" policies of protectionism (and other state intervention), per capita income in the developing countries grew at 3.0% annually. Since the 1980s, despite (or rather because of, in my view) large-scale trade liberalization, they grew at only about half the speed seen in the 1960s and the 1970s (1.7%). Growth slowed down in the rich countries too, but the slowdown was less marked (from 3.2% to 2.1%), not least because they did not introduce neo-liberal policies to the same extent as the developing countries did.

Growth failure has been particularly noticeable in Latin America and Africa, where neo-liberal programmes were implemented more thoroughly than in Asia. In the 1960s and the 1970s, per capita income in Latin America was growing at 3.1% per year, slightly faster than the developing country average. Since the 1980s, however, when the continent embraced neo-liberalism, Latin America has been growing at less than 1/3 the rate of the "bad old days". Even if we discount the 1980s as a decade of adjustment and take it out of the equation, per capita income in the region during the 1990s grew at basically half the rate of the "bad old days" (3.1% vs. 1.7%). Between 2000 and 2005, the region has done even worse; it virtually stood still, with per capita income growing at only 0.6% per year (Weisbrot et al., 2005). As for Africa, its per capita income grew relatively slowly even in the 1960s and the 1970s (1-2% a year). But since the 1980s, the region has seen a *fall* in living standards. Between 2000 and 2003, growth has returned to the region, but at a very low rate of around 0.5% (Mkandawire, 2005, p. 9, figure 1). This means that, even if the region continues to grow at the current rate for another 15 years, its per capita income in 2020 will be still lower than it was in 1980.

The poor *growth* record of neo-liberal globalisation since the 1980s is particularly embarrassing. Accelerating growth – if necessary at the cost of increasing inequality and possibly some increase poverty – was the proclaimed goal of neo-liberal reform. We have been repeatedly told that we first have to "create more wealth" before we can distribute it more widely and that neo-liberalism was the way to do that.

The story of Mexico – poster boy of the free trade camp – is particularly telling. If any developing country can succeed with free trade, it should be Mexico. It borders on the largest market in the world (the USA) and has had a free trade agreement with it since 1995 (NAFTA). It has a large diaspora living in the USA, which can provide important informal business links. Unlike many other poorer developing countries, it has a decent pool of skilled workers, competent managers, and relatively developed physical infrastructure (roads, ports, and so on).

Free trade economists argue that free trade has benefited Mexico by accelerating growth. Indeed, following NAFTA, between 1994 and 2002, Mexico's per capita GDP grew at 1.8% per year, a big improvement over the 0.1% rate recorded between 1985 and 1995. But the decade before NAFTA was also a decade of extensive trade liberalisation for Mexico, following its conversion to neo-liberalism in the mid-1980s. So trade liberalisation was also responsible for the 0.1% growth rate. Wide-ranging trade liberalisation in the 1980s and the 1990s wiped out whole swathes of Mexican industry that had been painstakingly built up during the period of import substitution industrialisation (ISI). The result was predictably a slowdown in economic growth, lost jobs, and falls in wages (as better-paying manufacturing jobs disappeared). Its agricultural sector was also hard hit by subsidised US products, especially maize, the staple diet of most Mexicans. On top of that, NAFTA's positive impact (in terms of increasing exports to the US market) has run out of steam in the last few years. During 2001-2005, Mexico's growth performance has been miserable, with an annual growth rate of per capita income at 0.3% (or a paltry 1.7% increase in total over 5 years).[1] By contrast, during the "bad old days" of ISI (1955-82), Mexico's per capita income had grown much faster than during the NAFTA period – at an average of 3.1% per year.[2] Mexico is a particularly striking example of the failure of premature wholesale trade liberalisation, but there are other examples (for further details, see Chang, 2005).

