

## **Aid for trade\***

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### **Abstract**

Adjustment to a post-Doha trading regime will be disproportionately costly and difficult for developing countries. Increased aid is vital for the poor countries if they are to grasp the opportunities provided through trade and meet transition costs. With aid-for-trade, for the first time, the developed countries have another bound and meaningful commitment that they can offer developing countries. Our proposal to provide new resources to meet adjustment needs, however, does not suggest that trade, when combined with aid, will be a panacea for developing countries. Interactions between trade, aid, and broader development policies and reforms are important.

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### **1. Introduction**

Fifteen years after the Washington Consensus, the world has come to acknowledge that free trade is not a magic wand.<sup>1</sup> Trade may be necessary for sustained industrial development, but it is not sufficient. In the right circumstances, trade liberalisation creates opportunities for development, but other factors determine the extent to which those opportunities are realised.

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<sup>1</sup> Peter Mandelson (2006) "To erase poverty, Africa needs both trade and aid", *The Independent*, July 4th, 2005. Pascal Lamy introduced the wand imagery in reference to the role of the WTO secretariat in the conclusion of the negotiations. He made this point by bringing a wand to the opening session of the Hong Kong Ministerial, December 13, 2005.

In addition, any 'gross' welfare gains from trade liberalisation must be balanced against its associated costs. Liberalisation incurs adjustment costs as resources are moved from one sector to another in the process of reform and whereas it may take decades for multilateral trade reform to deliver gains to developing countries, the adjustment costs are automatic and usually upfront.

Furthermore developing countries will need to incur additional costs if they are to realise the full benefits of new market opportunities. In many cases they lack the necessary exporting infrastructure (e.g. efficient ports, adequate roads, reliable electricity and communications) or lack the necessary technology and knowledge to meet product standards prevailing in high value markets (sanitary measures, technical barriers, certification, etc.). To benefit from liberalisation developing countries will need to make public investments in infrastructure and institutions as well as private investment in productive capacity.

The aid for trade agenda reflects the realisation that, for developing countries, the necessary investments are particularly large, and the capacity to meet them is particularly small. There is an emerging consensus that the current WTO Doha Round will require adequate trade-related assistance to mitigate the detrimental effects of trade reforms, and to enhance the trading capacity of developing countries.

The next two years represent a critical opportunity for progress on trade related development assistance. Following the G8 and EU summits in 2005 and various other recent commitments by developed countries, annual development aid is expected to increase by US\$50 billion between now and 2010. This will make more resources available for all kinds of aid. However aid for trade will attract a special focus. This is partly because donors are aware that increased aid flows may have unintended negative consequences for developing countries<sup>2</sup> if more aid leads to real exchange rate appreciations (Dutch disease) which reduce their international competitiveness. The threat of such an outcome will focus donors' attention on counterbalancing programs, including trade development, trade facilitation, and other programs to boost competitiveness.<sup>3</sup> The next two years are also a critical period for the WTO, during which it hopes to reach a

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<sup>2</sup> This goes beyond the traditional concerns of aid dependency.

<sup>3</sup> For a discussion of Aid for Trade, see Page (2006).

conclusion to the Doha Round.<sup>4</sup> The imperative to make good on the development promise of the round provides a political focus for aid for trade (for a broader discussion of the development potential of the Doha Round, see Stiglitz and Charlton (2005)).

Aid for trade involves the flow of development finance from rich to poor countries for the purpose of enhancing the world trading system. The design of an aid for trade framework involves three key questions. There is a 'needs' question: "What should be funded?"; there is an instrument question: "In what form should the money be given?"; and an institutional question: "Who should manage the transfer?".

In the context of trade, the answers to these questions depend critically on the purpose of the fund and its relationship to the trading system – fundamental issues which remain up in the air. Several (non-exclusive) purposes for trade related development assistance have been floated and these have very different implications for the design of an aid for trade mechanism.

First and most straightforward is the political motivation often ascribed to the rich countries, namely, that aid for trade is an instrument to 'buy' progress in the Doha Round. Put bluntly this view conceives of aid for trade as "your normal negotiating side payment"<sup>5</sup> necessary to ensure that the Doha Round package results in Pareto improvements for all developing countries – arguably a necessary condition for progress in the WTO's bargaining process which is characterised by both a single undertaking and consensus agreement (Evenett 2005). This view leads to the conclusion that aid should be directed to those countries that would be net losers from the Doha Round and have an incentive to block its progress.<sup>6</sup>

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<sup>4</sup> Although there are concerns that the round may not be finished within two years, see Evenett (2006).

trade (for a broader discussion of the development potential of the Doha Round, see Stiglitz and Charlton (2005)).

