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Chapter III

POLICY SPACE AND GLOBAL GOVERNANCE: ISSUES AT STAKE

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The discussions now under way on a post-2015 development agenda are aiming for an ambitious narrative that goes beyond "business as usual" to establish a more universal, transformative and sustainable approach than the one advanced through the Millennium Development Goals (MDGs) (United Nations, 2012). As such, it will play a key role in setting new goals and targets for policymakers, both at the national and international levels. The 17 goals (and related targets) agreed to at the United Nations Open Working Group on Sustainable Development point to a level of ambition and complexity well beyond the MDGs (United Nations, 2014). The international community faces three principal challenges in fashioning this new approach.

The first challenge is aligning goals and targets to a policy paradigm that can help raise productivity and per capita incomes everywhere, generate decent jobs on a scale needed to meet a rapidly growing and urbanizing global labour force, establish a stable international financial system that boosts productive investment, and deliver reliable public services that leave no one behind, particularly in the most vulnerable communities. The economic paradigm of market liberalism that has been in the ascendency for the past three decades has disappointed in most of these respects (UNCTAD, 2011; Caritas in Veritate Foundation, 2014).

The second challenge facing any new development agenda is the massive rise in inequality, which has accompanied the spread of market liberalism. This is important because, in addition to ethical considerations, and unlike the simple textbook trade-off between growth and equality, growing inequality can threaten economic progress and social stability, and undermine political cohesion (*TDR*s *1997* and *2012*; Wilkinson and Pickett, 2009; Piketty, 2014). The rising income share (and political influence) of the top one per cent has already helped revive this discussion; and figures such as the wealth of the 85 wealthiest individuals surpassing that of the bottom half of the world's population provide the desired shock effect. But for a full understanding of the recent rise of inequality, it is necessary to look more carefully at functional income dynamics and, in particular, at the divergence between wage and productivity growth, the imperatives of shareholder value and executive compensation in shaping corporate behaviour, and the regressive turn in taxation. Greater capital mobility has made it harder to tax some, often the largest, firms. In addition, it has reduced the bargaining power of labour and increased the State's reliance on regressive taxes and bond markets, and further amplified the adverse distributive impact of unregulated financial activity. A growing body of research has begun to tie the scale of the recent crisis to these inequalities, pointing to their skewed impact on the composition of demand and their links to an increasingly fragile, debt-driven growth model (Kumhof and Rancière, 2010; Stiglitz, 2012; Mian and Sufi, 2014).

The third challenge is to ensure that effective policy instruments, and the space to use them, are available to countries to enable them to achieve the agreed goals and advance the development agenda. This is very much the focus of this *Report*. The appeal but also the weaknesses of the MDGs[1] stem, in part, from their singular emphasis on clearly defined social outcomes, while giving virtually no consideration to either economic outcomes or the policy instruments required for achieving any of the set goals at the national and international levels. Only MDG 8 on a global partnership for development allowed for a discussion of those policy instruments, but it has proved much weaker and less specific than any of the other goals (UNCTAD, 2013).[2]

Addressing these three challenges would be a formidable task even under ideal circumstances, but it is all the more daunting now because of changes to the global economic environment resulting from the financial crisis in 2008–2009. Initial efforts to meet the MDGs took place in a generally supportive external economic environment: not only were aid flows growing, but there was also strong market demand in both developed and emerging economies, commodity prices were rising and access to external capital proved easier than before for many developing countries. These factors have contributed to strong growth across the developing world since 2002, where growth rates have been consistently higher than those in the developed world.

These trends were interpreted as part of a new era for the world economy, combining a "great moderation" in macroeconomic circumstances with a "great convergence" in global incomes, with expectations for sustained future growth linked to the rapid emergence of a "global middle class". Concomitantly, calls for stronger global governance of an increasingly interconnected world economy, diminished. For a time, it also encouraged a belief that growth in the poorer countries had decoupled from trends in the developed world (Canuto, 2012). However, recent events suggest that this is a premature conclusion (Akyüz, 2013).