Obviously, trade liberalisation is not the only reason for poor growth performance in the developing countries during the post-1980s period. However, at the least we can say that it has spectacularly failed to deliver their central promise of accelerated growth. Whatever the cross-section statistical studies may say on the relationship between trade openness and growth (and there are good reasons why their results may not be as robust as often thought to be – see Chang, 2005, section III.4.2 for a succinct review of this literature), there seems to be negative correlation, if anything, between trade liberalisation and growth, if we compare the record of the bad-old days of protectionism and the more recent period of freer trade.[3]

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[1] Mexican per capita income experienced a fall in 2001 (-1.8%), 2002 (-0.8%), and 2003 (-0.1%) and grew only by 2.9% in 2004, which was barely enough to bring the income back to the 2001 level. In 2005, it grew at an estimated rate of 1.6%. This means that Mexico's per capita income at the end of 2005 was 1.7% higher than it was in 2001, which translates into an annual growth rate of around 0.3% over the 2001-5 period. The 2001-2004 figures are from the relevant issues of the World Bank annual report, *World Development Report* (World Bank, Washington, D.C.). The 2005 income growth figure (3%) is from Moreno-Brid & I. Paunovic (2006), p. 47, table. The 2005 population growth rate (1.4%) is extrapolated from World Bank (2006), data for 2000-4, found in *World Development Report 2006*, p. 292, Table 1.

[2] Mexico's per capita income during 1955-82 grew at over 6%, according to J. C. Moreno-Brid et al. (2005). As Mexico's population growth rate during this period was 2.9% per annum, this gives us per capita income growth rate of around 3.1%. The population growth rate is calculated from Maddison (2001), p. 280, table C2-a.

[3] This record is supported by the fact that, when they had minimal policy space due to colonialism and "unequal treaties" (which most importantly deprived the weaker countries of their tariff autonomy), developing countries did very poorly. Between 1870 and 1913, per capita income in Asia (excluding Japan) grew at 0.4% per year while that in Africa grew at 0.6% per year. The corresponding figures were 1.3% for Western Europe and 1.8% per year for the USA. It is particularly interesting to note that the Latin American countries, which by that time had re-gained tariff autonomy and were boasting some of the highest tariffs in the world, grew as fast as the USA did during this period. Average tariffs in Latin America were between 17% (Mexico, 1870-1899) and 47% (Colombia, 1900-1913 (Clemens & Williamson, 2002). Per capita GDP growth accelerated in Latin America after the 1870s, from 0.1% during 1820-70 to 1.8% during 1870-1913, when most countries in the region acquired tariff autonomy with the expiry of the unequal treaties. The growth data are from Maddison (2001)

Free trade economists find all this quite mysterious. But when we break out of the narrow confines of orthodox trade theory and think more broadly, there is nothing mysterious about the failure of trade liberalization in the last two decades. Let me explain this point.

3. Incentives and Capabilities

3.1. Getting the Prices Right

In pushing for free – or at least freer – trade, orthodox trade theories have focused on the role of incentives. They argue that tariffs, quotas, and other restrictions on international trade means the distortion of the "true" incentives. When faced with "false" incentives, producers naturally engage in activities that should not have been undertaken – the aircraft industry in Indonesia or sugar production in Finland are two of the pet examples used in this context. When they do this, they often ended up creating "negative value-added" – or destroying value. Therefore, it is argued, trade should be liberalized so that economic agents can act under "right prices" and thus operate with maximum possible efficiency. "Get the prices right" was the simple but powerful message that has been the rallying call for the reform of the world trading system in the past two-and-half decades.

How can one argue against getting the prices "right"? The point is of course that what are the right prices is depends on who you are, what you want, and most importantly how you think the world works. Let me explain this at some lengths because this is an absolutely crucial but hardly noticed issue.