<sup>5</sup> Gary Hufbauer of the Institute for International Economics. Comments at a meeting of trade experts hosted by International Trade Canada, Ottawa, March 3, 2006.

<sup>6</sup> The relevance of this concern is highlighted by the fact that so many developing countries actually were worse off after the last round of trade negotiations (UNDP, 1997).

A second argument for aid for trade is discernable in the demands for compensation levelled by preference-dependent countries, net food importers, and those facing costs associated with industrial restructuring following the end of the textiles agreement. This compensation motivation appears to be based on the view that developing countries should be compensated for losses arising from specific elements of the agreement, independent of their gains in other areas and in the deal as a whole. This rationale leads some proponents of Aid for Trade to envisage compensatory schemes to address specific categories of adjustment costs arising from changes to the world trading system following implementation of the agreement.

A third (related but more general) rationale for aid for trade is fairness. There is no doubt that an ambitious Doha Round will deliver significant gains to the rich countries, and that these gains will far outweigh the gains to poor countries. For some, aid for trade is a mechanism of redistribution through which the reality of the unbalanced outcome can be squared with the rhetoric of the “Development Round”.

All of these three rationales see aid for trade as an exchange: either a payment, compensation, or gift in return for complicity in the multilateral trade liberalisation agenda. While we believe that each of these rationales has some merit, we have several concerns with their application.

The basic problem is that all three rationales place several undue and unhelpful constraints on aid for trade. First, limiting aid for trade to a ‘compensation’ concept limits the pool of donors. For example, the problem of preference losses is arguably an issue between the recipients and the granters of preferences (the EU and to a smaller extent the US), and other rich countries may be reluctant to commit resources to resolve a problem they did little to create. A more important concern is that a compensation approach limits the beneficiaries of aid, and may prevent aid for trade reaching the most needy countries. Losses from preference erosion, for example, are heavily concentrated in the handful of countries that have managed to benefit from preferential access, and these are not, for the most part, the least developed countries. Moreover some have expressed concerns about whether the erosion of rents arising from historical preferential

schemes gives rise, as an ethical matter, to a right to compensation.<sup>7</sup> Another question is how losses in some areas of the agreement should be treated relative to losses in other areas (i.e. should losses arising from terms of trade effects related to the elimination of export subsidies be compensated in the same way as losses arising from preference erosion; and should losses from preferential access in free trade agreements be treated in the same way as preferential schemes; and should losses from previous rounds, e.g. costs of the TRIPS agreement, be included as well?). In our view the most serious reservation about the compensation approach is that it does not necessarily imply that funds would be directed to the poorest countries, or even to those countries facing the largest net-losses from the round as a whole.

With these concerns in mind, we use a fourth rationale to motivate aid for trade in this report. Rather than seeing aid as an exchange for progress in the round, we see it as a necessary complement to the core market access issues at the centre of the round. Lack of supply capacity is a barrier to trade which limits market access for the poor countries. Aid for trade should be seen as an essential component of market access offers to the poor countries. The message from least developed countries in the Doha negotiations should be: “aid for trade must be part of the market access agenda. It is meaningless to give us tariff-free entry if we are unable to use it. In the context of supply constraints, giving access to your markets must mean giving us both free entry and aid to ensure we can use it.” Of course in the past the hope was that new market access by itself would spur investment in new supply capacity in the LDCs. However the lessons from the EBA and AGOA experiments indicate that this has not happened to any meaningful degree.

In our view aid for trade should be motivated by the imperative to create ‘effective market access’ by removing internal barriers to trade. We acknowledge that countries facing adjustment shocks (preference dependent countries, LDCs facing adverse terms of trade shocks, and tariff losses) should all receive funding. However, while adjustment costs should motivate

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<sup>7</sup> “One argument could be that there is no case for adjustment assistance: the countries knew that their income depended on preferences, and knew that trade policies could change, so their losses could have been anticipated. There are two reasons for rejecting this, one practical, one developmental: the first is that if they are not offered some compensation, they will have an incentive to delay or frustrate a settlement, which will damage other countries’ welfare. The second is that they are developing countries and should have some advantage in WTO agreements, particularly in a Development Round.” (Page, 2005).

donors and identify recipients, aid disbursements should have the purpose of promoting future exports, not compensating the loss of past exports.