The new development agenda is likely to face a harsher external environment in the years ahead. Some of the potential difficulties are outlined in chapter II of this *Report*, and they confirm the prolonged and fragile nature of the post-crisis recovery, particularly if a "business-as-usual" macroeconomic scenario continues. The financial crisis also revealed a set of persistent and highly interrelated economic and social imbalances that will inevitably have a strong bearing on efforts to design new development strategies aimed at tackling issues relating to a growing urban-rural divide, formal and informal livelihoods, access to affordable energy sources that minimize environmental damage, and food and water security. These will need to be resolved by both developed and developing countries if a more inclusive and sustainable global economy is to be achieved by 2030.

Rebalancing on these many fronts will require an integrated policy framework encompassing more viable and inclusive national development strategies, along with changes in the governance of the global economic system to accommodate and support them. If progress on social and economic goals is not underpinned by effective national strategies for sustainable and inclusive development, or if the global economy is incompatible with such strategies, progress towards achieving more ambitious development goals will, in all likelihood, be frustrated. Last year's *Trade and Development Report* argued that mobilizing greater domestic resources and building markets at the national and regional levels were likely to be key to sustained growth in many developing countries in the years ahead. Maximizing the contribution of national resources for achieving the economic and social goals envisaged in the post-2015 agenda will certainly require a more assertive macroeconomic policy agenda. Such an agenda would need to include the use of a broad array of fiscal, financial and regulatory instruments in support of capital accumulation, proactive labour market and incomes policies to generate more decent jobs, and effective control of the capital account to limit potential damage from external shocks and crises. But economic sustainability will also require diversification and upgrading of the productive structures and capabilities from which wealth is created and distributed (Salazar-Xirinaches et al., 2014). Building more competitive firms, moving resources into higher value-added sectors and strengthening national technological capabilities cannot rely on market forces alone; effective industrial policies and dedicated efforts to support and coordinate private- and public-sector activities will also be crucial.

Any such broadening and strengthening of national development strategies will need to be accompanied by institutional changes. Markets are rarely "free", and never operate in isolation; they require a framework of rules, restraints and norms to operate effectively (Polanyi, 1944). As such, the market economy is always embedded in a wider legal, social and cultural setting, and is sustained by a panoply of political forces. The search for profits by private firms implies that individual businesses are constantly testing the limits of these wider rules and restraints, and mobilizing for changes that give them more space to undertake that search, such as exerting pressure to reduce what they see as the "burden" of red tape, "excessive" taxes, the "strictures" of banking and accounting rules, the "biases" in labour and consumer laws, and the "constraints" on moving money in and out of a country. Most governments understand that the profit motive brings benefits but also entails costs. Accordingly, they strive to seek a balance between corporate interests and those of their other constituencies. How and to what extent the framework of rules and regulations for markets to operate is strengthened or weakened is part of a complex political process specific to each society, but it cannot be entirely dispensed with without threatening a breakdown of the wider economic and social order. A basic and dangerous flaw in market fundamentalism, as recently argued by Mark Carney, Governor of the Bank of England, is its denial of these complexities in the design and implementation of economic policies (Carney, 2014).

Historically, the evolution of today's successful economies has, above all, been marked by what has been described as "adaptive efficiency" (North, 2005); that is, the capacity to develop institutions that provide a stable framework for economic activity, but which are also flexible enough to provide the maximum leeway for the adoption and tailoring of strategies and choices to meet the specific challenges of a given time and situation. In the particular case of State institutions, the notion of adaptive efficiency implies that policymakers must have the requisite space to articulate priorities, choose their preferred policy instruments and implement what they consider to be the most appropriate policy mix. Some time ago, the eminent Dutch economist, Jan Tinbergen, established that for the mix to work at an aggregate level there have to be at least as many policy instruments as there are goals. If a programme includes more goals than instruments, at least one goal will not be met; whereas if it contains more instruments than goals, there will be more than one way of achieving the combination of goals.

Arguably, and as is certainly the case with most development strategies where a variety of microeconomic, macroeconomic, structural and strategic goals are pursued simultaneously, maximizing the number of instruments would seem to be the sensible option. However, simply reducing the issue of policy space to the number of instruments and goals is not sufficient for an understanding of the complexities involved. Different instruments are likely to have different degrees of effectiveness in meeting a particular goal; but also, because goals are interdependent, a particular instrument can potentially influence many goals at the same time, and not always in the expected or desired direction. Moreover, the distinction between goals and instruments is neither entirely unambiguous nor obvious. What is a target for one set of policymakers (or in one set of circumstances) may well be an instrument for another set of policymakers (or in another set of circumstances).