Few people in today's rich countries would consider the ban on child labour as a state intervention "artificially" restricting entry into the labour market, whereas many Third World capitalists – and indeed their own capitalists in the past – regard it as just that. Indeed, when the first legislation regulating child labour was proposed in the British Parliament in 1819, some members of the House of Lords objected to the law on the ground that "labour ought to be free" (Blaug, 1958), even though the law was an extremely mild one by the standards of our time.[4] Most factory owners and liberal economists of the time asked: the children want to work, they asked, and the factory owners want to hire them, so what was the problem? As long as children were not forced into the contract, they argued, the contract should be respected.[5] Today, even the greediest and the most hard-hearted capitalist in a rich country do not regard the ban on

[4] The law was supposed to apply only to cotton factories that were considered most hazardous and only banned the employment of children under the age of 9, while restricting the working hours of older children.

[5] The legislation was eventually passed, but it was not seriously implemented, securing only two convictions by 1825, at a time when many factories were violating the law. Only in the late 19th century was child labour law covering all industries introduced in Britain, although even then children over the age of 10 were allowed to work up to 30 hours per week. Hobsbawm (1999), pp. 635-6, footnote 47.

child labour as an unjust restriction on a free labour market because they accept that the rights of the children not to toil but to be educated have precedent over their rights to earn profit. But for someone who does not accept this premise, restrictions on child labour need to be abolished if we are to "get the prices right".

A similar argument can be made in relation to slavery. Whether slavery is justified or not all depends on your view on whether everyone should be allowed self-ownership (if you think some people shouldn't, then there is no difference between owning a slave and owning a cattle). Even if you agreed that everyone should have self-ownership, unless you object to people from transferring that ownership voluntarily, you should accept slavery (indeed this is known as the Libertarian case for voluntary slavery).

Still for another example, many free-market economists who criticise minimum wages and "excessively" high labour standards in the advanced countries as unwarranted state interventions that "artificially" set up entry barrier into the labour market do not even regard the heavy restrictions on immigration that exist in these countries as a state intervention (not to speak of supporting it). However, immigration control sets up an "artificial" entry barrier into the labour market as much as the above-mentioned "interventions" do. This contradictory attitude is possible only because these economists has an unstated assumption that the existing citizens of a country have the right to dictate the terms of the non-citizens' participation in "their" labour market.

All these examples have direct bearing on market freedom in international trade and thus the meaning of "right" prices in international trade. Free trade economists assume that world market prices are the "right" prices and therefore that removing barriers to international trade, such as tariffs and quotas, is the thing to do. But what about all those domestic regulations regarding health, consumer safety, slavery and other forms of forced labour, immigration, workplace safety, environmental standards, etc. that one's trading partners may regard – legitimately – as invisible trade barriers? To use a more concrete example what are the "right" prices , some people think China exporting things made in factories with poor working conditions is an "unfair" competition while others think this is exactly what is meant by free trade. In other words, the "freedom" in a market is in the eyes of the beholder and therefore what the "right" prices are is a political question that has no "scientific" answer. And this is even *before* we can ask whether following the world market prices will be good for a developing country in the long run – a question to which I now turn

3.2. Developing Capabilities

Even if we accept the underlying power structure and distribution of rights obligations and accept free trade prices as "right prices", the "rightness" is only for the short term. In the short run, free trade may be the best policy, as it is likely (although not guaranteed) to maximize a country's consumption possibilities. However, in the long run, countries can significantly raise their living standards only if they develop the capabilities to engage in more "difficult" activities that have higher productivity and, more importantly, have greater scope for productivity growth.

Sanjaya Lall played the pioneering role in bringing the issue of capabilities to our attention. Based on his rich empirical work on technological capabilities in developing countries, Sanjaya taught us how giving firm the “right” incentives is not enough to make them more productive because they may not have the capabilities to productively use advanced technologies that ultimately lie at the heart of higher productivity and thus higher living standards.

In the neoclassical trade theory (Heckscher-Ohlin-Samuelson), it is assumed that all firms in the world are equally capable in technological terms. The only difference between is the differences in relative factor endowments. So if Guatemala is not producing aeroplanes, it is only because aeroplanes are produced with a technology that uses too much capital (given Guatemala’s factor endowments), not because it does not have the capabilities to use the technologies that Boeing or Airbus use in producing their aeroplanes. Sanjaya’s work on technological capabilities clearly exposed the absurdity of such assumption and has made us re-think standard trade theory in a fundamental way.