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The objective should be to put resources into increasing the volume and value-added of exports, diversifying export products and export markets and attracting foreign investment to generate jobs and exports.

The primary instruments to achieve this should focus on private sector development by facilitating the improvement of the business environment for exporters. This involves helping developing countries to design and implement a trade development strategy as part of a broader national development strategy. It also means helping developing countries to improve credit markets both through the creation of new multilateral instruments to mitigate risk and through assistance to improve local financial markets. It also involves development aid to finance investments in trade-related infrastructure especially customs, ports, and roads, as well as investments in institutions.

This expansive definition of aid for trade raises the question of how aid for trade differs from development aid in general. When you are building a road, how close does it have to be to the port to become an aid for trade project? And a related question, if there is no clear dividing line between aid for trade expenditure and general development expenditure, is there merit in complicating the aid system by creating separate frameworks and structures for trade related assistance? We recognise, on the one hand, that there is value in a separate approach to aid for trade to the extent that it is useful to recognise that the world trading system is imposing costs on developing countries, and that the beneficiaries of the system should meet these costs. The WTO is a useful forum in which to recognise these costs and commit funds to redressing them, to ensure that the aid itself is not just a political

instrument, to be withdrawn if the country does something that the donor country does not like (such as voting the wrong way at the UN). The Doha round agreement provides a contract in which these commitments can be made binding, and the dispute settlement system could then be utilised to enforce them. However, we recognise, on the other hand, that the WTO has no capacity to manage or disburse aid funds, and there is little value in reinventing the wheel to create a new channel through which to deliver aid for trade.

Multiple channels already exist to deliver trade adjustment assistance, including the IMF's Trade Integration Mechanism (TIM), bilateral aid for trade programs, several World Bank programs and the Integrated Framework for Technical Assistance to Least Developed Countries (the 'IF') coordinating mechanism. In this paper we propose that the scale and scope of aid for trade be broadened and stress that this will require significant reform to the existing aid for trade system. New options for aid for trade need to be developed within the context of the "new aid framework" (See Prowse (2005)) which emphasises coordination between donors and coherence with national policies and priorities. Although new structures will be required to deliver increased trade assistance, these should build upon the progress of existing programs and leverage the capacity of existing institutions, rather than stand apart from them.

To summarise our recommendations, we propose significant reform to the existing channels of delivery. A new mechanism would have the following components:

- Existing multilateral aid for trade structures, particularly the Integrated Framework, should be consolidated under the management of UNCTAD where a new Global Trade Facility (GTF) should be housed much as the Global Environment Facility (GEF) is housed within the World Bank.
- The six agencies currently participating in the Integrated Framework would continue to operate in an advisory capacity. They would continue to promote harmonisation and to ensure that trade development is not considered in isolation, but as part of an overall package of domestic policy reforms and economic planning.

- The facility would receive a stream of funding (additional to existing aid commitments) agreed to as part of binding Doha Round agreements.
- These commitments would be subsequently enforceable within the WTO. The GTF could directly bring a charge of non-compliance against any country not meeting its aid commitments, and would have the right to auction off any enforcement action. All countries agreeing to contribute to the Trade Facility would subscribe to a Maintenance of Effort Commitment, that current aid levels would not be reduced, and such Maintenance of Effort Commitments would also be binding.
- The facility would have a broad mandate to finance technical assistance, trade related capacity building, enterprise development, and infrastructure projects through a combination of grants and concessional loans.

Finally it is important to consider how an aid for trade agreement would affect the political context of the negotiations. There are legitimate fears. ? Some worry that aid might provide a “way out” for developed countries to avoid making concessions on agriculture. Others are concerned that the offer of aid might be used to extort more concessions from the developing countries on liberalization. While the full analysis of the consequences of expanding the scope of bargaining is complicated and beyond the scope of this short paper, we believe that aid for trade may help the negotiations. Ultimately the outcomes of the round will be driven by the interests of the largest players, including (for the first time) countries like Brazil and India. Brazil will not be a recipient of aid for trade, and so its interest in eliminating agricultural subsidies will be unaffected. On the other hand, India’s interest in certain aspect of service sector liberalization may be even stronger than some of the more developed countries (who worry about outsourcing to India.) The liberalization agreements that emerge from the negotiations of these major players will be little affected by the least developed countries receipts of aid. Indeed the aid-for-trade initiative provides the LDCs with an incentive to cooperate, rather than bloc, such agreements. LDCs should demand that aid for trade be seen as a complement rather than a substitute for the liberalisation offers of the US and EU.

