HOW TO CHANGE THE WTO AND GLOBAL POLICY ON TRADE AND INVESTMENT: GAINING ACCEPTANCE OF “OPEN ECONOMY INDUSTRIAL POLICY” BY HOISTING NEOLIBERALISM ON ITS OWN PETARD

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Introduction

I agree with Martin Wolf and others who say that the WTO has become the world’s most important multilateral organization. It represents a quantum leap in the regulation or “governance” of world trade and investment according to principles of free or almost free markets. It is a spearhead for the “internationalization” of the Washington Consensus on desirable economic policy for developing countries. I part company with them in thinking that, for this very reason, the WTO has become a dangerous organization for development and a more equal world.¹

My evaluation of the WTO as it is and as it might be rests on a combination of empirical evidence and an admittedly simple notion of distributive justice applied to the world economy. In this note I emphasise the empirical part and the normative conclusions about how the WTO should be changed, leaving the larger notion of distributive justice implicit.

I see my argument as a contribution to a current of ideas in the “policy community” relevant to global economic governance, a current that challenges the prevailing neoliberal policy paradigm. It does so by identifying a set of serious “problems” facing those who claim to “think for the world” (problems that the neoliberal mainstream ignores or

underplays), and by linking the problems with possible public solutions. Those solutions include ideas for a different policy agenda, portrayed in simplified terms accessible to non-specialists so as to broaden the range of participants in the challenge; and also ideas for changes in the institutional venue where authoritative decisions are made concerning, in this case, international trade and investment issues—ideas for changes in the WTO.

The evidence that the prevailing neoliberal policy agenda and its derived rules are not promoting catch-up growth of developing countries is so strong that the existing “policy monopoly” is coming under threat. The past several years have been a time when “agenda access”, to use Baumgartner and Jones’ phrase, has expanded, with new participants becoming mobilized in the debate. In this condition, major changes in policy direction and organizational architecture become possible.

In particular, there is scope for building momentum for change in the trade and investment domain by linking such change to what a recent OECD report describes as the emerging “global anti-poverty consensus”. In the past 8 years or so global poverty has suddenly shot up the agenda of global public policy, having been relegated to the side-lines in the previous two to three decades. Even the Davos World Economic Forum saw senior European leaders in 2005 declare extreme poverty to be a global problem that could no longer be ignored. Earlier, the September 2000 declaration of the United Nation’s Millenium Development Goals (MDGs) gave tangible expression of the new global mood. Of the eight goals, # 1 is “eradicating extreme poverty and hunger”. The World Bank, since the late 1990s, has institutionalized the priority to poverty reduction in its overarching strategy document for each country, the Poverty Reduction Strategy Paper (PRSP), complete with organization and resources to facilitate policy coherence, monitoring, and mutual learning. The European Union has likewise established targets and timetables for reducing poverty and social exclusion, and an organizational apparatus to link with national ones to build coherent programs.

The intellectual link between the emerging “global anti-poverty consensus” and the reform of current world trade and investment rules is this: If the “eradicating extreme poverty and hunger” goal, and the other

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the MDGs, are to be anywhere near reached by the “average” developing country (DC), DCs have to grow much faster than over past 20 years. The question is (a) how likely is this outcome under the present WTO rules of trade and investment, (b) how should the WTO be reformed to make it more likely?  

My argument is that the emerging anti-poverty consensus can be harnessed to give “agenda access” for a change in world trade and investment norms, on grounds that the current norms and rules have not proven effective in speeding up economic growth or in reducing extreme poverty in most of the world.

*The WTO and Washington Consensus regime*

The WTO and Washington Consensus regime pushes DCs to undertake “deep integration”, involving far-reaching changes in domestic political economy arrangements in an economically liberal direction—towards free markets, zero transactions costs for goods and capital crossing national borders, and western quality standards.

