

# Global constraints: trade and intellectual property regulations applying to LICs; the role and power of TNCs in value chains

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# Global constraints: trade and intellectual property regulations applying to LICs; the role and power of TNCs in value chains

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## Introduction

Countries seeking to industrialise are faced with the challenge of bringing about the structural transformation of their economies—a daunting task which only a handful of countries have ever accomplished. Moving large parts of the population into higher productivity activities requires not only the accumulation of vast amounts of capital, but also the acquisition and development of detailed technical and procedural knowledge (Stiglitz & Greenwald 2014) and firm capabilities (Page 2012).

As all of these achievements tend to be in short supply in low-income countries, a successful development strategy depends on the strategic use of **international trade** and **investment from abroad** to fulfil national development goals. Historically, countries have relied on industrial policy measures and the active manipulation of their trade profiles in order to build up ever more sophisticated productive systems capable of providing higher incomes and better services to their citizens. Such a development path is dependent on countries having the power and independence, namely, the policy space, to determine their own industrial structures and trade profiles.

Advocates of a global architecture of free trade argue that the World Trade Organisation (WTO) will assist developing countries in such an economic transformation. This short issue paper will critically examine this claim by highlighting how the WTO system in fact serves to limit the industrial policy options open to developing countries. The agreements to which countries must become a party upon acceding to the WTO prohibit the use of many of the tools used by successful late industrialisers in the past. This paper will further illustrate how the global trading system, far from being a level playing field, is in fact organised into global production networks, whose value chains are dominated by large trans-national

corporations. Lastly, the paper will seek to identify realistic policy options that are still open to a large developing country such as Ethiopia.

## Free trade and protectionism

The purpose of the WTO is ostensibly to promote free trade across the globe, to the mutual benefit of all—at least in the long run. The underlying economic rationale is that free trade will allow for the most efficient allocation of resources – both across and within countries – and thereby will act as an engine of economic growth. According to this logic, abolishing ‘barriers to trade’ means that prices for goods and services will adjust freely according to international supply and demand—a process that will result in prices that are not ‘distorted’ by government intervention. These (supposedly) free market prices will deliver the ‘correct’ ratios of exchange between factors of production, that is, between capital and labour. Such prices will value these factors according to their relative scarcity in different countries.

Poorer countries tend to have little accumulated capital and large supplies of unemployed or underemployed labour. As labour is the abundant factor in these countries, it is cheaper, while returns to capital are higher, meaning that capital should flow from richer to poorer countries. According to mainstream trade theory, foreign investment will inject capital into those countries, bringing about development and slowly shifting the relative prices of both factors. Despite recent admissions from some quarters that structural transformation is unlikely to result from market mechanisms alone (Lin 2011), even these more sophisticated frameworks insist on global free trade as a prerequisite for development.

Given how prevalent the adherence to the free trade paradigm is among mainstream economists, it is surprising how little empirical evidence there is for the claim that free trade, or ‘trade openness’, actually results in faster growth in developing countries. Leaving aside the technical difficulties inherent in testing such propositions, the available evidence appears at best to be mixed (Rodriguez and Rodrik 2000, Rodriguez 2006). In fact, the histories of those few countries which have successfully managed to industrialise tell a very different story.

Almost all of the so-called advanced economies grew their industrial capacities behind walls of protection, deliberately distorted market prices and showed scant regard for intellectual property rights. They changed their stance only when they had accumulated sufficient capital and capabilities to feel that free trade was now to their advantage (Chang 2002). Similarly, the extremely rapid industrialisation achieved by the East Asian 'tiger' economies was founded on the previous accumulation of manufacturing experience in sectors shielded from international competition during a phase of import-substituting industrialisation (Amsden 2001), followed by a programme of careful and highly selective industrial policy (Wade 2003).

These success stories of rapid economic growth and transformation relied on a relatively permissive international environment that allowed developing economies to ignore, circumvent or subvert many of the provisions that supposedly governed the conduct of more economically advanced economies. But, following the end of the Cold War, the structure of the global trading system was fundamentally altered by the conclusion of the Uruguay round of trade talks in 1994, which culminated in the founding of the WTO in 1995. The WTO replaced the previous General Agreement on Tariffs and Trade (GATT), which had provided the governance structure for global trade in 1948.

