

Policy Space for a Capability-Centered Development Strategy for Latin America

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1. Introduction

During the last two decades Latin American countries have pursued an agenda of widespread market liberalization, commonly referred to as the Washington Consensus. These policies have left Latin American economies – with few exceptions - with a new/old comparative advantage in natural resources, a shrinking manufacturing sector, a growing informal sector, low investment ratios, slow economic growth, more unequal income distribution and rising poverty rates.

The aim of our paper is three-fold: (i) to outline key components of a new development agenda – a capability-centered development strategy - with a particular focus on industrial policies and tax policies (*section 2*); (ii) to sketch out a conceptual framework for analyzing the policy space available for implementing such an agenda and to assess the frontiers of possibilities (*section 3*); and (iii) to identify the potential constraints, external and internal, that could prevent the adequate implementation of the specific measures identified as main components of the new agenda for development (*section 4*).

We argue that the WTO has dramatically restricted the external policy space for Latin America. Bilateral agreements with the United States have further tightened the space with respect to a number of important policy instruments. Low tax ratios impose a severe limitation on the internal space for implementing a capability-centered strategy. But the willingness to use the policy space still available and to push for an expansion of its boundaries may no longer exist in countries, where importers, agro-industrialists, and foreign multinationals constitute the dominant coalition of interests.

2. A New Development Agenda for Latin America: The High Road to Development

After 20 years of neo-liberal reforms, most South American economies have returned to a comparative advantage based on primary products in agriculture and mining, while the exports of most Central American countries have come to be dominated by assembled labor-intensive products (e.g. Reinhardt and Wilson 2000). Even Chile, upheld in many contexts as Latin America's development success story, did not succeed in creating a technologically more advanced structure of production during

the 1990s (Albala-Bertrand 2006). After the lost decade of the Eighties, Latin America's GDP grew at a paltry rate of 2.6 percent between 1990 and 2002 (CEPAL 2005, 15). Such rates of growth are insufficient to address the pressing social problems in the region.

There exists a large literature which analyzes the dismal development results of Washington Consensus policies in Latin America and offers new policies for the future. Some authors blame the poor outcomes on the insufficient and incomplete application of neo-liberal reforms, and thus urge a deepening of market liberalization (e.g. Singh et al., 2005, Krueger 2004, both cited in Rodrik 2006). But critics of the Washington Consensus refute the proposition that free markets in general, and free trade policies in particular, can provide a solid foundation for development (e.g. Shafaedin 2006, Gallagher, 2005, Paus 2004, Rodrik 2001). They stress that – with rare exceptions – latecomers in the development process have caught up with some form of protectionist measures and active government intervention (e.g. Chang 2005, Rodrik 2004, Amsden 2001). And they highlight the disjuncture between the theoretical underpinnings of the neoliberal model where markets are perfect and complete and the realities in most developing countries where markets are riddled with failures and imperfections (e.g. Lall 2005, Stiglitz 1998, Arndt 1988).

Natural resource exports can make an important contribution to development, through the generation of foreign exchange and tax revenue. But they cannot form the basis for sustained development, as they generate few technological spillovers, provide little basis for a move up the value chain, and are beset by declining relative prices. These very arguments provided the rationale for import substituting industrialization (ISI) more than 50 years ago. The fact that ISI, as pursued in many Latin American countries, had deficiencies does not invalidate the arguments about the need for structural change and comparative advantage in higher value added production. Rather, a new development agenda has to be cognizant of the policy mistakes of the ISI era, especially the absence of effective reciprocal control mechanisms for industrial policies and the blind belief in the absence of government failures.

At the beginning of the 21st century, the global economic environment is dramatically different from what it was in the 1950s and 1960s, the heydays of ISI. Thanks to China's seemingly insatiable demand for primary products, commodity prices have been rising in recent years, leading to higher economic growth in many Latin American countries.¹ The commodity price boom provides a propitious context in which to adopt a new development friendly strategy in the region. But that strategy has to be informed by today's global realities which provide new opportunities and pose new challenges for Latin America.

Global capitalism in the 21st century: development challenges and opportunities

The entry of China, India, and Central Europe onto the global capitalist stage is perhaps the most significant change in today's global economy. The resulting doubling of

¹For Latin America as a whole, GDP grew 5.9 percent in 2004 and 4.3 percent in 2005 CEPAL (2005, 14).

the global labor force alters the range of possibilities for Latin America's new comparative advantages. Wages in Latin America are relatively too high for countries to compete any longer in the production of unskilled-labor-intensive commodities. And productivity is often relatively too low to compete successfully with more technologically advanced countries, including with China and India, in the production of highly skill-intensive goods and services.² As a result, Latin American countries face a twofold challenge. On one hand, China and other Asian developing countries are displacing Latin American exports in the major markets. On the other hand, Latin America's imports from these countries are displacing domestic production, which has given rise to increasing demands for trade remedy actions by domestic producers.

But China and India also offer significant potential opportunities to Latin American countries. The increasing buying power of emerging Asian economies and the resurgence and consolidation of regionalism among developing countries have led to a 'new geography of international trade' (UNCTAD 2004). Currently more than 40 percent of developing country exports are destined for other developing countries, and developing countries' share of global demand is growing steadily. Latin American countries need to generate the skill base, or more broadly the knowledge-based assets, to develop new comparative advantages higher up on the value chain to confront the challenges of the intensified international competition and to reap the benefits from new market opportunities.

The increasing fragmentation of production processes across national borders is the second distinctive characteristic of the current globalization process. It opens up new possibilities for Latin American countries to attract foreign direct investment (FDI) and reap technological spillovers, and for indigenous producers to become part of the global networks of transnational corporations (TNCs). But the growing competition for FDI in conjunction with the ongoing process of global production shifting have left developing countries less time to reap the potential benefits of foreign direct investment, raised the threshold for host country firms' participation in global value chains, and increased the pressure on indigenous companies for constant upgrading (e.g., Paus, 2005, Yusuf 2003).

The third important feature of today's global capitalism is the high cross-border mobility of financial capital. Access to the global capital market provides valuable opportunities for developing country producers to raise capital for investment purposes. But with international short-term capital transactions of well over \$ 1 trillion a day, the potential for financial volatility has increased considerably. A sudden massive capital outflow can wreak havoc with a country's macroeconomic stability. Developing countries need to find ways to reduce the likelihood of a financial and foreign exchange crisis, whether it is of their own making or the result of contagion effects from other countries.

Latin America at the crossroads

² Ten years ago, Adrian Wood (1996) was one of the first to call attention to Latin America's dilemma of being caught in the middle between countries with much lower wages on the one hand and countries with much higher productivity on the other.