The biggest problem with standard trade theory is that, as Sanjaya and many others in this conference have amply demonstrated, it is very difficult, if not totally impossible, to develop such capabilities under “right prices” – that is, under free trade conditions. Put starkly, free market prices would dictate that developing countries should stick to low-productivity activities they have comparative advantage in at the moment (e.g., agriculture, simple manufacturing). If developing countries face competition with more productive producers from richer countries before their producers accumulate enough capabilities, they are likely to see their producers being wiped out, or at best survive as a junior partner to the rich country producers. It may be OK if this happens only in a small number of industries, but if it happens across all industries, it will limit the future development prospect of the country. If the less capable producers are to have the opportunity to accumulate such capabilities, they need a period of protection from superior foreign producers through tariffs, subsidies, and other means. This is the essence of the infant industry argument, which informed the policy-makers in all the late-20th-century success stories of Japan, South Korea, Taiwan, China, India, and so on.

What is more interesting is that this line of thinking is not a late-20th invention but has been at the heart of development strategies used by virtually all of today’s rich countries (for further details, see Chang, 2002). Even more interestingly, infant industry promotion is exactly how Britain and the USA – two countries that most people think invented free trade – became top dogs.

Infant industry thinking was behind Britain’s economic ascendancy in the 18th and the early 19th century. It was first theorized by none other than the first finance minister (Secretary of Treasury) of the USA, Alexander Hamilton. Indeed, despite their pretense that they have practically invented free trade, Britain and the USA were among the most protectionist countries in the world when they were trying to catch up with more developed economies (the Low countries in the case of Britain and Britain in the case of the USA). None of the other countries among today's wealthy nations were ever as protectionist as Britain or the USA, with the brief exception of Spain in the 1930s. France, Germany, and Japan – the three countries that are usually considered to be the homes of protectionism – always had lower tariffs than Britain or the USA (until the latter two countries converted to free trade following their economic ascendancy).

France is often presented as the protectionist counterpoint to free-trade Britain. But between 1821 and 1875, especially up until the early 1860s, France had lower tariffs than Britain (Nye, 1991). Even when it became protectionist – between the 1920s and the 1950s – its average industrial tariff rate was never over 30%. The average industrial tariff rates in Britain and the USA were 50-55% at their heights. Tariffs were always relatively low in Germany. Throughout the 19th and in the early 20th century (until the First World War), the average manufacturing tariff rate in Germany was 5-15%, way below the American and the British (before the 1860s) rates of 35-50%. Even in the 1920s, when it became more protective of its industries, Germany's average industrial tariff rate stayed around 20%. The frequent equation of fascism with protectionism in free trade mythology is highly misleading in this sense. As for Japan, in the very early days of its industrial development, it actually practiced free trade. But this was not out of choice but due to a series of unequal treaties that it was forced by Western countries to sign, upon its opening in 1853. These treaties bound Japan's tariff rate below 5% until 1911. But even after it re-gained tariff autonomy and raised manufacturing tariffs, the average industrial tariff rate was only about 30%.

It was only after the Second World War, when the USA became top dog and liberalized its trade that countries like France came to look protectionist. But even then the difference was not that great. In 1962, the average industrial tariff in the USA was still 13%. With only 7% average industrial tariff rates, the Netherlands and West Germany were considerably less protectionist than the USA. Tariff rates in Belgium, Japan, Italy, Austria, and Finland were only slightly higher, ranging from 14% to 20%. France, with a tariff rate of 30% in 1959, was the one exception.[6] By the early 1970s, the USA could not claim to be the leading practitioner of free trade any more. By then, other rich countries had caught up with it economically and found themselves able to lower their industrial tariffs. In 1973, the US average industrial tariff rate was 12%, compared to Finland's 13%, Austria's 11%, and Japan's 10%. The average tariff rate of the EEC (European Economic Community) countries was considerably lower than the US rate, at only 8%.[7]

Of course, average tariff rate of course does not tell us the full story. A country may have a relatively low average tariff rate, but this could be the result of the heavy protection of certain sectors counterbalanced by very low or zero tariffs in other sectors.