Like GATT, the WTO is at heart a global system designed to permanently bind down tariffs amongst member states. The guiding principle is that related to the 'most favoured nation', meaning that a country must offer the tariff rate that it offers to its most favoured trading partner to all other trading partners as well<sup>1</sup>. But beyond this superficial similarity, there are important differences. WTO rules, unlike GATT, require all countries to become party to *all* of the main agreements signed by other WTO members. Moreover, the WTO has fundamentally redefined the special and differential treatment (S&DT) clauses that allowed developing-country GATT members to not fully reciprocate the lowering of barriers that was undertaken by richer countries and nevertheless still remain party to the agreement.

Under GATT, the principle of S&DT was taken to mean that the developmental requirements specific to poorer countries implied that not all strictures of all agreements

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<sup>1</sup> Reality, as always, is slightly more complicated, as there is a distinction between applied and declared tariff rates.

would apply to them, leaving developing states room for manoeuvre. While the WTO still pays lip service to the principle of S&DT, and the ongoing Doha round of negotiations even recognises that developing countries by and large are unhappy with how S&DT is now being interpreted, S&DT has been watered down to mean that least-developed countries are given longer periods of adjustment (usually five to ten years) before trade agreements have to be fully in force.

The permanent opt-out option has disappeared (UNCTAD 2014). In fact, the Doha round (properly known as the “Doha Development Round”) of WTO talks has been stalled almost since its inception in 2001, owing to the disappointment of developing countries over the limited access that they gained to developed country markets in return for accepting the rules of the Uruguay round.

In the case of Ethiopia, the reduction in policy space that the country might experience from acceding to the WTO should be analysed with regard to possible detrimental effects on its current national development plan and industrial strategy. The leading role that the industrial sector is expected to play in the economy, through employment creation and increasing foreign exchange earnings and savings, is explicitly stated in the Growth and Transformation Plan (GTP). Particularly, the new strategic sectors featured in the GTP--namely, the metal and engineering industries and the chemical and pharmaceutical industries--are a manifestation of the structural transformation that Ethiopia is targeting to undertake in order to progress beyond an economy that is typically dominated by agriculture.

Some of Ethiopia’s strategic sectors also have a strong linkage with its socio-economic and infrastructural development endeavours. For instance, a competitive metal and engineering industry could play a critical role in the country's physical infrastructural development, which in turn would be essential for the achievement of the country's long term target of eradicating poverty through broad based, accelerated and sustainable economic growth. The development of the pharmaceutical sector could contribute to the effectiveness of both preventive and curative health care, which in turn could improve human wellbeing and boost labour productivity in the country.

Hence, the protection of these sectors may well be crucial to realizing the structural transformation of the economy. However, the highly restrictive nature of WTO rules could constrain the ability of the country in developing the competitive edge that it will need in order to effectively enter the international market in addition to supplying the domestic market, especially considering the country's limited expertise in trade negotiations.

## TRIPS, TRIMS and GATS

But the biggest changes brought by the WTO relate less to tariffs *per se* than agreements regulating other aspects related to trade and investment, such as the rights of investors or the protection of intellectual property rights. These new treaties extend far beyond 'what happens at the border' to regulate how governments must treat foreign companies within their borders and what kinds of laws and regulations can be put in place to control their behaviour. In many ways these new rules are therefore more akin to investment treaties aiming at the deep integration of countries' regulatory systems, rather than simple trade agreements (Shadlen 2005).

We will examine the three agreements that have the biggest implications for the conduct of effective industrial policy: the agreements on Trade-Related Intellectual Property Rights (TRIPS) and Trade-Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS). This discussion, unless indicated otherwise, draws on DiCaprio & Gallagher (2006), UNCTAD (2014) and Wade (2005).

While containing other aspects, TRIPS is primarily concerned with the protection of patents and copyrights. The agreement forces countries to automatically grant patents for certain products for a period of 20 years, and makes it much more difficult for countries to side-step patents, such as allowing for the production of cheap generic medicines, for instance. These obligations are enforceable through the dispute resolution mechanism (DRM) of the WTO. While the now-developed countries typically had weak, or even non-existent, copyright protection during their own periods of industrialisation (Chang 2002), TRIPS severely

curtails the possibilities for gaining access to technology through reverse engineering or similar measures.