In general, Latin America is not well prepared to master the challenges of globalization and take advantage of its opportunities. Of course, Latin American countries are not all alike, occupying different places on the spectrum of economic diversification, development, and exposure to short-term financial capital flows. Each country has to find new comparative advantages, and thus a sustainable basis for development, in accordance with its country-specific endowments, path dependency, and institutional characteristics. But for all countries, productivity growth and a move up the value chain provide the only shot at the high road to development. The low road of insufficient productivity growth and declining wages is not a road to development, but it is the *de facto* default option.

All indications are that Latin America is currently heading down the low road. Under the neo-liberal strategy, the productivity record of the region has been dismal (e.g. Paus 2004, IADB 2001). Labor productivity in Latin America grew at an average annual rate of 0.7 percent during the Nineties, a third less than in Asia, and only slightly higher than in Africa (IADB 2001, 12).³

An expansion of domestic technological capabilities, macro-economic stability, the requisite infrastructure improvements as well as institutions conducive to fostering these elements are important ingredients for increased productivity growth and the ongoing creation of new comparative advantages. The global competitiveness index (GCI) of the World Economic Forum presents the most far-reaching attempt to capture this multiplicity of factors into one single index. It is based on an elaborate weighting of quantitative data as well as survey results where dozens of respondents in each country assess a set of claims about their particular country ranging from '1' (low) to '7' (high).⁴ The results give us some indication of Latin America's relative competitiveness at this juncture (and of some of the reasons for its discouraging productivity performance over two decades).⁵

The Global Competitiveness Report for 2005-2006 includes 117 countries. The average GCI score for Latin America (3.5) is right between Africa (3.4) and Transition Economies (3.7), and significantly lower than in Asia (4.1). Some of the sub indices underlying the CGI highlight the key areas where Latin America is not comparing well with competitor regions, namely education, technological capabilities, and a business-enabling environment with access to loans and appropriate infrastructure (see Table 1).⁶

TABLE 1

³ During the 1980s, Latin America was the region with the lowest labor productivity growth rate in the world, negative 1.4 percent compared to 3.4 percent in Asia and .3 percent in Africa.

⁴ For the exact composition of the global competitiveness index see Porter, Schwab, and Lopez-Claros (2005, 36-42).

⁵ Given the inherent difficulty of assessing survey data across countries, the results have to be taken with the necessary grain of salt.

⁶ We thank Vidya Sampath for the elaboration of Table 1.

At a time when education and knowledge acquisition are more important than ever to achieve sustained economic growth, it is particularly grave that Latin America scores the lowest in the world regarding the quality of public education, 2.6 compared with 2.8 for Africa and 3.7 and 3.9 for Asia and Transition Economies, respectively.⁷ The poor quality assessment is matched by and partly reflective of poor quantitative indicators. In 2000, the average gross enrolment rate in secondary schools was 72 percent in Latin America, compared to 91 percent in East Asia and 95 percent in Eastern Europe (IADB 2005a, 6), with completion rates in Latin America much lower than in the other regions. One bright light for the future is that the number of students enrolled in technical subjects at the tertiary level is, comparatively speaking, quite high in several Latin American countries (UNCTAD 2005, 296).

On average, the technological abilities of Latin American firms are insufficient to confront the global challenges. The average score for ‘firm level technology absorption’ is not much different from that in Africa and Transition Economies, though considerably lower than in Asia.⁸ The fact that TNCs in Latin America source only a small percentage of their inputs in the host countries is a powerful reflection of limited domestic technological capabilities. In 2002, TNCs in Costa Rica and Mexico sourced less than three percent of their inputs domestically (Paus and Gallagher 2006, 19, 25). TNCs are also not inclined to move more R&D intensive activities to the more advanced Latin American destinations because of the “lack of a growing, highly skilled work force” (A.T. Kearny 2005, 16).⁹

Latin America also lags behind in access to information and communication technology (ICT). In 2004, fixed line access per 100 inhabitants was 17.3 for Latin America and 53.1 for the high-performing Asian economies. For internet users the respective figures were 14.4 versus 56.5, and for personal computers 8.1 versus 57.5 (IADB 2005b, 117). The low level of R&D spending in Latin America is another indicator of the region’s relative technological deficiencies. All Latin American and Caribbean countries together spend \$ 1 billion less on R&D than South Korea on its own with \$ 12 billion (IADB 2005b).

The pursuit of Washington Consensus policies with a hands-off government approach to economic development is one important reason why FDI has not provided a major impetus for the expansion of indigenous knowledge-based assets. When indigenous producers have imperfect information and face high financing costs, risk, or barriers to entry, they are not likely to compete successfully with TNCs. National and local governments ignored the importance and pervasiveness of market failures. They did not support the private sector – directly and pro-actively – in competing effectively with

⁷ The survey respondents were rank the quality of the public free schools in their country on a scale of ‘1’ (poor quality) to ‘7’ (equal to the best in the world).

⁸ Survey respondents were asked to assess the ability of companies in their country to absorb new technology, ranging from ‘1’ (not able to absorb new technology) to ‘7’ (aggressive in absorbing new technology).

⁹ See also Mortimore in this volume.

foreign investors and developing the national capabilities necessary to benefit from positive spillover effects.

Changing gears: Policies for the high road to development

The new development strategy has to be a capability-centered strategy, where the expansion of domestic knowledge-based assets is at the core of achieving comparative advantages beyond primary products and unskilled labor-intensive goods.¹⁰ Such an expansion will lead to increased investment rates and productivity growth, if the general business framework is favourable, i.e. in terms of requisite infrastructure, competitive non-traded services, competition in the markets, and pro-competitive input prices (e.g. Abugattas, 2005b).

Since market failures and inadequacies are especially prevalent in the context of the expansion of domestic technological and learning capabilities, a capability-centered strategy requires activist government policies. They have to be strategic and long-term, yet dynamic and flexible in response to changing national and global circumstances. Generally speaking, the strategy needs to delineate policies in four critical areas and specify their interactions and complementarities: (1) industrial policies that address market failures and realize positive externalities, (2) public finance policies which identify sources and agency for increased expenditures on infrastructure, education, and technological and technical training, (3) development-friendly macroeconomic policies that aim to increase stability and reduce financial volatility, and (4) pro-poor policies which pay deliberate attention to poverty reduction rather than rely exclusively on trickle-down effects. These policies have to be complemented with an environment-friendly approach which does not opt for short-term economic gains at the expense of long-term environmental degradation. Country-specific considerations will determine the exact nature of such a development plan, and the relative importance and role of each of its constituent elements. Here we offer some general considerations, which are summarized in Chart 1.