## 2. Principles

The goal of expanded trade related development assistance should be to enhance the export capacity of developing countries. Programs must be linked into overarching development strategies, and complement rather than replace other development priorities. Until recently the existing aid for trade approach was to provide modest amount of aid on an ad hoc basis – primarily to cope with specific bottlenecks, or to support participation in WTO negotiations. In this section we identify some of the principles that should guide the expansion of the aid for trade system.

**Additionality:** *“Developing countries need aid for trade and such aid must not come at the expense of aid for development”*<sup>8</sup>

Aid for trade has entered the WTO agenda partly because of the widespread view that the trading system is unfair and previous agreements have been unbalanced, and had the effect of marginalising the developing countries in the world trading system. In recognition of this, aid for trade should supplement, not replace, existing aid commitments.

But assessing the additionality of aid commitments is a difficult task. As Prowse (2005) points out care needs to be taken in interpreting aid figures. A large fraction of the increase in dollar denominated value of aid in the last five years is accounted for by exchange-rate changes. In 2002, over half the increase in official aid was due to debt relief to just two countries (Afghanistan and Pakistan) and in 2003/4 87 percent of the increase was made up by reconstruction aid to Iraq. Since Monterrey, the increment flowing to low-income countries has in fact been very small. Aid for trade commitments must provide complementary funds to those provided as aid for development. It should not merely rename or divert resources from existing programmes.

**Predictability:** *“It is easy to be taken in with promises of bilateral aid, and make seemingly innocuous commitments in bilateral agreements.”*<sup>9</sup>

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<sup>8</sup> UN Secretary General, Kofi Annan’s statement at the WTO’s Fifth Ministerial in Cancun, Mexico, 2003.

<sup>9</sup> *Pop of the world, Equity Watch*, Center for Science and Environment, October 25, 2002.

Experience in the Uruguay Round demonstrated the need for a mechanism that provides a level of commitment to promises of assistance from rich countries and gives poor countries a degree of certainty about their funding. In the past, 'best endeavour' promises to provide assistance have often not materialised, leaving poor countries sceptical about the merits of agreeing to binding trade disciplines in return for unbound promises of help with implementation and adjustment.

Part of the problem is that while the WTO has enforcement mechanisms that apply to the liberalisation elements of agreements, it has not yet attempted to specify and enforce promises of assistance embedded in the agreement. Moreover the WTO has no capacity to manage aid flows, requiring instead that they be channelled through other international organizations. These facts significantly reduce the negotiating leverage of developing countries, whose liberalisation commitments are made and enforced within the WTO, but whose receipts of aid are handled and distributed outside it. To be credible, the aid for trade mechanism must include monitoring capacity to ensure that the funds are being provided.

**Country ownership:** *"Development cannot be imposed, it can only be facilitated."*<sup>10</sup>

Best practices in aid delivery indicate that donors must be responsive to partner countries' priorities for aid financed projects.<sup>11</sup> This is particularly true for aid for trade, where export promotion projects will be ineffective unless tailored to the needs of the private sector; and technical assistance and government support must form part of the local administrations' broader development plan. Donors must ensure that aid complements and

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<sup>10</sup> President Benjamin Mkapa of Tanzania, November 2004.