This provision is especially problematic since patents are overwhelmingly held by firms based in rich countries. So TRIPS not only slows down the rate of technology adaptation, which damages economic growth (Stiglitz & Greenwald 2014), but also results in substantial resources transfers from poor to rich countries in the form of licence fees and similar payments. Not all products are equally patentable though, so there remains some room for skilful adaptation.

These arrangements could pose a challenge for Ethiopia if it accedes to the WTO since the current national plan and industrial policy aim to expand the sectors that have strong technology requirements. The very nature of TRIPS can slow or even prevent technology acquisition and reverse engineering in the manufacturing sector, especially in the chemical and pharmaceutical sectors and the manufacture of small scale machinery.

The PASDEP and GTP have identified a set of strategic sectors to drive the structural transformation of the Ethiopian economy. Among these are small- and medium-scale industries such as textile and garments, leather and leather products, chemical products and pharmaceuticals. These sectors were targeted because they are labour intensive and are reliant on domestic raw materials. But the imposition of TRIPS upon accession to the WTO will restrict learning and technology transfer in these sectors, thereby restraining the structural transformation of the economy brought about through improved productive capacity both in terms of the quality and value of output.

Furthermore, given the fact that the country has stringent resource constraints as it is, having to pay for patents and licences of products could reduce its net benefit margins, thereby restraining not only its ability to compete in the international market but also drain the resources that it could have used for other developmental purposes. For instance, the licensing of the layout design of integrated circuits, which is a component of TRIPS, impacts on the strategically important metal and engineering sector. Such a regulation is likely to have strong cost implications and restrict prospects of technology acquisition.

Additionally, the transfer of resources from this sector affects the development endeavours of the country as a whole, since its outputs are channelled to the large-scale infrastructural development projects that Ethiopia is currently undertaking. Nonetheless, the country can make use of the available room for manoeuvre by devising innovative ways of circumventing the restrictions posed by WTO rules. For this purpose, it is essential to strengthen the knowledge base in international trade law and trade policy analysis by providing specialized training for experts.

The TRIMs agreement is probably the most restrictive in its effect on classic tools of industrial policy. This highly invasive agreement bans a wide range of 'trade and investment distortions', which are taken to include performance requirements for firms, including, but not limited to, export requirements, local content rules and conditions to balance trade. 'National treatment' rules mean that companies must be treated the same, regardless of whether they are foreign or domestic, thereby making targeted support to local firms much more difficult. Again, these rules are enforceable through the DSM. These are precisely the kind of requirements that were used by the East Asian NICs to discipline their burgeoning corporate conglomerates during their period of catch-up (Amsden 2001).

It is however still possible for countries to place conditions on the entry of foreign firms into specific sectors, and local-content requirements remain possible in services, unless these have been opened under the GATS. Moreover, the invasive nature of TRIMs justifies S&DT for low-income countries, which will find it challenging to bring their national legal and regulatory systems into full compliance. Such countries are therefore granted longer transition periods after accession to the WTO, but these are not nearly substantial enough to mount a serious programme of national upgrading and industrialisation.

The GATS extends the principles of most favoured nation and national treatment to 'trade' in services, where 'trade' also means foreign direct investment with the intention of providing services. The primary aim of GATS is to increase market access for foreign companies. In principle any service provided 'on a commercial basis' can be negotiated under GATS. A commercial basis is presumed to exist as soon as any form of purchase takes place. This is a provision that can include large swathes of public services. It can make it extremely difficult to protect public services from outside competition since the principle of



national treatment means that any support, given for instance to a municipal water company, would also have to be offered to prospective foreign competition. Non-discrimination under this treaty is defined broadly and in (deliberately?) vague terms, meaning that GATS can in principle be applied to domestic laws and regulation aiming for instance at consumer or environmental protection.