CHART 1

There are many potential reasons for the need for industrial policies. The fact that knowledge development does not happen overnight based on a blue print, but over time through learning-by-doing means that private firms will not and cannot seek out new opportunities without help that compensates for their currently higher costs. Such support, especially in the critical early learning phase, could come in the form of temporary protection or through subsidies linked to particular performance goals. If such activities are not deemed profitable in the medium-run, private sector companies will simply not invest. When the financial system is biased against affordable loans to small and medium-sized enterprises, when the capital market is underdeveloped thus making it difficult to raise venture capital or funds for long term projects, then pro-active financial

¹⁰This is not a new term. Evans (2005) emphasizes a ‘capability-centered approach.’ UNIDO entitled its 2005 Industrial Development Report *Capability Building for Catching Up*. Other authors use a different terminology; e.g. Amsden (2001) and Paus (2005) focus on the development of knowledge-based assets.

policies are needed. When information is imperfect, when there are barriers to entry in new markets, when agglomeration economies are not realized because of coordination failures in investment, when there are acute human capital and skill deficiencies in particular technological areas, then targeted policies are required to overcome these market failures.

Active public policies are also needed to overcome the time-lag that exists between the launch of basic reforms, e.g. in education and training or the creation of a national innovation system, and the achievement of the desired outcomes (Abugattas 2005b) The imperatives of the new realities of globalization deny Latin American countries the luxury to wait until such reforms deliver all their promises. There is the need to address the short term requirements of the productive sectors in order to develop knowledge-based assets providing competitive advantages and allowing countries to confront the challenges of globalization.

Industrial policies can be horizontal, i.e. available for all producers, or specific to a sector or sub-sector, i.e. restricted to particular firms or sub-sectors. Targeted intervention is justified when resources are limited (financial as well as institutional) and particular subsectors hold out the promise of particularly high development payoffs, for example, because they are technology intensive with a broad impact on the economy through spillovers and productivity growth, and face a high income elasticity of demand. With the minimization of government intervention under neo-liberalism, Latin American countries abolished many of their prior industrial policies, ranging from the drastic decline in tariff protection, to the elimination of subsidies, to a shrinking range of action of development banks, if those persisted at all. While some industrial policies persisted, e.g. the support of the automobile industry in the MERCOSUR, it was only in the second half of the 1990s that targeted policies re-emerged in some countries. Nearly all of them have been in the form of fiscal incentives and loans to sectors other than manufacturing (Peres, 2006).

A capability-centered development strategy requires increased expenditures in key areas of infrastructure, education and training, and financial incentives or grants in targeted areas. Higher expenditures can be financed through either additional tax revenues, or resources from abroad, or borrowing or debt reduction or rescheduling, or rationalizing current expenditures. The more sustainable way of increasing resources is through increasing tax revenues without compromising the competitiveness of the productive apparatus of the country.

The industrial and tax policies (as well as the policies in the other two areas not discussed here in detail) have to be articulated in the context of a long-term development plan, which guides government policies beyond the duration of any particular government. The national development plan needs to lay out priorities, quantifiable targets, time duration and agency for the achievement of different goals and institutional responsibility for the different policies.

3. Policy Space for a Capability-Centered Development Strategy: A Conceptual Framework

Policies for a capability-centered development strategy cannot be formulated in the abstract, as a utopian model for development in a political vacuum. They have to be conceptualized within the realm of possibilities, recognizing the degrees of freedom that countries effectively have to implement policies within existing international and domestic constraints. In this section, we propose a conceptual framework for analyzing the policy space available for implementing a new capability-based development strategy.

Based on Hamwey (2005) we distinguish between *external policy space* and *internal policy space*. The former is circumscribed by international agreements and global market expectations, while the latter is constricted by domestic institutional capabilities, resources, and the political economy behind a particular government's agenda. A country's *available policy space* is then confined to the intersecting set of the two policy spaces. The boundaries of the available policy space are not fixed, over time and across countries. They vary with differences in bilateral agreements and in internal constraints like the development-mindedness of a government and its willingness and ability to push the boundaries of the available policy space.

External Constraints on Policy Space

In assessing the external constraints on available policy space we consider two main dimensions: the constraints resulting from countries' adoption of internationally binding and enforceable commitments, and the effects of globalization on national sovereignty and policy options. In the first case, policy space is relinquished as an act, at least in principle, in the exercise of national sovereignty. In the second case, policy space is limited as a result of the new emerging realities of a global capitalist market and the behavior of private actors.

Binding international commitments

The results of the Uruguay Round reflect a fundamental paradigm shift. Under the General Agreement on Tariffs and Trade (GATT), developing countries had a high degree of flexibility in their choice of development strategies and policies. The special and differential treatment (S&DT) accorded to developing countries was grounded in preferential market access to developed countries' markets, flexibility in the application of disciplines, and more broadly non-reciprocal trade relations between developed and developing countries. Under the WTO, the basic objective of trade disciplines is to oblige all market participants to abide by the same rules. The "single undertaking" nature of multilateral negotiations and the adoption of common obligations for both developing and developed countries achieved such objective. S&DT is limited to transition periods which give developing countries time to comply with obligations, and to best endeavour clauses which call on developed countries to provide technical assistance to help developing countries implement their obligations.

Compared with the GATT, these obligations were expanded to deal with domestic policies beyond the border, e.g. subsidies, technical standards and sanitary rules. And the trade-related agenda was broadened to incorporate intellectual property rights (TRIPs), investment (TRIMs) and services (GATS). WTO rules were understood as embodying "sound economic policies," reinforcing and securing the Washington Consensus and providing "good governance" by constraining the possibilities for special interest groups to lobby for public policies at odds with the supposedly optimal policy mix. The substantive legitimacy of WTO rules was sought in economic welfare considerations with its claims about the welfare-enhancing effects of free trade rules.

An analysis of the constraints emerging from international commitments has to be broadened beyond the WTO agreements to incorporate the effects of the emergence of a multilayered structure of international agreements. Latin American countries, for example, are adopting commitments at different levels of integration: multilateral, regional, inter-regional, bilateral, and potentially hemispheric, if the FTAA process is brought back to life. Multi-level rule making is emerging in virtually every policy area, with the various levels in a state of constant flux. Increasingly, international agreements are covering a wider range of policy areas, many of which used to be considered the exclusive domain of domestic policies. Regional and bilateral agreements, particularly those signed between Latin American countries and the US and the EU, have incorporated areas beyond those covered by the WTO agreements, such as government procurement, investment, competition, labor rights, environment, and trade and corruption. In areas already covered by the WTO, bilateral and regional agreements tend to enshrine even deeper commitments.

The extent to which binding commitments adopted in international agreements constrain policy options depends on whether provisions are subject to voluntary acceptance, as in the case of the plurilateral agreement on government procurement in the WTO, or whether they are part of a single undertaking where countries must adopt them, as the case of government procurement provisions in the bilateral agreements. In the first case there is the possibility of retaining policy space by not entering into commitments. But once the agreement is accepted, for whatever reason, it constrains policy options. Another factor is the extent to which the agreements allow for maintaining some reservations to the general obligations, as is the case of the GATS where reservations can be inscribed in the commitments or in agreements with negative lists where parties can maintain non-conforming measures

In the context of the Doha Development Round negotiations, the issue of policy space played a prominent role in all the negotiating areas, in which a number of proposals to regain and retain policy space were on the table. The WTO Ministerial Meeting in Hong Kong in December 2005 brought perhaps the clearest admission to date that the WTO agreements might not be - by definition - development friendly. Members decided in favor of a "round for free" for LDCs, where these countries were not expected to make any new commitments in all the negotiating areas. The final outcome of the Round itself and its possible effect on policy space are uncertain, as negotiations were suspended in July 2006.