<sup>11</sup> Country ownership has become a basic principle of initiatives like the Millennium Challenge Account or the Millennium Development Goals. Various new donor organisations, including the Global Fund to Fight AIDS, Tuberculosis and Malaria, have implemented financing instruments to fund projects which are both proposed and implemented by local organisations. Implementation is carried out by a wide variety of stakeholders including the academic sector; government; non-governmental and community-based organizations; the private sector; religious organizations; and multi-/bilateral development partners.

strengthens a country's own plans, budgets, and structures, rather than undermining them by parallel donor-run administration.<sup>12</sup>

Trade related assistance has a mixed record on country ownership. In some cases, technical assistance has seemed to focus on assisting local bureaucracies to participate in negotiations with the donor countries with a view to ensuring progress in trade agreements, instead of focussing on the practical difficulties faced by local agricultural producers, industry cooperatives, or individual enterprises. Particularly during the Cancun WTO meeting, many developing countries felt that offers of technical assistance reflected "less a burning desire to accelerate development" than provide "the bare minimum to keep them afloat so they don't break the system by walking away".<sup>13</sup>

**Coherence:** *"Trade liberalization must be carefully managed as part of comprehensive development strategies"*<sup>14</sup>

Related to the principle of country ownership is the need for coherence. Not only must aid for trade must be linked with broader development programs, its effectiveness is also dependent on the ability of donors to coordinate their efforts with a broad national development strategy. These two requirements create a trade-off for the design of mechanisms for aid for trade. On one hand, the establishment of a stand-alone aid for trade fund would centralise trade facilitation financing and potentially enhance the coherence of different programs. But on the other hand, a stand-alone fund would be less likely to successfully integrate trade projects into broader national poverty reduction and development strategies.

Currently, coherence in trade-related aid projects is managed by the Integrated Framework, which is intended to ensure that aid for trade

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<sup>12</sup> The Heavily Indebted Poor Countries (HIPC) debt relief initiative was one of the first aid schemes to successfully implement the country-led approach to development assistance. Eligible countries were asked to incorporate debt relief into national poverty reduction strategies which demonstrated how the extra money would be used to further the country's own development goals.

<sup>13</sup> Henri-Bernard Solignac Lecomte, quoted in Interaction (2005) "Strengthening the Connection Between Trade and Development by Reorienting Trade Capacity Building Assistance", Interaction Working Paper, March 2005.

<sup>14</sup> UN Secretary General, Kofi Annan's statement at the WTO's Fifth Ministerial in Cancun, Mexico, 2003.

corresponds to country priorities and focuses on poverty reduction. Six multilateral agencies, led by the World Bank, use the IF to coordinate aid for trade programs. The IF proposes to assess each LDC's needs, report these to donors, and eventually integrate trade promotion programs into the country's Poverty Reduction Strategy Paper. While the IF's diagnostic studies are valuable tools for promoting coherence, it is not clear that the IF structure will be able to manage the imminent changes in the volume and nature of aid for trade financing. High-level coordination mechanisms might be too slow and unwieldy to offer useful guidance to aid for trade strategies, particularly programs involving private sector development. In addition, an institution, which is, in principle, jointly managed by six agencies, is probably too cumbersome to administer aid delivery.

**Private sector:** A drawback of many aid programs is that they often tend to focus too much on the role of the public sector and of government planning. The UN Conference on Financing for Development in Monterrey, Mexico, in 2002 stresses the need to foster private sector actors to promote development. This is particularly important in aid for trade where capacity building and export promotion rely on the ability of donors to identify and remove roadblocks to private sector development.

For the poorest and least creditworthy countries, direct grants to governments will continue to be the primary means of addressing development needs, but for countries with existing industrial capacity, donors should devote greater attention to the private sector, and attempt to implement programs which act as catalysts and facilitators for enterprises to establish themselves, grow, adopt technology, acquire finance, and reach international markets.

**Instruments: loans vs. grants:** *“Many have rallied to the idea of dropping the debt. I say let's rally to the idea of stopping the debt.”*<sup>15</sup>

Since the Meltzer Report (2000)<sup>16</sup> multilateral development banks have shifted their support towards performance-based grants and away from loan instruments. This has been a welcome move since they prevent the accrual

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<sup>15</sup> George W. Bush (2000). Remarks by the President on Global Development, Inter-American Development Bank, March 14, 2002.