To balance these dangers, GATS offers a seemingly strong protection mechanism. Countries list the sectors that they want to liberalise and in theory GATS provisions should then not apply to other sectors. However, in practice countries may come under intense pressure from other governments and foreign firms alike not to exclude any sector from GATS. Thus, it is easy to imagine how a country dependent on development aid and foreign commercial loans might struggle to act in the best interests of its citizens in negotiations.

While it is of course vital to analyse the real, practical limitations that WTO rules place on selective industrial policies, we must at the same time not lose focus on the practical options that remain, nor should we place too much emphasis on the WTO framework alone. Even under current WTO rules, there are still ways in which countries can place effective performance requirements on firms. The point is simply that it has become more difficult to do so, and governments have to be more creative. For instance, Amsden (2005) demonstrates this possibility by using the example of Thailand. In practical terms, the WTO rules are probably not the most immediate binding constraints on the policy space of most countries. As Shadlen (2006) points out, regional and bilateral trade agreements often go much further than actual WTO rules.

In bilateral agreements, which in many cases radiate outward from the USA and the EU, the differentials in power between parties are much more pronounced and such negotiations are much easier to subject to direct (political, economic and military) pressure than the one-country-one-vote system of the WTO. This point is also made by Wade (2005) and UNCTAD (2014), both of which warn of rich countries trying to impose 'TRIPS-plus' and TRIMs-plus' requirements on their bilateral trading 'partners'. Thus, developing countries should exercise extreme caution when considering bi-lateral or regional trade agreements.

## Global value chains

At least as important as the rules governing global trade, however, is the *structure* of that trade. The structure of global trade, both in terms of content and destinations, has undergone sweeping changes in the last few decades; and these changes are too often ignored completely or confined to the margins of debate. Mainstream trade theory, with its emphasis on comparative advantage as a result of factor endowments, is not only incapable of explaining much of the actual trading activity in the world, but it has also been silent on the restructuring of global production systems as a result of the rise of the TNC and the relocation of production from advanced economies.

While commodities are still overwhelmingly consumed in rich countries, they are increasingly being produced in global production networks spanning multiple countries. The production of the final commodity is disarticulated along a value chain featuring companies in different countries, each of which is using the primary and intermediate goods sold by actors 'lower' down the chain and in turn selling their output further 'up' the chain. As this language implies, global value chains are conceived of as vertical structures through which information, finance and material resources flow (Gibbon & Ponte 2005). Global trade patterns can then be explained as the amalgamation of large numbers of such chains crisscrossing the globe, thereby forming a vast network of interchange, with global manufacturing hubs as its nodes.

Within these vertical structures of buyer-seller relationships there are clear divisions of labour, with primary resource input, manufacturing, assembly and packaging generally located lower down the chain, while design, marketing and research and development are generally retained closer to the top of the chain. This structure is hardly surprising, given that these chains are often the result of TNCs shedding activities that they are no longer interested in performing and retaining only those functions directly in-house that promise the highest value added, or those functions that are closest to the firm's core business interests.

The TNC continues to sit at the apex of most chains, a position from which it can control the terms of inclusion for other actors in the chain. The firm at the apex of a given chain, generally referred to as 'lead firm' in the literature, sets prices, product quality standards,

delivery schedules and volumes, and the relevant environmental, safety or ethical standards to which all others are obliged to adhere.

Understanding the world in terms of value chains illustrates the opportunities available to developing countries. With production organised as a 'trade in tasks', firms no longer need to immediately learn all of the complex steps necessary to produce a given commodity, but rather they can begin by performing relatively simple 'tasks', i.e., slivers of a complete manufacturing process, within a global value chain (Page 2012). Not only does this arrangement reduce the barriers to entry in terms of the sophistication of firm capabilities that are necessary to export, but it can also give firm access to production and process knowhow possessed by firm higher up the chain.

As standards are set by lead firms in the chain, those firms in developing countries hoping to participate in the chain must learn to conform to the exacting standards set by the leader (UNCTAD 2014). The hope is that as firms learn new capabilities by serving sophisticated and demanding clients, they will be able to engage in 'functional upgrading', i.e., move up the chain to perform more sophisticated tasks that allow them to capture a larger share of the total value shared along the chain.