Regional agreements among Latin American countries have not significantly infringed upon the policy autonomy of participating countries, since enforcement mechanisms are limited, and flexibility has been provided by the nature of the processes in which political negotiations have played a dominant role. Regionalism has not yet been effectively integrated into the countries' national development policies. Where governments have tended to comply with their regional commitments, it has only been to the extent that those did not directly collide with national economic policies (ECLAC 2006). Nevertheless, there are some institutional differences, e.g. the strength of the dispute settlement mechanism and the efficacy of the institutional arrangements, that explain different degrees of constraints on national policies in the framework of these integration agreements among Latin American countries. Regional agreements, however, can also increase policy space for Latin American countries. For example, local content requirements, which are proscribed in some bilateral agreements, could be replaced by regional rules of origin.

Since trade agreements and bilateral investment agreements (BITs) need to account for a wide range of possible situations, they are generally crafted in vague, open-ended terms. Thus, the exact specification of implied policy constraints is often left to dispute settlement proceedings. The Dispute Settlement Body (DSB) of the WTO has played an important role in providing definitive interpretations or amending provisions of the agreements; and it is likely that the DSB will come under increasing pressure to legislate through interpretation and filling in the blanks in WTO disciplines (Barfield 2001, Bronckers 1999). BITs tend to be imprecise in many areas regarding the substantive legal standards to be applied leaving considerable discretion to panels to interpret the scope of the obligations emanating from the agreements (see the discussion of van Harten in this volume). In addition, issues arising from non-violation complaints, both in the WTO and in other agreements, can also have an effect on available policy choices (Hsu 2005).¹¹

The dispute settlements panels' discretionary interpretation of commitments in trade and investment agreements can undermine the stability of the policy space to pursue national developmental objectives.¹² In the context of multi-layered binding and enforceable commitments, potential *rule-making by adjudication* adds additional complexity in defining the needed policy space for the implementation of a capability-centered development policy.

Global market constraints

¹¹These complaints do not result from a breach of a country's obligations under the agreement, but from measures impairing other countries' rights.

¹² See for example the ruling in the gambling case brought by Antigua and Barbuda against the US in the WTO (Pauwelyn 2005; Wunch-Vincent 2005) Also, investment disputes arising from Chapter 11 of the NAFTA agreement have shown the profound effect that the interpretation of a countries' commitments can have on policy choices (IIDS 2001).

Globalization has had a significant impact on national sovereignty by limiting policy options in a number of areas. The increasing integration and concentration of production and distribution of goods and services in global value chains, and the growing use of cyberspace for conducting business transactions (e.g. financial flows and cross-border trade in services) reduce the space available for national development policies.

In today's global economy, foreign investors' actual or anticipated response to domestic development policies has emerged as a significant constraint on the policy options available to developing countries. Policy-makers are held accountable by the international markets. If a policy is not perceived as business-friendly, from the perspective of international capital and the developed countries governments, it can evoke strong negative reactions in international markets (e.g. a higher risk assessment and lower credit rating), with significant domestic repercussions.

Perceived best practices legitimate some policies and de-legitimize others. Benchmarking with standards for a 'business-friendly' environment set by policies in other countries may act as a constraint on policy options. This is of particular significance in a context in which Latin American countries are competing for FDI and other financial flows.

Finally, expanding globalization with its growing standardization of production has raised the bar for national producers to become integrated into global value chains. Increasingly, producers need to have adopted quality standards (e.g. ISO standards) before being even considered as a potential input supplier to TNCs. The growing expectation that producers meet product, environmental and labor standards established by industry itself has an important impact on policy space in that it may call for government measures to support private producers in achieving such standards.

Internal Constraints on Policy Space

Internal constraints on policy space may make it difficult for many countries to take advantage of the external space still permitted. The internal policy space is defined by the availability of resources that can be deployed to implement a development policy, by the institutional capabilities of the state to manage the instruments of such policy, and by the size of the country. These three factors define to a large extent the capacity of countries to implement development policies. That is particularly true, since the existing external constraints imposed under the international trade agreements tend to leave space mainly for policies which require government resources and institutional capabilities. But government capacity has to be matched by government willingness to implement a capability-centered development strategy, which depends on the economic interests that dominate a government's policy agenda.

The development and upgrading of infrastructure and human capital, and the implementation of different instruments of industrial policies require resources. They entail significant public investment or expenditure, and/or financial transfers or tax revenue made available to private producers. Therefore, the availability of resources to

finance a capability-centred development strategy is a key factor shaping the internal policy space. Resources can be derived from taxes on international transactions or on the domestic economy, from the appropriation of a higher share of the rent generated by natural resource-based production activities, or from financial transfers from abroad.

Institutions are a crucial factor for the development and implementation of proactive development policies (e.g., World Bank 2002, Malik 2002, Rodrik et al., 2002). Policy instruments which are permitted by international rules cannot be used in the absence of the requisite institutional capacities. The WTO subsidies agreement, for example, allows certain types of subsidies for research and development (R&D), the WTO agreement on agriculture allows support for farmers. However, the implementation of such subsidies and support measures requires domestic capacities that many developing countries may not have.

It is often argued that developing countries cannot pursue interventionist policies similar to the ones implemented by the high-performing Asian economies because they lack requisite institutional capacities (World Bank 1993). In other words, the risk of government failure is assumed to be high, since the capacity of the government machinery is low (World Bank 1994). It is ironic then that many of the analysts, who question the feasibility of industrial policies on the grounds of inexistent institutional state capacities, have high expectations that the same bureaucratic cadres will be able to manage the complex institutions and regulatory frameworks required by the second and third generations of the market-liberalizing reforms they promote.

Institutional development requires government resources, among other things. The state has to be able to compete with the private sector for skilled personnel and to undertake the required investments. The range of policy options that can be implemented to foster economic and social development can be broadened or constrained depending on existing institutional capacities.

Country size also plays a role in determining the internal policy space. Certain policy alternatives, e.g. for industrial policies and macroeconomic management, might be open for countries with large internal markets, such as Brazil and Mexico; but they may be outside the range of possibilities for medium-sized and small countries. The issue of size has been brought onto the agenda of trade negotiations at the multilateral and regional levels, where small economies have insisted on their special needs for retaining policy space to address their particular challenges.

Finally, the political economy behind a government's policy agenda is the key determinant of whether a government has any interest in using the internal policy space or in pushing for the expansion of its boundaries. Sanchez-Ancochea (in this volume) argues that even though all Central American governments enthusiastically supported and signed the CAFTA-DR agreement, differences in class dynamics explain the different degree of acceptance and implementation of the agreement across countries.