WTO rules disallow a range of policy instruments used successfully in East Asia—and more sporadically in Latin America—to domesticate industries developed elsewhere and to upgrade existing industries towards better practice elsewhere; and also used by earlier industrializers.

For example, TRIMS disallows: Local content requirements (LCRs); foreign exchange balancing requirements; quantitative restrictions on imports; and measures that favour domestic over foreign firms. (The requirements on foreign firms must be equal to those on domestic firms, or if anything, more favourable to foreign firms.)

The Agreement on Subsidies and Countervailing Measures (SCM) disallows: subsidies for export performance, or for buying locally-made goods.

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4 The point of referring to the “average” DC is that even some very poor Sub-saharan African countries are on track to meet a few of the goals (eg literacy), while many richer DCs are not.

5 I deal only with WTO rules. But world trade & investment rules are also shaped through bilateral and regional agreements (eg preferential trade agreements), which can be even more damaging for weak DCs. For example, the US is putting tougher-than-WTO patent rules into its PTAs, and insisting that its partners institute free capital mobility.

TRIPS is widely seen as a protectionist device for western firms, at high cost to DCs. Even staunch economic liberals like Martin Wolf and Brian Hindley, who think the WTO a very good thing, think that TRIPS is a big mistake for everyone except big pharma, software, and Hollywood. They agree that Bolivia should not devote scarce skilled manpower to instituting a “WTO/WIPO/almost US” intellectual property regime, at cost of much higher priorities for national development.

But beyond the specific WTO agreements, the operating premise of the WTO is that all countries should move rather quickly to free trade, on the assumption that the move to free trade is a powerful propulsive force for economic development. Much evidence questions this core proposition.  

_Evidence (1): Trends in world growth and inequality are not in the right direction_

Since the early 1980s the center of gravity of economic policy world-wide has moved strongly in a neoliberal or Washington Consensus direction. Looked at in the round, the anticipated improvement in performance has not occurred.

The growth of world output has fallen sharply—the rate has roughly halved—between the twenty five year periods, 1955-1979 and 1979-2004. The median growth rate in most developing country regions has been well below the median growth rate of the advanced industrial countries (ACs), with East Asia as the exception.

World income “polarization” has increased sharply (for example, income of the richest 0.1% or 1% of households relative to the median). And world income “inequality” (calculated over the whole range) has widened since around 1980 by several plausible measures; dramatically so if China is excluded.

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7 Charles Sabel argues that the kinds of policy instruments that the WTO rules out or makes actionable are not relevant to the growth of manufacturing industries in today’s DCs, because of the new production paradigm. Charles F. Sabel, “Bootstrapping Development: Rethinking the Role of Public Intervention in Promoting Growth”, paper presented at the Protestant Ethic and Spirit of Capitalism Conference, Cornell University, Ithaca, New York, October 8-10, 2004.

8 This is a contested proposition. See Wade, “Is globalization reducing poverty and inequality?”, World Development, 32, 4, 2004; and “The causes of increasing world poverty and inequality, or why the Matthew Effect prevails”, New Political Economy, April 2004.
Even if it were true that world income inequality has fallen, *absolute* income gaps (e.g., between the top 20% of world households and the bottom 80%) have widened greatly.  

As for poverty, the World Bank claims that the extreme poverty headcount—the number of people living on an income of less than $1 per day (in purchasing power parity, PPP, dollars)—fell sharply between 1981 and 2001, from 1.5 billion to 1.1 billion, or 400 million. The fall is the first fall in the poverty headcount in the past 200 years.

This is the good news. Now for the qualifications. First, the fall in the extreme poverty headcount depends entirely on China. If China is removed, the PPP$1 per day poverty headcount increased between 1981 and 2001 (though not by much). In other words, the only significant fall in extreme poverty was in China; it was not a generalized process.

Second, with the international poverty line set at PPP$2 per day, the world poverty headcount increased.