<sup>16</sup> Metzler (2000), “Report of the International Financial Institution Advisory Commission”, US Congressional Report, March 2000.

of unpayable debt, which has proved so problematic in the past. But donors should not turn their back entirely on soft loans in favour of grants. The type of trade expansion projects being financed by aid will vary widely from long-term public institutional development to short-term finance for individual industries or enterprises. One form of assistance may, for instance, be creating lending institutions to finance export oriented investments. Funds provided to the private sector should be largely on a commercial basis, with the expectation that they generate returns large enough to make them self-liquidating.<sup>17</sup> In this context there are merits to embracing a multiplicity of instruments. The level of the concessional element should vary depending on the type of project, the level of development of the recipient country, and the type of recipient (government, NGO, enterprise).<sup>18</sup>

### 3. Adjustment needs

*“Not only are the gains from trade, there are also ‘pains from trade’”*<sup>19</sup>

Trade liberalization creates adjustment costs as resources are moved from one sector to another in the process of reform. When tariffs are reduced, import-competing firms may reduce their production in the face of new competition, causing some of their workers and capital to lie idle for a period. The firm’s laid-off workers will incur costs while searching for new jobs and may need to invest in retraining. Governments will be called upon to provide assistance to the unemployed, while also incurring costs associated with implementing the new systems to manage reform.

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<sup>17</sup> There are also arguments that because lending requires repayment, it generates more ownership and commitment from the recipient country than does a grant. To the extent that that is true, it argues for blending grants and loans.

<sup>18</sup> A main concern with the shift from loans to grants is that the reflows will not be available for helping developing countries, and that the net flows to developing countries may actually be reduced, as governments try debt forgiveness—even when the moneys would never in any case have been repaid—as “aid,” subtracting that amount from what otherwise would have been given.

<sup>19</sup> Term originally due to Sapir (2000). Sapir, A. 2000. “Who Is Afraid of Globalization? The Challenge of Domestic Adjustment in Europe and America.” CEPR Discussion Paper 2595, Centre for Economic Policy Research, London.

Significant trade liberalization will also affect the distribution of income among factors of production: the relative price of the factor which is in relative scarcity will decline, while that of the abundant factor will increase.<sup>20</sup>

Even the elimination of distortionary policies has costs. Agricultural subsidies get capitalized in the price of land, and landowners will lose substantial amounts when such subsidies are eliminated.<sup>21</sup> Because there are large distortionary costs associated with taxation, there are large societal costs associated with the compensations designed to mitigate these effects.<sup>22</sup>

Trade liberalization may impose further costs: the movement from quotas to tariffs, whatever its merits, may expose countries to additional risks.<sup>23</sup> Developing countries with weak social safety nets will have to devote more resources to strengthening these safety nets and to mitigate the cost of risks. This too needs to be viewed as part of the costs of trade liberalization. Given the severe constraints on developing countries in raising taxes, the opportunity cost of funds diverted for even partial compensation and to strengthen the safety nets may be very high. Moreover adjustment costs are not just one time adjustment costs— some of these are persistent. The loss of revenue is a problem that will persist until the countries reach a more advanced stage of development. And openness exposes a country to more shocks—and the volatility of the global market place means that they will constantly face adjustments.

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<sup>20</sup> This is the implication of the renowned Stolper and Samuelson (1941) theorem; but even if the restrictive conditions under which it holds are not satisfied, there is a presumption that relative rewards to different factors will change in the way indicated.

<sup>21</sup> The numbers can be large. A \$4 billion annual cotton subsidy translates if fully capitalized in land values at a 5% interest rate into \$80 billion.

<sup>22</sup> Thus, even if the dollar value of the gains to the winners from liberalization are greater than the dollar value of the losses to the losers, when the costs of compensation are taken into account, trade liberalization may *not* be welfare enhancing.

<sup>23</sup> That is, countries now are more subject to the vagaries of international prices. See P. Dasgupta and J. E. Stiglitz “Tariffs Versus Quotas As Revenue Raising Devices Under Uncertainty,” *American Economic Review*, 67(5), December 1977, pp. 975-981. More generally, trade liberalization may make countries more vulnerable to external shocks, and for countries in which trade looms large in GDP, the result may be greater macro-economic volatility.

In one sense, these adjustment costs can be thought of as the ‘price’ to be paid for the benefits of multilateral tariff reduction. Together these adjustment costs and trade benefits determine the net effect of trade reform for each country. The Doha Round has placed renewed emphasis on the importance of sharing the benefits of trade reform fairly among developed and developing countries. However there has been less attention paid to the distribution of adjustment costs among countries.