Effective Policy Space: Availability versus Utilization

The effective policy space for implementing a capability-based development strategy is defined by the intersection of the external and internal policy spaces. These policy spaces are not completely independent from each other. International commitments, for example, can have a favorable or a negative impact on the availability of resources. And greater institutional capabilities make it easier to retain or regain external policy space in the negotiation and administration of international trade agreements.

The boundaries of the external policy space are not written in stone. The paradigm shift from the GATT to the WTO is an example par excellence. But rules and disciplines can also change on a smaller scale. As the expected development gains did not materialize and the Washington Consensus started to lose legitimacy, the dynamics of multilateral negotiations during the post-Uruguay Round period have been shaped by the struggle of developing countries to retain and regain policy space. The elimination of three of the four "Singapore issues" from the WTO work program decided at the 2003 Cancun Ministerial Meeting (competition, investment, and transparency in government procurement) allowed the retention of policy space in highly sensitive areas. Developing countries have also succeeded in regaining policy space in a number of areas. The most prominent examples include (i) the amendment introduced to the TRIPs agreement allowing access to affordable drugs to developing countries suffering from epidemics, (ii) the extension of the transition periods for LDCs under the same agreement, (iii) the extension of the timeframe for eliminating export subsidies for a number of developing countries, and (iv) the granting of numerous waivers allowing developing countries to depart from obligations.

The potential for redefining the external policy space is quite different at the different layers of integration. At the multilateral level, the possibility of *coalition building* among developing countries, and also among like-minded countries including developed countries, has opened the door for attempts to increase the existing policy space with a certain degree of success. The situation is different in bilateral agreements with developed countries, like those signed between Latin American countries and the US. Power asymmetries and agreement competition among countries substantially limit the possibilities for a Latin American country to retain policy space during the negotiations or to expand the exogenous policy space once the agreement is signed (see Shadlen in this volume).

However, the fact that international commitments and market realities might leave some space for internal policy autonomy does not necessarily imply that countries will make effective use of it, even if the internal conditions allow it. A government's political will and the overall orientation of its development policies determine whether available policy space will be used and whether a government is likely to press for an expansion of that space. Thus, the utilization of the effective policy space for a capability-based development strategy depends on the existence of a development-oriented leading political coalition willing to shift gear and implement policies outside the variants of neoliberal conventional wisdom. In this context, it is important to note that other external

constraints on policy space derive from the particular nature of the relationships between a country and the international financial institutions, the IMF and the World Bank.¹³

In sum, the implementation of a capability-centered development strategy faces formidable challenges, externally and internally, at the economic and the political level. Latin American development policies need both domestic and international legitimacy requiring a complex balance between the demands and expectations of domestic stakeholders and of international markets. Synchronizing national development policies and objectives with binding and enforceable multiple-dimensional commitments in different layers of integration has become the core of statecraft for Latin American and other developing countries (Abugattas 2004). In the context of multiple and simultaneous intrusive trade agreements, Latin American countries are challenged to preserve the required policy space for a new capability-based development strategy, while reaping the benefits of effective integration into the international economy.

4. The realities of available policy space

Ultimately, an analysis of available policy space has to be undertaken at the country level. For example, among the countries that have signed bilateral agreements with the US the available policy space varies with the differentiated reservations that countries have inscribed, under the "negative list" approach, in the substantive commitments emanating from those agreements. Here we will use specific examples to illustrate how the WTO and other agreements affect the space for specific policies of a capability-centered agenda (summarized in Chart 2) and how the internal space is constricted.

CHART 2

Industrial Policies

The rationale for industrial policies derives from infant industry considerations, coordination and information externalities, strategic trade policy, promotion of productive restructuring and compensation for the time-lag between the point when structural reforms are implemented and when they come to fruition. Many analysts agree that WTO agreements limit the space for industrial policies, through the agreement on subsidies and countervailing measures, the agreement on agriculture, TRIMs, TRIPs, and the GATS (e.g. Gallagher 2005, Wade 2003, World Bank 1993). But they also concur that the agreements still allow some space for active public development policies. However, in many cases, the external policy space left is in areas which demand domestic resources and institutional capabilities that are outside the range of possibilities for many developing countries.

¹³ The international community aiming to assure countries' ownership of their development policies has made repeated calls for the enhancement of the coherence and the consistency between the international monetary, financial and trading systems in support of development (UNCTAD 2004).

In the past, protective tariff and non-tariff barriers and tariff sequencing were the most common industrial policy instruments. Today protection is no longer an option, due to market access commitments under the WTO as well as regional and sub-regional agreements. The different FTAs in Latin America have accomplished their liberalization objectives, with few exceptions. And bilateral agreements with the US incorporate significant liberalization (more than 80 per cent of total trade) when entering into force. Currently more than 85 per cent of total trade in the Western Hemisphere is tariff free. Negotiations under the WTO, based on bound tariff levels and the current liberalization proposals under consideration, might have a further significant impact on MFN liberalization (Bachetta and Bora 2003; Laird, et al 2003). Protection is now only a policy option for a small number of sensitive agricultural products.

The alternative to protection at the border is support for domestic undertakings through subsidies. The WTO agreement on subsidies and countervailing measures (ASCM) has imposed considerable constraints on industrial policy options (e.g. Ayala and Gallagher 2005). The existing rules leave a certain margin for subsidies by developing countries, and the Agreement on Agriculture also provides some policy space to support the agricultural sector through, *inter alia*, its *de minimis* provisions. In the ASCM most Latin American countries are sheltered from action by the requirement that the complainant has to demonstrate injury before taking action. Latin American countries have not used this flexibility to the extent possible, due to deliberate self-constraint. Bilateral agreements between the US and Latin American countries are silent on the question of subsidies for goods, deferring on this issue to WTO rules.

WTO rules on subsidies apply to trade in goods only. Thus there is ample policy space for Latin American countries to use these instruments in the case of services, which constitute a very dynamic segment of world trade.¹⁴ US bilateral agreements explicitly exclude subsidies from the rules on trade in services. Given the crucial role played by services in economic development and the potential they offer for Latin American countries to alter their pattern of integration into the world economy, a capability-centered development strategy should try to maximize the use of the available policy space to promote these activities.

A central element of a capability-centered development strategy is the realization of positive externalities from FDI. In this area, multilateral agreements impose drastic limitations on policy options. Under the Agreement on Trade-Related Investment Measures (TRIMs), the WTO prohibits the use of local content requirements or trade balancing measures widely used in the past. The specific commitments on market access and national treatment, which countries might voluntarily undertake on commercial presence under the General Agreement on Trade in Services (GATS), might also impose limitations on policy space.

The bilateral trade agreements with the US incorporate even stronger binding constraints on FDI-related policies. They go far beyond those incorporated in traditional

¹⁴Though rules on services are currently negotiated under the WTO, the outcome is far from certain (Abugattas 2005a).