Third, the propositions so far as based on World Bank poverty numbers. But we should not take these numbers at face value. The World Bank’s international poverty line is rather arbitrary, not closely related to calorific and demographic characteristics—to what people have to consume in order to maintain basic physiological well-being. The Economic Commission for Latin America defined an extreme poverty line for Latin America based on calorific and demographic characteristics, and found the extreme poverty headcount for most countries was 2 to 3 times higher than the World Bank’s figure. Also, the World Bank’s poverty numbers are politically sensitive, which makes it plausible that their measurement is distorted. The Bank finds its performance being judged—for example, by the US Congress, by Alan Meltzer—on the basis of changes in the world poverty headcount. The judgement is quite spurious, because the Bank is too small a player to have any direct impact on the world poverty headcount. But that does not stop Bank critics from making it. It would be surprising if the Bank were exempt from the wisdom of the Chinese proverb, “Officials make the figures and the figures make the officials”; or from Goodhart’s Law,

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9 Our measures of income distribution deal only with relative incomes. So with two countries, A with average income of $2,000, B, $1,000, if A’s doubles to $4,000, income distribution between A and B remains unchanged if B’s doubles to $2,000. But the absolute gap increases from $1,000 to $2,000. The question: are the negative effects that we find associated with rising inequality of (relative) income also associated with rising absolute gaps (even if income distribution is becoming more equal)?
which states that when an indicator is used as a target its measurement will be distorted.

This and a lot of other evidence suggests that we cannot be confident that the trends in world growth, income distribution and poverty are heading in the right direction. This empirical proposition—and the normative judgement implicit in “right”—underlies my concerns about the direction of the WTO.

The evidence (2): The proposed solutions are not working

Consider two big categories of evidence on the impact of WTO/Washington Consensus policies and rules. The first relates to the two giants, China and India. To the extent that there has been improvement in overall performance indicators for the world economy, it is due mainly to the big improvement in China’s and India’s economic performance over the past one to two decades. But this improvement cannot be attributed to their adoption of the Washington Consensus policy prescriptions. On the contrary, the theory behind the Washington Consensus predicts that they would show poor economic performance, on account of their substantial deviations from it. Hence they question the Washington Consensus more than they confirm it.

Second, cross-sectional evidence on the impacts of trade liberalization. This is the core process of concern to the WTO, which receives much of its legitimation from the overarching argument that countries which liberalize trade show improved economic performance. However, the evidence suggests that “most” DCs—even as they undertook substantial trade liberalization and deep integration reforms—have not succeeded in accelerating the growth of manufactured exports; and that roughly half of developing countries de-industrialized during the 1990s (in the sense that manufacturing value-added fell as a share of GDP), including not only low income countries but also middle income countries like Brazil. Among the minority which did succeed in accelerating the growth of manufactured exports, “most” did not have an accompanying growth of manufactured value-added (a measure of upgrading) or growth of manufacturing investment.

To be more exact, in a sample of 46 DCs for the period 1989-2000, the East Asian countries stand out for being the one set which experienced fast growth of manufactured exports, upgrading of

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10 This holds in constant prices, and even more so in current prices (because the relative price of manufactures has fallen more in relation to other components of GDP).
manufactured exports, and increased investment in manufacturing. They had already attained a relatively high level of industrialization by the early 1980s; and the reforms they undertook in the 1980s and later continued a policy of gradual and selective trade liberalization as part of a long-term industrial policy.

Most of the others, mainly in Latin America and Africa, embarked on rapid structural reform in the 1980s, including uniform and across-the-board trade liberalization after decades of high and uniform protection. (“Universal” liberalization in the sense of all countries adopting the same trade liberalization formula; “across-the-board” liberalization meaning that all industries received the same--rapidly falling--level of protection.) Since the liberalizations, most of them experienced little increase in manufacturing value added or manufacturing investment. To the extent their total exports accelerated, the growth was along the vector of static comparative advantage—in natural resource based industries and the labour intensive stages of production.