Policy space essentially refers to the freedom and ability of a government to identify and pursue the most appropriate mix of economic and social policies to achieve equitable and sustainable development that is best suited to its particular national context. It can be defined as the combination of de jure policy sovereignty, which is the formal authority of national policymakers over policy goals and instruments, and de facto national policy control, which involves the ability of national policymakers to set priorities, influence specific targets, and weigh possible trade-offs (Mayer, 2008). Both are affected by the external environment, albeit in different ways, and there is well-recognized tension between the consequences of external economic integration and national policy flexibility (Panic, 1995).

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Restoring a development model that favours the real economy – and the constituencies that depend on it for their livelihoods and security – over financial interests, will almost certainly require adding more instruments to the policy toolkit than is currently contemplated by economic orthodoxy. However, broadening development strategies in this way must still recognize the contingent and uncertain effects of particular policy instruments, as well as the potential trade-offs and adjustment costs of choosing one set of policies over another. Typically, policy goals are rarely of the "either-or" type (e.g. employment or inflation, open or closed economies, State or private ownership, fixed or flexible exchange rates), but of various shades in-between. This would already suggest that learning to mix objectives and instruments is an unavoidable component of policymaking, and that experimentation becomes all the more important, given that there are different ways of achieving faster growth, macroeconomic stability, openness and a more equitable distribution of income (World Bank, 2005).

Moreover, at any particular time, there is an unwritten social contract about the rules that make an economy work and which set boundaries to the State's economic role. The process whereby a consensus is forged, priorities are set and attitudes are shaped is just as important a part of defining policy space as technocratic competence. Deciding on the appropriate policy mix will also involve judgements and quantitative estimates about the likely magnitude of the adjustments arising from a particular programme. In any event, the combination of leadership, judgement and experimentation is certain to make for an open-ended policymaking process.

The State's capacity to coordinate different interest groups, generate confidence in its actions and behaviour, and establish national development as an urgent, overarching project continues to distinguish those countries that have promoted catch-up growth and sustained structural transformation from those that have not. Successful States have enhanced their competencies through the development of structures of accountability; through continuous improvements to staff recruitment, promotion, compensation and training; and through the creation of (semi-) public institutions and other types of partnerships, particularly with industry associations, but also with trade unions, universities and research bodies. They have also established regulatory and supervisory bodies, often with significant degrees of independence from the political process, to provide the rules, disciplines, incentives and surveillance that help markets to operate, while seeking to minimize possible microeconomic and macroeconomic distortions. In the context of the structural, technological and social deficits that need to be corrected in all developing countries, albeit to varying degrees, UNCTAD has associated these various institutional elements with the efforts of a "developmental State" to oversee successful transformation.

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In an increasingly globalizing world, no less than at the domestic level, market activity also requires a framework of rules, restraints and norms. And, no different from the domestic level, the weakening and strengthening of that framework is a persistent feature. However, there are two important differences. The first is that the international institutions designed to support that framework depend principally on negotiations among States with regard to their operation. Essentially these States must decide on whether and how much of their own policy space they are willing to trade for the advantages of having international rules, disciplines and support. Inevitably, in a world of unequal States, the space required to pursue their own national economic and social development aspirations varies, as does the likely impact of an individual country's policy decisions on others. Managing this trade-off is particularly difficult at the multilateral level, where the differences among States are the most pronounced. Second, the extent to which different international economic forces can intrude on a country's policy space also varies. In particular, cross-border financial activities, as Kindleberger (1986) noted in his seminal discussion of international public goods, appear to be a particularly intrusive factor. But in today's world of diminished political and legal restraints on cross-border economic transactions, finance is not the only such source; as chapter V notes, there are also very large asymmetries in international production, in particular with the lead firms in international production networks, which are also altering the space available to policymakers.