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[6] The average industrial tariff rates were 14% in Belgium (1959), 18% in Japan (1962) and Italy (1959), around 20% in Austria and Finland (1962), and 30% in France (1959). See Chang (2005), Table 5.

[7] Chang (2005), Table 5. In 1973, the EEC countries included Belgium, Denmark, France, Italy, Luxemburg, the Netherlands, UK, West Germany.

For example, during the late 19th and the early 20th century, while maintaining a relatively moderate *average* industrial tariff rate (5-15%), Germany accorded strong tariff protection to strategic industries like iron and steel. During the same period, Sweden also provided high protection to its newly emerging engineering industries, although its average tariff rate was 15-20%. In the first half of the 20th century, Belgium maintained moderate levels of overall protection (around 10% average industrial tariff rate), but heavily protected key textile sectors (30-60%) and the iron industry (85%). Moreover, tariffs are only one of the many tools that a country can use to promote its infant industries. Britain and the USA may have used tariffs most aggressively, but other countries often used other means of policy intervention – for example, state-owned enterprises, subsidies, or export marketing support – more intensively.

But the upshot is that, while the exact methods used were different across countries, practically all of today's rich countries used nationalistic policies (e.g., tariffs, subsidies, restrictions on foreign trade) to promote their infant industries, though the exact mix of policies used, as well as their timing and duration, differed across countries. There were some exceptions; notably the Netherlands (which has had the best free-trade credentials since the 19th century) and Switzerland (until the First World War) consistently practiced free trade. But even they do not conform to today's neo-liberal ideal, as they did not protect patents until the early 20th century. The Netherlands introduced a patent law in 1817, but abolished it in 1869 and did not re-introduce it until 1912. The Swiss introduced their first patent law in 1888, but it protected only mechanical inventions. It introduced a full patent law only in 1907.

4. Capability Building and Policy Space

Whatever the need is for those policies that are necessary to promote capability building, it is no good if countries cannot use it. Unfortunately, the changes in the world trading system in the past 20-25 years have shrunk the "policy space" for the developing countries in which they can use these policies.

I have already mentioned the role of the structural adjustment programmes (SAPs) and the launch of the WTO in shrinking the policy space available. But in the last several years the move to reduce this space even further has been intensifying. Inside the WTO, rich countries have been pushing for a multilateral investment agreement, which will restrict the ability of developing countries to regulate foreign investment, while arguing for a drastic cut in industrial tariffs through the NAMA (non-agricultural market access) negotiations. Outside the WTO, rich countries, especially the USA, have been pushing for regional and bilateral free-trade agreements, where their member countries are supposed to adopt "WTO-plus" policies – the best example of the former is the NAFTA (North American Free Trade Agreement), which the USA is seeking to expand into the FTAA (Free Trade Agreement of the Americas).

In pushing for the reduction in policy space for developing countries, rich countries have deployed some principles that look reasonable in abstract but are highly biased against developing countries when applied to reality. Let me examine some of the key principles that govern the negotiation processes surrounding the international trading system today and expose their internal contradictions and limitations.

4.1. The "Level Playing Field"

In the push for the reduction in policy space for developing countries, the rhetoric of level playing field is usually deployed as the most important principle that justifies a drastic shrinkage in that space. The developing countries should "level the playing field", it is argued, by removing the "unfair" advantages that they are currently enjoying in their competition with the developed countries, such as higher tariffs, weaker protection of intellectual property rights, and more stringent restrictions on foreign investment.

Level playing field is like, as the Americans say, motherhood and apple pie. It is *definitionally* good that it is difficult to oppose it. But it is something that has to be opposed if we are going to build a world trading system that is truly pro-developmental.