In the same countries, the only industries to benefit from radical trade liberalization—benefit in the sense of upgrading—were those near maturity when the liberalization began. (They had come to maturity under selective “bad” protection.) They could respond to the increase in competition by becoming more efficient rather than going under. Aerospace in Brazil is an example. In many DCs, however, substantial trade liberalization went with de-industrialization and increased specialization in natural resource-based activities.

Mexico is a grim case in point. It has been a star pupil of the Washington Consensus ever since 1984, intensifying since it joined NAFTA in 1994 and entered into free trade agreements with other Latin American countries, the EU and Japan over the 1990s and 2000s. It has had fast growth of manufactured exports; but little growth of manufacturing value added, due to the high import content of non-oil exports; little growth of GDP; and its investment to GDP was lower in 2000 than at the start of the liberalization, with a much higher share of investment going to “unproductive” residential construction than before, a much lower share to productive investment. This is about as thorough a

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11 S. Shafaeddin, “Trade liberalization and economic reform in developing countries: structural change or de-industrialization?”, Discussion Paper 179, UNCTAD, April 2005. The 46 countries were chosen according to data availability; and they almost all met minimum criteria of industrial capacity and manufactured exports at the start of the period in 1989 (such as share of manufactured exports in total exports, share of manufacturing value-added in GDP).

failure of the Washington Consensus—and the prescriptions on which WTO rules are based—as one can get. Knowing only the performance record, a champion of the Washington Consensus and the WTO could not possibly guess that Mexico has been a star pupil for the past 20 years, no more than that China and India were not star pupils.

Why does it matter what happens to manufacturing value-added, manufacturing exports, and manufacturing diversification? Because there is robust empirical evidence that as per capita income rises, production and employment diversify. This is contrary to the neoliberal understanding that development is driven by specialization in line with comparative advantage. On the contrary, diversification dominates specialization all the way up to per capita incomes at the bottom level of the OECD.¹³ Not just diversification from agriculture to manufacturing and services, but also within manufacturing.

There are good reasons for thinking that diversification will proceed very slowly if left to “the market”, because the process of diversification of a national (or regional) production base is subject to strong “market failures” or “market inadequacies”, such as coordination externalities and information externalities.¹⁴ These market failures can justify—even within mainstream economics—an active state industrial policy to offset them and accelerate diversification. International rules should be judged against how they assist or hinder production diversification.

The WTO’s “double twist” against DCs and in favour of ACs

The “deep integration” agenda of the WTO and other international organizations (summarized earlier) has pros and cons in terms of moving DCs towards a productive capitalism.

On the pro side, it helps to discipline governments and domestic firms not to use resources in wildly uncompetitive ways; in other words, it helps the “efficiency” function of markets.

On the con side, it makes the other, “creative” function of markets more difficult, by hindering the diversification and upgrading of

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production within the national economy (or in the case of small national economies, within the regional economy).

But not only do the WTO agreements discourage industrial upgrading in (most) DCs, they encourage industrial upgrading in ACs. This “double twist” against DCs and in favour of ACs happens because, on the one hand, the kinds of policy instruments the WTO rules out are the kind needed in the context of establishing and nurturing basic industries that are already established elsewhere (eg local content requirements)--in other words, the kinds of instruments needed by DCs. On the other hand, WTO rules permit industrial policy activism of the kind needed to nurture “knowledge-intensive” industries and activities--the kinds needed by ACs.

For example, TRIMS and SCM allow a whole raft of policies needed for accelerating R&D and the commercialization of products from R&D.

SCM allows public subsidies aimed at encouraging innovation, going from innovation to commercialization, upgrading technology, financing high-tech start-ups with subsidized venture capital funds, promoting exports, subsidies to help domestic firms win public procurement contracts abroad, and to encourage end user demand for particular technologies. 15

Art. 21 of GATT allows states to exempt whole sectors on “national security” grounds. Exemption has been used to cover vigorous industrial policy in military-linked industries in US and UK. But not much use to DCs. Bangladesh won’t be developing its own nuclear-powered submarines any time soon.