The growing interdependence among States and markets provides the main rationale for a well-structured system of global economic governance with multilateral rules and disciplines. In principle, such a system should ensure the provision of global public goods such as international economic and financial stability and a more open trading system. In addition, it should be represented by coherent multilateral institutional arrangements created by intergovernmental agreements to voluntarily reduce sovereignty on a reciprocal basis. The guiding principle of such arrangements should be their ability to generate fair and inclusive outcomes. This principle should inform the design, implementation and enforcement of multilateral rules, disciplines and support mechanisms. These would contribute significantly to minimizing adverse international spillovers and other negative externalities created by national economic policies that focus on maximizing national benefits. From this perspective, how these arrangements manage the interface between different national systems (from which they ultimately draw their legitimacy), rather than erasing national differences and establishing a singular and omnipotent economic and legal structure, best describes the objectives of multilateralism.

The extent to which national development strategies respond to national needs and priorities can be limited or circumscribed by multilateral regimes and international rules, but equally, they can be influenced by economic and political pressures emanating from the workings of global markets, depending on the degree of integration of the country concerned. While the extent and depth of engagement with the global economy may result from domestic economic policy choices, subsequent policies are likely to be affected by that engagement, sometimes in a way and to an extent not anticipated. As noted in *TDR 2006*, it is not only international treaties and rules, but also global market conditions and policy decisions in other countries that have an impact on policy space. Global imbalances of power (both economic and political) also remain undeniably significant in affecting the capacities of governments of different countries to engage in the design and implementation of autonomous policies.

There are valid concerns that the various legal obligations emerging from multilateral, regional and bilateral agreements have reduced national policy autonomy by restricting both the available range and the efficacy of particular policy instruments. At the same time, multilateral disciplines can operate to reduce the inherent bias of international economic relations in favour of countries that have greater economic or political power (Akyüz, 2007). Those disciplines can simultaneously restrict (particularly de jure) and ease (particularly de facto) policy space. In addition, the effectiveness of national policies tends to be weakened, in some instances very significantly, by the global spread of market forces (especially financial markets) as well as by the internalization of markets within the operations of large international firms.

It is important to consider whether, how and to what extent policy space is reduced and reconfigured. Limits on policy space resulting from obligations or pressures to deregulate markets tend to circumscribe the ability of governments to alter patterns of market functioning to meet their broader social and developmental objectives. Yet unfettered market processes are unlikely to deliver macroeconomic and financial stability, full employment, economic diversification towards higher value added activities, poverty reduction and other socially desirable outcomes.

But while national policies are obviously affected by the extent of policy space available, as determined by the external context, they are also − and still fundamentally − the result of domestic forces. These include, among others, politics and the political economy that determine the power and voice of different groups in society, domestic expertise and capacities, the nature of institutions and enforcement agencies, the structure of the polity (e.g. degree of federalism), and prevailing macroeconomic conditions. Even when policymakers have full sovereign command over policy instruments, they may not be able to control specific policy targets effectively.

Furthermore, the interplay between these internal and external forces in determining both policymaking and implementation within countries in today's globalized world is an increasingly complex process. The emergence in the 1980s and 1990s, and the growing acceptance by policymakers throughout the world, of what could be called a standard template for national economic policies – irrespective of the size, context and nature of the economy concerned – was certainly influential (even if not always decisive) in determining patterns of market liberalization. But even as waves of trade liberalization and financial deregulation swept across the world, culminating in what we experience as globalization today, variations across individual countries suggest that they have retained some degree of policy autonomy, along with relatively independent thinking.

Certainly, for the more developed countries, globalization *à la carte* has been the practice to date, as it has been for the more successful developing countries over the past 20 years. By contrast, many developing countries have had to contend with a more rigid and structured approach to economic liberalization. This one size-fits-all approach to development policy has, for the most part, been conducted by or through the Bretton Woods institutions – the World Bank and the International Monetary Fund (IMF) – whose surveillance and influence over domestic policymakers following the debt crises of the 1980s were considerably extended giving them greater authority to demand changes to what they deemed to be "unsound" policies. Countries seeking financial assistance or debt rescheduling from the Bank or the IMF had to adopt approved macroeconomic stability programmes and agree to "structural" and political reforms, which extended the influence of markets – via liberalization, privatization and deregulation, among others – and substantially reduced the economic and developmental roles of the State. Similarly, and as discussed in greater detail in the next chapter, the Uruguay Round of trade negotiations extended the authority of the World Trade Organization (WTO) to embrace services, agriculture, intellectual property and trade-related investment measures, thereby restricting, to varying degrees, the policy space available to developing countries to manage their integration into the global economy.