Needless to say, level playing field is the right principle to adopt when the players are equal. However, when the players are unequal, it is the wrong principle to apply. For example, if a team of made up of my 11-year-old daughter is playing football against the Brazilian national team, it is only fair that the playing field is not level and that the girls are allowed to attack from up the hill. Of course, we don't see this kind of "tilted playing field" in real life exactly because the Brazilian national team will never be allowed to play against a team of 11-year-old girls.

Indeed, in most sports, unequal players are not even allowed to compete against each other. In boxing, wrestling, and many other sports, they have weight classes. A heavyweight boxer like Muhammad Ali would not have been allowed to box Roberto Duran, the legendary Panamanian boxer, and take away his titles, however likely his victory was.[8] In boxing, the weight classes are so narrowly defined that in lighter weight classes, the gap between classes is 2-3 lbs. We may ask why we think it is unfair for a boxer to box against another boxer who is 2-3 lbs lighter than he is but think nothing of Honduras or Mozambique being asked to compete with the USA or Switzerland on equal terms.

Weight classes are not the only thing to prevent competition on an equal footing among unequal players. In many sports, including football itself and baseball (the Little League in American baseball), there are age classes – adult teams are not allowed to play against children and juvenile teams. In sports like golf, we even have an explicit system of handicaps that allows weaker players to compete with advantages in (inverse) proportion to his playing skills. And so on.

To take the boxing analogy further, the developed countries seeking a radical tariff reduction, as they are currently doing in the NAMA negotiation, are like a

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[8] Duran is one of only four boxers in history to hold four different world titles— lightweight (1972-79), welterweight (1980), junior middleweight (1983) and middleweight (1989-90).

heavyweight boxer who sweet-talks a host of lighter boxers into fighting games with him by promising that they will be allowed to use protective gears and then suddenly turns around and accuses the others of playing foul by arguing that they have "unfair" protection. And when the heavyweight boxer insists on wearing protective gear for his abdomen (agriculture and textile?) on the ground that it is his weak part, we begin to wonder whether there is any sense of fair play in his mind. Added to this the fact that the heavyweight boxer almost single-handedly writes the rules of the game, owns the only bank in town (and may refuse to lend money to those boxers who complain about his tactics), and also controls the town newspaper (which will assassinate the characters of those boxers who speak against him), we begin to see how absurd the rhetoric of "level playing field" is in the present world trading system.

4.2. "Special and Differential Treatment" and "Less-than-full Reciprocity"

There is, naturally, some unease with the rhetoric of level playing field among the developing countries, which the developed countries cannot totally ignore. This is why we have "special and differential treatments" (SDT) in the WTO and why the developed countries in the NAMA negotiation say that they happy with "less than full reciprocity" (LTFR) from the developing countries. However, there are serious problems with these "concessions" in the forms of SDT and LTFR.

The problem with SDT is the word "special". To call something "special treatment" is to say that the person getting the treatment is getting an unfair advantage. However, in the same way we wouldn't call stair-lifts for wheelchair users or Braille writings for the blind "special treatments", we should not call the higher tariffs and other means of protection more extensively (but not exclusively) used by the developing countries "special treatments" – they are just differential treatments for countries with differential capabilities and goals.

The notion of LTFR should also be questioned. The notion implies that the developing countries will give less than will the developed countries in the NAMA deal. However, the notion of reciprocity cannot be discussed without some reference to the relative positions of the parties involved. We would not say that a poor friend is being "less than reciprocal" simply because he cannot buy champagne and caviar for his rich friend, as far as he is treating his rich friend often enough and generously enough, *given his means*. For all we know, the poor friend may have skipped three lunches to save up the money to buy pizza for his rich friend, whereas the money the rich friend spends on caviar and champagne may be, for him, some loose change that he has found in the glove compartment of his car.

Likewise, even a small cut in tariff may be a lot to ask for a developing country desperate to preserve jobs, develop industrial capabilities, and collect government revenues (for tariffs constitute the biggest source of government revenue in the poorest countries because they are the easiest tax to collect), while even a relatively large cut may not be such a big burden on countries with greater wealth and higher industrial capabilities.