However, value chains are structured buyer-seller relationships in which buyer and seller are not equal partners. Chains are usually 'driven', i.e., defined and controlled, by either buyers or sellers. In African value chains in particular, a rise in 'buyer-drivenness' has been observed, meaning that lead firms are ever more able to dictate terms to firms lower down the chain. In part this is due to the liberalisation of many African economies, which has abolished the (government-run) single distribution channels for many primary commodities (Gibbon & Ponte 2005). Similar trends can be observed in value chains for electronic goods, for instance, where prospective suppliers are often required to open their books to lead firms, with the result that they are subsequently forced to operate on a cost-plus-basis, with already slim margins constantly under pressure from buyer demands for price reductions (Ravenhill 2014).

Moreover, competition among lead firms in value chains is leading to a process of concentration down the chains so rapid and so stark that Nolan et al. (2008) have termed it a

'business revolution'. They outline how lead firms increasingly act as 'system integrators', who own (in a strictly legal sense) less and less of the total production process needed to make a given commodity, but can rely rather on smaller and smaller numbers of first-tier suppliers. In this way, these system integrators can maintain tight control over the production process, without direct ownership. In an era where the 'performance' of firms is measured almost exclusively against financial indicators, this arrangement provides a competitive edge.

First-tier suppliers are expected to closely integrate their business processes with lead firms, and organise ever larger parts of their production process accordingly-- including maintaining substantial research and design budgets of their own to help them meet the needs and continuous demands for cost reduction from lead firms. To be able to meet increasingly stringent requirements for efficiency and flexibility, first-tier suppliers have had to increase massively their business scale, often becoming TNCs themselves in the process.

Of course, these first-tier suppliers in turn exert similar pressures on their own (second- and third-tier) suppliers, with the result that the need for greater size 'cascades' down the value chain (Nolan et al. 2008). The minimum size to be able to partake in global value chains thus rises at all levels of the chain, raising barriers to entry and underscoring once again the need for targeted government support for firms seeking to enter such chains.

There is, of course, a direct connection between the existing and emerging system of trade and investment rules and the growth of global value chains. These rules are primarily designed to increase market access for large (and small) corporations and to protect investments and property (physical and otherwise). A free market environment, especially one in which it is difficult for developing countries to champion and grow 'system integrators' of their own, is of course conducive to the establishment and control of value chains by TNCs located in already rich countries. In fact, even when policy advice does concern itself directly with the implications that value chains have for developing countries, much of the advice coming from big multilateral organisations boils down to call for greater liberalisation and the reduction of selective industrial policies (Ravenhill 2014).

## What remains?

So far this paper has highlighted the very practical loss of policy space that full engagement with current multi- and bi-lateral trading rules implies, and has made clear that current trade regimes are much more invasive than earlier incarnations and that this process has significant implications for implementation costs since entire national legal systems and institutional set-ups have to be revised in order to ensure compliance. The paper has also then highlighted that international trade is increasingly structured through international production networks in which powerful lead firms, acting as 'system integrators', control the terms of inclusion and the distribution of the profit.

It might therefore appear easy to draw the conclusion that the future for developing countries is a bleak one indeed. But this is not necessarily true. While the challenges outlined above are real, and in some cases, are projected to become even more severe, there are still opportunities for progress, especially for a low-income country such as Ethiopia.

Incubating successful firms means furnishing them with the protection that they need to be able to learn, while keeping them disciplined through the application of suitable reciprocal control mechanisms that make continued support conditional on performance (Amsden 2001). While the ability of developing countries to use these fundamental tools of industrial policy might have diminished, it has far from disappeared.

Firstly, the WTO rules are not quite as limiting as they look on paper. As a low-income country, Ethiopia can appeal to S&DT in order to buy time in putting rules into practice, giving firms thereby much needed breathing space. Not all instruments of industrial policy have been banned. Regional subsidies are still permissible, for instance, and this condition is unlikely to change given the EU's reliance on regional structural funds. R&D subsidies are also 'actionable' under WTO rules, meaning that they are not banned outright though they could be challenged by member states (DiCaprio & Gallagher 2006).