BITs which aimed to protect investment once it had been undertaken in a country. The investment commitments in the new agreements extend a country's obligations to the pre-establishment phase assuring market access and national treatment to foreign investors (Peterson, 2004, and UNCTAD, 2000).

The proscription of any type of performance requirement on FDI significantly constrains the possibilities to foster linkages with domestic producers and to promote positive spillovers. In addition, limitations on mandated joint ventures might negatively affect the potential to promote technology transfer. Bilateral agreements with the US prohibit all performance requirements either implemented through legal mandate or as a condition for particular benefits for FDI. Market-based constraints which reflect the anticipated or actual response of foreign investors to domestic policies are of particular importance in government policies towards FDI, as the latter is increasingly footloose, with the exception of natural resource seeking investment.

Government procurement policies that grant preferences to local production over imports have been actively used to promote domestic sectors. The Government Procurement Agreement in the WTO is a plurilateral agreement to which very few Latin American countries are signatories. The bilateral agreements, on the other hand, incorporate strong rules about government procurement extending national treatment to imports. For example, under the DR-CAFTA Agreement and the US-Peru Agreement, Latin American countries have, for all practical purposes, forgone public procurement as a potential instrument of industrial policy.

The commitments on intellectual property rights (IPRs) in international agreements seriously affect the capacity of the Latin American economies to access and adapt technologies. Besides the increased cost of "knowledge" resulting from enforced IPRs (World Bank 2002), the agreements limit the capacities of the national state to implement policies facilitating the transfer of foreign technology to domestic firms. Fink and Maskus (2004) argue that developing countries may want to opt for different standards of protection of IPRs than those prevailing in countries with different technological and financial capabilities, and that TRIPs still leave some room to adjust IPR norms to domestic needs. However, that limited policy flexibility has been forgone in the bilateral agreements with the US, which have significantly deepened the commitments by Latin American countries (Roffe 2004).

International commitments do not constrain the other potential tools for implementing a capability-centered development strategy, such as, *inter alia*, coordination policies, technical assistance and information provision. However, those require adequate institutional capacities.

Fiscal Policies

Tax ratios in Latin American countries range from below 10 percent to a high of 17.5 percent in Uruguay. Such ratios do not compare too badly with other latecomers in the development process, though a few countries stand out with substantially higher rates

(see Table 2). Nonetheless, in most cases the tax ratio is still not sufficient to address the requirements of a pro-active development policy. The problem is compounded by the loss of revenues from trade, and by the burden of foreign debt servicing which compromises a significant share of fiscal revenues in many countries of the region. Furthermore, the growth of the informal sector has been eroding the tax base making it more difficult to overcome the resource constraints on internal policy space.¹⁵

TABLE 2

There are a number of reasons why the need for increased tax ratios is particularly pressing in Latin America. First, in concordance with the neo-liberal paradigm public sector investment rates declined considerably in most Latin American countries, leading to a relative deterioration or insufficient improvement in key infrastructure areas (see Table 3).

TABLE 3

Second, for a number of Latin American countries, trade taxes traditionally generated a significant share of tax revenue, which declined considerably as tariffs were reduced, shifting the tax effort to other taxes and contributions that are more difficult to enforce. Taxes on international trade as a percentage of tax revenue declined from 16.5 percent in 1990 to 7.2 percent in 2003 in Peru, from 23 percent to 4.5 percent in Costa Rica, and from 19 percent to 11 percent in Guatemala. Over the period from the early 1980s to the late 1990s, Haiti, El Salvador, Costa Rica, Chile, Trinidad and Tobago, and Panama recovered less than 70 percent of lost tariff revenue through other taxes, whereas Argentina, Bolivia, Guatemala, Ecuador, Uruguay, Barbados, Honduras, Colombia, and Peru had a recovery rate of more than 70 percent (IMF 2005, 26-27).

The IADB (2004) estimates that completion of the FTAA would imply a loss of tax revenue close to one percent of GDP for the Andean Community countries and the Central American countries, and to between 0.2 and 0.4 of GDP for MERCOSUR countries. Fernandez de Cordoba and Vanzetti (2005) estimate the loss of revenues from the MFN tariff reductions considered in the current WTO negotiations at close to \$ 11 billion for the Latin American region. For most countries of the region the estimated revenue losses exceed the expected welfare gains from trade liberalization!

Third, the Transition Economies, which have about the same average GDP p.c. as Latin American countries, are seeing a huge increase in revenues through external transfers, which puts them in a better position to promote a capability-centered development strategy. European Union policies have always reflected the belief that a true common market can only be achieved and sustained with income convergence among the member countries. To speed up the convergence process, there has been a net transfer of development funds (structural funds) from the richer member countries and

¹⁵ According to ILO data, in 2001, the informal sector in Latin America accounted for 46.3 percent of total non-agricultural employment, compared to 42.8 in 1990. Only in three out of 12 Latin American countries was the percentage below 40 percent (Chile, Mexico, and Panama). The proportion of informal employment reached 60 percent in the cases of Honduras and Peru.

regions to the poorer ones. In the case of Ireland, for example, EU structural funds amounted to 2.5 – 3.5 percent of GDP during the 1990s.¹⁶ The Cohesion Framework for 2007-2013 allows for structural funds of up to about 3 percent of GDP for the new member states, depending on their income gap relative to the EU average (Council of the European Union, 2005).

One source of increased tax revenue lies in the abolition of the differential tax treatment which many Latin American governments have accorded to domestic and foreign investors via tax preferences in export processing zones. The ‘race to the bottom’ of competitive tax breaks and subsidies to attract foreign investors makes it difficult for any one Latin American country to break out of this race. But the termination of preferential tax treatment of export activities, as mandated by the WTO, offers a real opportunity for increased tax revenue.

Higher rents on natural resource extraction offer another possibility for increasing government revenues. The case of Chile, which maintains public ownership of a significant share of copper production and recently raised the mining *regalias*, demonstrates that revenues from this source can be increased and utilized for development purposes. Bolivia, Ecuador, and Venezuela are attempting to increase state revenues from the foreign exploitation of oil and gas. But their more drastic measures have generated a negative international market response.¹⁷ The recent experience of Peru shows that even in the case of existing tax stability contracts, revenues from the exploitation of natural resources can be increased. In mid-2006, the government of Alan Garcia was able to negotiate a voluntary contribution from mining companies of around \$ 800 million dollars over five years, to be used for development projects.

Investment provisions in the bilateral trade agreements with the U.S. may well limit the potential to increase tax revenues from natural resource-based activities and foreign-owned production in other areas. Investment provisions address the issue of ‘indirect expropriation,’ by which a foreign investor has recourse to the dispute settlement mechanism if he/she considers that domestic measures are tantamount to indirect expropriation. The new formulation in DR-CAFTA and the Peru-US Agreement does not go as far as the notion of "regulatory taking" incorporated in NAFTA. But coupled with the broad definition of investment, which includes *inter alia* economic interest, it is likely to lead to future disputes where foreign investors may challenge the capacity of the states to pursue resource-enhancing policies. The recent experience of Argentina which is facing a large number of investor-state disputes attests to the possible implications of the investment provisions of the agreements (Mortimore and Stanley 2006)

¹⁶ For a detailed discussion of the development implications of EU structural funds for Ireland see Paus (2005).