So, when the tariff cuts asked from the developing countries are much larger in their impacts – due to their greater absolute magnitudes and, more importantly, to their weaker adjustment capabilities and their greater needs to use the tariffs – it is wrong to say that these countries are being less than fully reciprocal, even if they are making less cuts in proportional terms than are the developed countries (although even this is not necessarily the case[9]).

To make matters even worse, it is often not even true that the developed countries are necessarily making larger cuts in proportional terms. For example, according to the calculation by the Indian government presented in Khor & Goh (2004), the average industrial tariff of Japan will go down from 2.3% to 1.3% (EC formula) or 0.7% (US formula) and that of the USA will go down from 3.2% to 1.7% (EC formula) or 1.0% (US formula). These may be large cuts in proportional terms, but are not larger even in proportional terms than in the case of some developing countries. For instance, the Japanese or the US cuts according to the US formula will be about 70% (from 2.3% to 0.7% and from 3.2% to 1.0% respectively), whereas the cut for Indonesia will be 82% (from 35.6% to 6.3%) and that for Brazil will be 80% (from 30.8% to 6.2%).

Even when tariffs are reduced in a truly reciprocal manner, developed countries are much more adept at using NTBs, anti-dumping measures, sanitary and phyto-sanitary standards, etc., to restrict access to their markets by developing country producers. Of course, they can be, and are sometimes, taken to WTO dispute settlement panels for abusing these measures by their trading partners, but many developing countries lack the legal and intellectual resources to do so, except in the most obvious cases.

4.3. The One-Way-Street View of Flexibility

The developed countries have tried to sell certain agreements in the WTO to the developing countries on the ground that they give enough flexibility to the latter countries – mainly in the form of keeping some sectors off the agreements. So GATS is said to be flexible because it allows countries to keep some sectors off their market-opening commitments. The same notion of flexibility was bandied about in the (now-dormant) negotiation for the MIA in the run up to the Cancun ministerial meeting in 2003. In NAMA, it is said that there is some flexibility because countries can reserve some sectors from their tariff-binding and -cutting commitments, although the scopes

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[9] For example, according to the calculation by the Indian government presented in Khor & Goh (2004), the average industrial tariff of Japan will go down from 2.3% to 1.3% (EC formula) or 0.7% (US formula) and that of the USA will go down from 3.2% to 1.7% (EC formula) or 1.0% (US formula). These may be large cuts in proportional terms, but are not larger even in proportional terms than in the case of some developing countries. For instance, the Japanese cut according to the US formula will be about a 70% cut (from 2.3% to 0.7%), whereas the cut for Indonesia will be 82% (from 35.6% to 6.3%) and that for Brazil will be 80% (from 30.8% to 6.2%).

for these are supposed to be quite limited.

However, this is a very peculiar notion of flexibility. For, once a sector is liberalised, there is no going back. Indeed, the whole idea of tariff binding in the WTO is based on this notion. The exercise is based on the belief that there is a tariff rate in a sector above which the tariff should *never* rise.

If there is going to be genuine flexibility, countries should be allowed to unbind and raise their tariffs, if there is a reasonable ground for it. For example, if a country genuinely under-estimated the adjustment costs when it made a decision to cut the tariffs in particular industries – as it was in fact case with many developing countries in the Uruguay Round – it may be reasonable to allow that country to raise tariff ceilings in those industries. For another example, a country may have set low tariff ceilings in certain industries because it under-estimated the capabilities of domestic producers and did not think any infant industry protection would ever become necessary in those industries. However, it should be allowed to raise tariff ceilings if it later finds that after all there is some hope of viable domestic producers emerging with stronger tariff protections in those industries.