Emphasizing the role of policy, and of the international economic institutions in promoting one set of policies over another, is an important correction to the view that globalization is an autonomous, irresistible and irreversible process driven by impersonal market and technological forces. Such forces are undoubtedly important, but essentially they are instigated by specific policy choices and shaped by existing institutions. It is also misleading to think of the global economy as some sort of "natural" system with a logic of its own. It is, and always has been, the evolving outcome of a complex interaction of economic and political relations. In this environment, multilateral rules and institutions can provide incentives and sanctions that encourage countries to cooperate rather than go their own way. And as the world has become increasingly interdependent, it is more challenging for countries to build institutional structures and safeguard remaining flexibilities in support of inclusive development. To the extent that markets and firms operate globally, there are grounds for having global rules and regulations. Moreover, international collective action is needed to help provide and manage global public goods that markets are unable or unwilling to provide. Dealing effectively with emerging threats, such as climate change, also requires appropriate global rules, regulations and resources. However, it goes without saying that governance at the international level is very different from governance at the national level, given that governments are being asked to surrender some measure of their sovereignty and responsibility to support collective actions and goals. It is imperative, therefore, and all the more so in a world of interdependent but unequal States and economies, for international measures to be designed in such a way that they complement or strengthen capacities to achieve national objectives and meet the needs of their constituencies.

The system that has evolved under finance-led globalization has led to a multiplicity of rules and regulations on international trade and investment that tend to excessively constrain national policy options. At the same time it lacks an effective multilateral framework of rules and institutions for ensuring international financial stability and for overseeing extra-territorial fiscal matters. Within this imperfect system, policymakers in developed countries are aiming to tackle a series of interrelated macroeconomic and structural challenges, while those from developing countries are trying to consolidate recent gains and enter a new phase of inclusive development. It is therefore more important than ever before for national policy space to be made a central issue on the global development agenda.

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Subsequent chapters of this *Report* address a number of these issues in detail. Chapter IV looks at the origins of the post-Second World War multilateral system and, in particular, at efforts to ensure that the space for a new State-led policy consensus that avoided the mistakes of the inter-war years would be consistent with multilateral arrangements and disciplines in support of a more open, stable and interdependent world economy. It contends that the partial efforts to internationalize the New Deal in the 1940s eventually gave rise to a more inclusive multilateral agenda that was championed by the developing world. Chapter V reviews the mostly de jure policy constraints on developing countries, associated with multilateral, regional and bilateral agreements on trade and investment, which hamper their efforts to advance and direct the structural transformation of their economies. It presents some of the options that are still available to these countries in the areas of trade and industrial policy, and discusses how a further shrinking of their policy space can be avoided. It also highlights the importance of policy space in relation to the spread of global value chains. Chapter VI discusses the mostly de facto constraints on policies aimed at securing macroeconomic and financial stability in developing countries. Such stability is a prerequisite for achieving a high level of productive capital formation and productivity gains, which can benefit entire populations of these countries. In addition, the chapter examines efforts to strengthen capital account management, and considers various options to avoid the destabilizing effects of short-term flows. Further, it considers the impact of international investment agreements on policy space, particularly through dispute settlement mechanisms that favour private over public law and interests, and examines the possible options to redress that anomaly without foregoing the potential benefits accruing from hosting foreign direct investment (FDI). Chapter VII deals with the factors that are limiting the scope of governments to use fiscal instruments for pursuing their development objectives, and provides some ideas on how fiscal space could be enlarged through national and global reforms. In particular, it looks at the economic costs resulting from the surge in tax evasion by individuals and corporations that use secrecy jurisdictions, as well as the specific challenges facing commodity-dependent economies in bargaining over the distribution of resource rents.

Notes

1 For a discussion on whether and which of the Millennium Development Goals has been attained, see UNCTAD, 2014.

2 Employment targets, which were added somewhat later to Goal 1, have contributed to opening up the discussion to wider policy issues.

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