¹⁷ Interestingly enough, at the same time, the House Appropriations Committee in the U.S. Congress approved a bill ordering the Interior Department to renegotiate about 1,000 leases for companies drilling in the Gulf of Mexico to reduce the benefit conferred to oil firms who are producing in publicly-owned waters without paying royalties to the government (Andrews, 2006).

In the context of the European Structural Funds we saw that financial transfers from abroad can play a significant role in providing necessary resources for implementing a pro-active developmental strategy. Financial transfers are incorporated in most of the trade agreements that the European Union negotiates with developing countries, e.g. the Euro-Mediterranean agreements, and they are on the agenda of the current negotiations with the ACP countries towards Economic Partnership Agreements (EPAs) under the Cotonou Agreement. However, financial transfers are conspicuously absent in agreements signed by the EU with Latin American, such as Mexico and Chile.

The regional integration agreements among Latin American countries have not incorporated mechanisms for transferring resources to less developed member countries to address gaps in the level of development. A rare exception is MERCOSUR's recent agreement on a very limited amount of structural funds aimed at benefiting Paraguay and Uruguay.

Development-Friendly Macroeconomic Management

Most countries in Latin America have been caught in a "stabilization trap", unable to embark on a route of sustainable growth with equity based on the transformation of the production structures of their economies. An *unfriendly macro environment* has been a crucial factor explaining the observed results in the region (French-Davis, 2005). Therefore policy discretion is needed to achieve the appropriate macroeconomic balances and basic prices that reflect the particular characteristics of the national economies and promote investments, productive diversification and improve equity (Bradford 2005) There is growing consensus that policy space should be retained to address, *inter alia*, the increasing volatility of international financial flows in order to minimize the perverse impacts on the domestic economies.

International commitments adopted in enforceable agreements can seriously undermine the policy discretion needed to assure a development friendly macroeconomic environment. There are at least three sources of constraints with respect to capital controls. The most direct constraint emerges from explicit commitments to maintain unrestricted capital flows, like the one Chile accepted in the bilateral agreement with the U.S. The extent of the commitments with respect to financial services liberalization, in particular cross-border trade in these services, imposes another limitation on policy discretion. This constraint is further aggravated by the fact that Latin American countries which have signed such agreements have committed themselves, *a priori*, to liberalize fully any new financial service that might emerge in the market, on the only condition that such service has been authorized in the country of origin. Finally, the provisions on investment incorporated in the bilateral agreements, guaranteeing unrestricted transfer of funds to investors and investments also undermine the policy space to control capital flows. By relinquishing policy space to control capital flows, countries are also compromising the possibility to manage exchange rate policies.

5. Summary and Conclusions

Two decades of neo-liberal reforms have left most Latin American countries without a basis for sustained growth and development. Countries are ill-prepared to master the challenges of globalization and take advantages of its opportunities, as limited technological capabilities and productivity growth make it impossible to move up the value chain based on free-market policies. We argue that the high road to development will not be a feasible option unless countries adopt a capability-centered development strategy, where the expansion of domestic knowledge-based assets is at the core of achieving structural change and comparative advantages in higher value-added goods and services.

Such a capability-centered strategy has to encompass proactive policies in four key areas: industrial policies, public finance policies, development-friendly macroeconomic policies, and pro-poor policies. In this paper we focused on the first two policy sets.

Policies for any development strategy have to be conceptualized within the realm of possibilities, recognizing the degrees of freedom that countries effectively have to implement policies within existing international and domestic constraints. We propose a conceptual framework for understanding the constraints on policy space, arguing that a country's available policy space is confined to the intersecting set of external and internal policy spaces. The external policy space is circumscribed by multi-layered international agreements as well as global market expectations, while the internal policy space is primarily constricted by limited domestic institutional capabilities and fiscal resources.

We argue that the fundamental change in understanding of special and differential treatment for developing countries from the GATT to the Uruguay Round has dramatically restricted the external policy space for Latin America. But bilateral agreements with the United States have tightened the space even further, with respect to a number of important policy instruments. Low tax ratios and the difficulties of raising taxes on foreign investors are imposing severe limitation on the internal space for implementing key policies of a capability-centered strategy.

However, it is critical to note that a country's available policy space is a contested space. Differences in development-mindedness of governments and in governments' willingness and ability to push the boundaries of the available space can make the policy space for Latin American countries larger or smaller. In the end, a key question will be whether governments have the political will to retain and use the available policy space left and the political will and wherewithal to regain spaces that were given up earlier.

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Table 1. Competitiveness Indicators in Comparative Perspective

Region/Country	Macro Stability Index	Public Institut. Index	Firm Level Technol. Absorption	Infra-Structure Quality	Public School Quality	Access to Loans
Africa (n=23)						
(GDP* p.c. : \$ 3,600)						
Average	4.05	3.91	4.1	3.1	2.8	2.6
Stand. Dev.	.58	.63	.6	.9	.8	.7
Asia (n=24)						
(GDP* p.c. : \$ 11,990)						
Average	4.77	4.45	4.9	4	3.7	3.5
Stand. Dev.	.66	1.06	.8	1.4	1.1	.8
Transition Economies (n=24)						
(GDP* p.c. : \$ 8,992)						
Average	4.45	4.1	4.2	3.2	3.9	3
Stand. Dev.	.47	.65	.7	.9	.9	.7
Industrialized countries (n=23)						
(GDP* p.c. : \$ 31,324)						
Average	4.81	5.82	5.4	5.7	5.4	4.5
Stand. Dev.	.45	.45	.6	0.8	.6	.6
Latin American countries (n=21)						
(GDP* p.c. : \$ 6,995)						
Average	4.25	3.9	4	3.1	2.6	2.7
Stand. Dev.	.59	.69	.6	.8	.7	.6
(GDP* p.c. : \$ 3,600)						
Argentina	4.59	3.96	4	3.6	3.2	2.1
Bolivia	3.69	3.71	3.1	2.1	2.1	2.0
Brazil	4.14	4.06	4.8	2.8	2.2	2.8
Chile	5.66	5.58	4.9	4.9	2.8	3.9
Colombia	4.61	4.55	3.9	2.9	3	2.5
Costa Rica	3.62	4.32	4.6	2.6	3.7	2.6
Dominican Republic	3.63	3.24	4.3	3.1	1.5	2.5
Ecuador	4.84	2.93	3.3	2.8	2	2.2
El Salvador	4.42	4.45	4.3	4.6	2.7	3.5
Guatemala	4.24	3.22	3.8	2.6	1.9	2.4
Guyana	3.13	3.1	3	2.2	2.8	2.3
Honduras	4.11	3.61	3.5	3	2.3	2.3
Jamaica	3.63	4.14	4.4	3.6	3	2.6
Mexico	4.76	4.03	4.2	3.5	2.8	2.6
Nicaragua	3.88	3.74	3.4	2.4	2.2	2.1
Panama	4.03	3.9	4.2	3.6	2.7	3.9
Paraguay	4.16	2.97	3	2	2	2.3
Peru	4.53	4.27	4.1	2.5	1.8	3.2
Trinidad and Tobago	5.23	3.73	4.2	3.3	3.7	3.3
Uruguay	3.85	5.19	3.7	3.8	3.9	2.2
Venezuela	4.46	3.23	4.4	3.2	2	2.6

*: PPP. 2004, Source: Calculated based on Porter et al. (2005).