More importantly, it should be recognised that the developing countries, whose economic structures have to evolve a good deal before they can become rich, will need to vary the tariff rates for individual industries in the future to a far greater extent than will the developed countries. As a country climbs up the ladder of international division of labour, tariff protection needs to go down in some of the old infant industries that are now matured, while protection needs to be accorded to new emerging infant industries. If tariffs are cut and bound for each and every industry, as it is currently proposed by the developed countries in the NAMA negotiations, this kind of flexibility, which is absolutely crucial for the developing countries, will not exist (see Akyuz, 2005, for an elaboration of this point).

4.4. National Autonomy – "The Right to be Wrong"

Many free-trade economists like to present themselves as defenders of the interests of the developing countries. The World Bank, for example, in its famous *East Asian Miracle* report, warned that other developing countries should not try to emulate the interventionist trade and industrial policies of East Asia, because they do not have the administrative capabilities to make these complex policies work (World Bank, 1993 – for example, p. 26). In doing so, the Bank wants to be seen as protecting the developing countries from harming themselves by employing policies that have little chance of success. Interestingly, Adam Smith was doing the same for the Americans in his *Wealth of Nations*, when he was advising them not to protect manufacturing.[10]

Some would go even further. They would quite explicitly pitch themselves against the ignorant and often corrupt developing-country governments beholden to interest groups, in defence of the "common men", who would benefit from free trade. For example, right after the collapse of the Cancun ministerial talk of the WTO in September 2003, Willem Buiter, the then chief economist of the EBRD (European Bank for Reconstruction and Development), lamented that "although the leaders of the developing nations rule countries that are, on average, poor or very poor, it does not follow that these leaders necessarily speak on behalf of the poor and poorest in their countries. Some do; others represent corrupt and repressive elites that feed off the rents created by imposing barriers to trade and other distortions, at the expense of their poorest and most defenceless citizens" (Buiter, 2003).

Thus seen, whichever variant of the free-trade view one takes, the shrinking of policy space for developing country governments in the area of trade and industrial policies is a good thing, as it prevents the developing countries from making costly policy mistakes, whether out of misguided belief in interventionism (the World Bank version) or due to interest group politics (the Buiter version).

What is curious, however, is that that the free-trade economists who display such paternalistic attitude to the developing country policy choice are usually people who would vehemently denounce most government regulations for their underlying paternalism and argue for individual "freedom to choose". They would say that governments should not try to restrict people's freedom of choice out of fear that they may make "wrong" choices, because, after all, the ability to make mistakes and learn from them is the genuine sign of autonomy and free choice.

There is something deeply troubling about this. A consistent free-trade economist who values autonomy and choice for individuals should be willing to do the same for developing countries as independent entities – that is, unless they adopt the Libertarian view and deny the legitimacy of any collective decision. However, if they did that, they would also have to deny the legitimacy of WTO decisions, which they are not doing. If so, they cannot avoid the accusation of employing a double standard. They passionately advocate the individual's "right to be wrong", on the ground of individual autonomy, but they are not willing to respect national autonomy of the developing countries, thus denying them the same "right to be wrong".

[10] In his *Wealth of Nations*, Adam Smith wrote: "Were the Americans, either by combination or by any other sort of violence, to stop the importation of European manufactures, and, by thus giving a monopoly to such of their own countrymen as could manufacture the like goods, divert any considerable part of their capital into this employment, they would retard instead of accelerating the further increase in the value of their annual produce, and would obstruct instead of promoting the progress of their country towards real wealth and greatness" (Smith, 1776 [1973], pp. 347-8).

5. Concluding Remarks

In this paper, I have shown why the recent restructuring of the world trading system has resulted in poor results, especially for developing countries, and is likely to produce poor outcome in the future, unless there is a major rethinking on the principles that are behind the system. The importance of building productive capabilities for the purpose of long-term economic development – a notion in whose development over the past three decades Sanjaya Lall played a critical role – needs to be recognized and the system needs to provide the space in which developing countries can do that. The Orwellian use of concepts like fairness, reciprocity, flexibility, and autonomy needs to be stopped and a genuinely pro-developmental trading system put in place.

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