What should be done?

1. The frequently made mistake today is to say that there are only two alternatives, old-fashioned import substituting industrialization (ISI) or free-market liberalism. The WTO (also World Bank et al.) should aim to encourage and advise governments on how to do the nurturing of new industries and upgrading of existing ones well, rather than simply push rules that make them do it less (on the spurious proposition that specialization in line with comparative advantage is the core process of development, which is best promoted by free trade). This requires a

change in *norms* about what governments should and should not do, as well as change at the level of policy instruments.

This is not to suppose that DCs in general should try to copy Japan’s, Korea’s, Taiwan’s developmental states, that their governments should try to “pick winners”. For one thing, the “government picking winners” is not an accurate description of East Asian industrial policy. Governments did not “command” private capitalists (or at least not most of the time), not even in Korea. They interacted closely with associations of private business firms and directly with big firms, in what Linda Weiss calls “governed interdependence”. 16 WTO norms have to change to accommodate this type of political economy.

2. WTO rules should allow for *gradual and selective trade liberalization*, on the principle that (a) liberalisation is important when an industry reaches or comes near to maturity, but (b) uniform across-the-board liberalization—which WTO rules now require—is in the general case a recipe for de-industrialization, a recipe for low and middle income countries to become trapped in the production and export of primary commodities, and simple processing or assembly operations. So this argument is in no sense “anti-trade”, in no sense against expanding market opportunities abroad. Japan, Taiwan and Korea in the post-war catch-up decades had managed trade regimes and fast growth of trade.

In short, international rules should allow policy space for both selective protection and gradual and selective liberalization, geared to the circumstances of each country and to the competitiveness of different industries within it.

The policies of gradual and selective trade liberalization have to be anchored in a larger framework of “open economy industrial policies” to accelerate diversification and upgrading towards more dynamic activities.

3. Some of the core clauses of the WTO—as distinct from the earlier GATT—should be revised. One is the notion of “Special & Differential Treatment” (SDT): it should not be limited to longer adjustment periods in order to arrive at the same end point (the same patent regime, for example), but should embrace a larger notion of “less than full

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reciprocity”, closer to the content of the GATT’s SDT clause which allowed more policy space to developing countries simply because they were less developed (in line with the principle that “equal treatment of unequals is discriminatory”). The GATT’s “infant industry” clause should also be restored. All this implies the idea of a “multi-speed” organization, for which the creation of EEC and EU provides insights.

4. Parts of the agreements coming out of the Uruguay Round (TRIMS, TRIPS, SCM, GATS, etc.) should be renegotiated so as to widen the range of industrial policy measures permitted to DCs, in the interests of faster growth and (among other things) fuller achievement of MDGs.

For example, WTO rules should allow more scope for the use of tariffs and/or subsidies to encourage local production of currently imported items, both as a way to upgrade domestic industry and to provide the foundation for export diversification.

As a specific example, TRIPS Art. 27.1 says that “a patent shall be available and patent rights enjoyable without discrimination as to … whether products are imported or locally produced.” This article should be revised to give DCs the right to discriminate against patent rights when – after an appropriate period of years – the product is not locally produced. Revising TRIPS 27.1 in this direction would help the wider change of norms towards more favourable perception of the process of import replacement.17

5. The ongoing Doha Round negotiations over Nonagricultural Market Access (NAMA) have to be redirected. If DCs accept current AC proposals for radical, universal, and across-the-board trade liberalization they will be agreeing to their own continuing underdevelopment. For example, the EU is proposing (“the Swiss formula”) an agreement that would require much steeper tariff cuts by DCs than ACs. By this formula, if an AC has a tariff of 5%, it will cut to 3.33%, a reduction of 33%. If a DC has a tariff of 60% it will cut to 8.8%, a reduction of 85%.