Table 2. Tax Revenue as a Share of GDP

Country	Tax Revenue/GDP	Year
Latin America		
Argentina	9.4	2002
Bolivia	13.3	2003
Brazil	12.2	1998
Chile	16.2	2003
Colombia	13.9	2003
Costa Rica	13.5	2003
Dominican Rep.	15.7	2002
Guatemala	10.3	2003
Mexico	11.7	2000
Nicaragua	15.3	2003
Panama	9.3	2001
Paraguay	9.5	2003
Peru	12.9	2003
Uruguay	17.5	2001
Venezuela	11.3	2003
Africa		
Algeria	32	2002
Cote d'Ivoire	14.9	2001
South Africa	25.1	2003
Tunisia	20.6	2003
Uganda	11.8	2002
Asia		
India	9.1	2003
Indonesia	13.0	2001
Korea	15.4	2001
Malaysia	17.6	2003
Philippines	12.3	2003
Thailand	15.4	2003
Transition Economies		
Belarus	14.2	2002
Bulgaria	19	2003
Czech Republic	16.4	2003
Estonia	15.5	2001
Hungary	22.2	2003
Poland	17.4	2002
Slovenia	21.6	2003

Source: World Development Indicators. On-line. Retrieved April 2006.

Table 3. Public and Total Fixed Capital Formation (FCF) as a Share of GDP, Selected Latin American Countries

	1990	1995	2000	2001
Argentina (prices of 1993)				
Public FCF/GDP		1.5	1.1	0.7
Total FCF/GDP		20.2	15.1	10.1
Bolivia (prices of 1990)				2002
Public FCF/GDP	7.6	7.5	4.9	5.0
Total FCF/GDP	12.6	14.7	17.6	15.0
Chile (prices of 1996)				2003
Total FCF/GDP			23.2	23.4
Colombia (prices of 1994)				2003
Total FCF/GDP	16.8	22.3	12.4	17.7
Costa Rica (prices of 1991)				2003
Total FCF/GDP		20.5	20.4	22.1
Dominican Republic (prices of 1970)				2003
Total FCF/GDP		24.3	33.3	28.2
Ecuador (prices of 2000)				2003
Total FCF/GDP	23.4	25.9	20.5	23.8
El Salvador (prices of 1990)				2003
Public FCF/GDP	2.5	3.5	2.6	3.2
Total FCF/GDP	13.7	20.8	19.3	19.2
Guatemala (prices of 1958)				2003
Public FCF/GDP	2.6	2.9	2.7	2.8
Total FCF/GDP	8.4	10.4	11.4	11.2
Honduras (prices of 1978)				2003
Public FCF/GDP	5.9	8.5	5.8	5.4
Total FCF/GDP	17.0	21.1	24.3	21.0
Mexico (prices of 1993)				2002
Public FCF/GDP	4.2	3.6	3.3	3.6
Total FCF/GDP	17.0	14.6	20.9	19.4
Nicaragua (prices of 1994)				2003
Public FCF/GDP		7.7	6.2	5.5
Total FCF/GDP		20.2	26.6	24.1
Panama (prices of 1996)				2003
Public FCF/GDP			4.8	5.6
Total FCF/GDP			20.9	16.9
Paraguay (prices of 1994)				2003
Total FCF/GDP		24.2	17.7	15.7
Peru (prices of 1994)				2003
Total FCF/GDP		23.8	19.6	17.3
Uruguay (prices of 1983)				2003
Public FCF/GDP	2.8	3.4	3.6	2.2
Total FCF/GDP	10.8	14.7	13.8	8.5
Venezuela (prices of 1997)				2002
Total FCF/GDP			23.8	23.5

Source: CEPAL (2004).

Chart 1. A Capability-Centered Development Strategy

Policy Set	Rationale	Policy Tools
A. Industrial Policies Horizontal or sector/sub-sector-specific	Address market failures, realize positive externalities, infant industry considerations	Protection
		Subsidies (grants and fiscal expenditures)
		Performance requirements
		Government Procurement policies
		Coordination policies (match-making)
		Cluster formation
		Linkage formation
		Technology transfer mechanisms and assistance
		Information provision
		Financing mechanisms
B. Public finance policies	Need for creating "fiscal space" for, <i>inter alia</i> : improvements in education, infrastructure, technological learning complex, support for private sector	Tax policies Tapping natural resource rents Borrowing (foreign and domestic) Management of foreign debt (reduction or rescheduling)
		Public investment
		Public-private partnerships
C. Development-friendly macro-policies	Increase macroeconomic stability, and setting basic prices right for development	Control over short-term capital flows Interest rate policies Exchange rate management
D. Pro-poor policies	Need to supplement market outcomes	Targeted interventions

Chart 2. External Constraints on Policies for a Capability-Centered Strategy

Policy Tool that might be affected	GATT	WTO Agreements	NAFTA-Type Bilateral Agreements
Industrial Policies			
<ul style="list-style-type: none"> • Protection 	Bound Tariffs	Bound Tariff	Dismantling of applied tariffs
<ul style="list-style-type: none"> • Subsidies 	Plurilateral Agreement	Agreement on Subsidies y Countervailing Measures	No covered
<ul style="list-style-type: none"> • Performance requirements 	Not Covered	TRIMS Agreement	Investment provisions: prohibition
<ul style="list-style-type: none"> • Government procurement 	Plurilateral Agreement	Plurilateral Agreement	Commitments on market access and national treatment
<ul style="list-style-type: none"> • Technology transfer 	Not covered	TRIPS Agreement	TRIPs plus provisions
Public Finance policies	No significant impact	No significant impact	<ul style="list-style-type: none"> • Tariff revenue loss • Potential Constraints in tapping natural resource rents and increasing tax burden on FDI (Investment provisions)
Development-friendly macroeconomic policies	No impact	GATS provisions on payments and transfers, commitments on financial services liberalization	Commitments on opening capital account Commitments on payments and transfers Financial services wide liberalization
Pro-poor policies	No effect	No effect	No direct effect