As already mentioned, countries can also choose not to open certain service sectors to GATS provisions, and this opportunity should be fully exploited. There are also ways of protecting and controlling firms that are not in direct violation of WTO rules. Firms could be given to understand that future infrastructural investments are dependent on their needs (which

could proxy for their performance and expansion), and land leases and their renewal could be tied to the particular requirements of having passed developmental milestones.

The existence of a separate land administration system for investment in industries provides leverage for tying developmental content and performance to access to land for investment purposes. The inflow of foreign workers can also be controlled through visas. Development banks can also offer practical support to firms that are initially weaker and so on. Infrastructure, logistics and security are frequently more important in guiding firms' investment decisions than the particularities of investment law or patent protection.

Secondly, while there is nothing in WTO rules, for example, that would prevent a 'race to the bottom' in terms of offering ever more concessions to investors (Wade 2005), it is not at all clear that a country as large as Ethiopia has to engage in such a race in order to attract investment. Given the huge population of Ethiopia, a purely outwardly oriented growth strategy is likely to fail in any case. Enforcing decent pay and working conditions not only could help shield workers from abuses, but, crucially, also could help grow aggregate domestic demand, while stringent taxation of both incomes and profits could bring much needed revenue to public coffers. If such funds are invested in education and training, a virtuous circle could develop, wherein more efficient workers attract investment through low unit labour costs, while rising wages increase overall welfare.

This is the pathway followed by the Ethiopian government. It is continuously improving its tax administration and collection capacity. The expansion of tax revenue over the past decade is a reflection of this development. Revenues have been channelled to investment in physical and socio-economic infrastructure, such as roads, energy generation and education. In fact, the strategic position that education assumes in driving the quality and competitiveness of industrial production has been explicitly stated in all of the industrial policy and strategy documents of the government. However, amid the progress in both tax collection and administration capacity as well as investment in education, there are challenges yet to be faced. Primarily, the tax base of the economy is still very shallow, leaving the majority of the potential tax payers in the informal sector. Moreover, there is still room for improvement in bringing about compliance among tax payers. The education sector also faces some important challenges. Although the country has been undertaking an

immense expansion in access to education, there is still a long way to go in ensuring its quality at primary, secondary and tertiary levels. Addressing these challenges, hence, is imperative to unleashing a virtuous circle of development.

Lastly, value chains are of course a huge opportunity for developing countries if they allow domestic companies and domestic capitalists to learn and build capabilities. While FDI brings employment and can lead to technology transfer, it is vital that value chains extend linkages into the local economy. This process not only increases spill-over effects but also reduces the mobility of international capital, making long-term investments in plants and staff more profitable and hence more likely.

In a similar vein--and this is already being done in Ethiopia--attempts can be undertaken to situate entire value chains within a country. The cotton to garments chain is a good example. Global value chains were part of the main criteria considered in identifying the priority sectors of the Ethiopian manufacturing industry in the current industrial strategic plan. For example, the sectors into which the manufacturing industry is planned to diversify are biotechnology, ICT (both software and hardware) and petrochemical industries.

The governance of the value chains of such products are "producer driven", a process that is more vertically integrated and provides integrated suppliers with technological and scale advantages, in contrast to conditions in "buyer driven" value chains, which are dictated by large retailers and branded merchandisers at arms-length and with limited or no production capacity (there is a vast literature on 'drivenness' in value chains; see for instance Gerrefi and Stark, 2011). Hence, under such conditions producers can have better control over their production both in terms of quality and value, and generate higher earnings.

However, it is vital to have a strategic view on how these sectors can acquire the necessary technology and effective management skills that enable them to achieve process, product and functional up-grading, especially in the face of stringent WTO rules. It is also important to identify the nodes of the global value chain that the firms in these industries are planning to enter. The extent of investment on R&D and marketing in each of these sectors should

also be carefully considered, as these factors determine the nature and extent of upgrading along the value chain<sup>2</sup>.

In conclusion, while some of the classic tools of industrial policy have been curtailed, there is still plenty of room for intelligent, creative and determined industrial policy to drive the structural transformation of the Ethiopian economy.

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<sup>2</sup> It is also not clear that upgrading necessarily improves wages and working conditions. 'Better' technology might end up-deskilling the labour process and increasing management control, leading to detrimental effects on the bargaining power of workers (see for instance Butollo, 2014).



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