17 Ken Shadlen reminds me that the implications of Art. 27.1 are contested. The US has tried to insist that the pre-TRIPS norms in most countries—a foreign patent holder had to undertake “local working” in order to keep the patent—is no longer valid under TRIPS, and has brought a case against Brazil to the WTO. The Brazilians pointed out that US patent law permits the state to require local production as a condition of the patent—or can issue a compulsory license if the patent holder does not permit local production. The WTO rejected the US case and the US dropped the matter, for the time being. The main point is that TRIPS and Art. 27.1 have introduced a cloud of uncertainty over what used to be an accepted industrial policy instrument.
6. The WTO secretariat should work with the IMF and World Bank and other UN organizations to support DCs in putting together national development strategies ambitious enough and focussed enough to achieve the MDGs by 2015. WTO itself should concentrate on the national and international trade and investment measures needed to accelerate growth in DCs. It should especially concentrate on the changes needed in advanced countries’ trade and investment rules to encourage growth acceleration in DCs. WTO, having such a small (550) staff, would have to sub-contract much of this work.

Objection: WTO has a small staff because it is a member-driven organization, and it is a member-driven organization, unlike IMF & WB, for good reason: whereas they are operational organizations, the WTO simply forms and sanctions rules and settles disputes. To get buy-in to rules and arbitration, senior political leaders must be deeply involved in the negotiations.

Counter: WTO should expand its staff numbers, go from secretariat to bureaucracy, and trade ministers should have less negotiating power. This is in order, partly, to offset the huge disadvantage of most DCs when their inexperienced and understaffed trade ministers negotiate with highly experienced and massively staffed counterparts from ACs. The change would bring WTO governance closer to that of IMF/WB. The staff—meant to be “thinking for the world”—would be responsible for formulating draft agreements, and so would have more agenda-setting power. The trade ministers would have not much more negotiating authority than their ministerial counterparts in the IMF/WB.  

Counter: If the WTO is a dangerous organization, why strengthen it?

7. What might prompt AC governments to move in the directions indicated here? When do elites see an interest in more equality? A major WTO reform is not on the cards any time soon. But concerted action by groups of DCs—and development of the ideas sketched here in the policy community so as to build a countervailing consensus—has some chance of changing the direction of travel of on-going negotiations (eg NAMA) and of getting revisions to specific damaging articles (eg TRIPS Art. 27.1). The chances are higher if the Doha “Development” Round is seen to fail, while the US, EU and Japan continue to see benefit to themselves from multilateral trade and investment negotiations. Groups of DCs would then have a stronger negotiating hand.

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The question is how to increase the receptivity of authoritative people and organizations to these policy ideas. The rhetorical tactic should be to accept some neoliberal goals as extremely important—higher economic growth, reduction of gross inequality, reduction of extreme poverty; and to endorse, in particular, the recent emergence of a global anti-poverty consensus. And then to present “open economy industrial policies” as a way to better achieve the values embodied in these goals (the neoliberal route of the Washington Consensus having been tried to over 20 years and mostly failed to deliver).

It is important, rhetorically, to switch from “industrial policies” to “open economy industrial policies” (OEIPs), so that the automatic negative connotation evoked by “industrial policies” in the neoliberal world view is balanced by the automatic positive of “open economy”. (This is a variant of a rhetorical technique much used in economics, where a positive or negative connotation is built in to the terms used to describe a phenomenon, as in “price distortion” and “financial repression”.) Talk of “open economy industrial policies” suggests something new, suggests that one is not trying to resurrect (apparently) failed policies of the past—“import substituting industrialization”—but rather advancing something that builds on the legacy of the now superceded neoliberalism and helps to better achieve neoliberalism’s own values. Acceptance of OEIP principles therefore does not have to look like a defeat of neoliberalism. Enough people can claim to have won for the new-old ideas to gain acceptance. All the more so if the OEIP “solution” can be piggy-backed on the still newly powerful global consensus on the need for action on the “problem” of world poverty.

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