A theme that runs through the empirical evidence is that the adjustment process resulting from the proposals emerging from the Doha round will impact particularly harshly on the people and governments of developing countries – especially small developing countries. There are several reasons for this asymmetry. First, developing countries are particularly vulnerable to policy shocks because their export industries are the least diversified – many are dependent on the export and hence world price of just one or two commodities. Second, developing countries are likely to need to make the largest changes to comply with international regulations. Third, the structure of world trade is most distorted in the industries of importance to developing countries. World markets for agriculture, processed foods, textiles and other critical goods are the most distorted by developed countries tariff policies. Consequently these industries will be highly impacted by liberalization – even where reform has long-run net positive effects for developing countries, they will have to cope with adjustment costs, investment costs, and redistributive effects. Fourth, and most importantly, developing countries are home to the world’s poorest people and the weakest credit markets. These people are particularly vulnerable to adjustment costs. Fifth, almost by definition, markets are less well developed in developing countries; their economies are marked by much larger market imperfections. Well functioning markets enable resources to be deployed easily. In poorly functioning markets, such redeployments are more likely to be slow, with longer periods during which resources are not fully utilized.<sup>24</sup> For all of these reasons, the adjustment to new trading rules is a radically different experience for developed and developing countries.

**Fiscal losses:** Trade liberalization reduces tariff revenue. In some countries tariff revenues make up a substantial part of total government revenue. Many

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<sup>24</sup> Even in developed countries, there is evidence that less well educated workers that are displaced experience greater adjustment costs.

of these countries are concerned that trade liberalization will have a significant adverse effect on public revenue and the ability to fund public expenditure.

Taxes on international trade account for around one per cent of government revenues in developed countries and around 30 per cent in the least developed countries. Small countries are the most reliant on tariffs. For example tariffs make up 62 per cent of tax revenue in the Bahamas, 54 per cent in the Solomon Islands, and 75 per cent in Guinea (Ebrill et al 1999). Changes in tariff revenue resulting from trade reform will have disproportionate effects on developing countries: African governments are most reliant on revenue from tariffs, followed by Middle Eastern and Asia/Pacific countries.

Governments can of course attempt to replace lost tariff revenue with other sources, but these may be limited and may have high associated costs. Thus, either public expenditures get reduced or other taxes are increased and either may have significant adverse effects on growth.<sup>25</sup> The desirability of replacing revenue from trade taxes with domestic revenue sources raises the issue of relative efficiency of alternative forms of taxation. There is some theoretical evidence suggesting that reducing trade taxes and replacing them with a consumption tax is welfare-enhancing (Keen and Lightart, 1999) on the basis that they are broader and less distortionary. More recently, Emran and Stiglitz (2004) have shown that in developing countries with an informal sector in which, say, a V.A.T. cannot be imposed, it is desirable to retain some trade taxes, e.g. to tax imports at a higher rate than domestic production.

The effect of trade liberalization on government revenues is difficult to predict. Senegal pursued trade liberalization in the mid-1980s following which there were large revenue shortfalls. Lost tariff revenue combines with slow growth in trade volumes and weaknesses in economic management led to dire fiscal consequences. To raise more revenue, the tariffs reductions were quickly abandoned and the liberalization process delayed. By contrast, trade liberalization in Morocco was accompanied by programs to broaden

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<sup>25</sup> Many countries have shifted to greater reliance on the V.A.T., but as Stiglitz has argued, this switch may have adverse effects on development, See J. E. Stiglitz, "Development Oriented Tax Policy", paper presented to 59th Congress of the IIPF, Prague, August 24-25, 2003.

the domestic tax base, including the introduction of a VAT in 1986. As a consequence, Morocco was able to reduce its reliance on trade taxes while maintaining a stable ratio of public revenue to GDP.

The main point is that global trade reform has significant consequences for the fiscal structures of developing countries, whereas developed countries are by and large immune. Developing countries rely on tariffs as a source of revenue far more than do developed countries largely because tariffs are an administratively efficient way of raising revenues; switching to other sources of revenues not only entails switching costs, but there may be permanently higher administrative burdens.

As a result developing countries are likely to suffer either a loss of total tax revenue, or at best, a large administrative cost – and even more economic distortions – associated with the implementation of a new taxation system.

**Net food importing countries:** Agricultural liberalization presents developing countries with the benefits of increased market access, but also the (potential) costs of higher prices for domestic consumers. The reduction in tariffs, domestic support and export subsidies for agricultural products that has been agreed to will impact on developing countries largely through higher international prices of previously protected and supported products. The World Bank has estimated that total losses for net food importers would be between \$300 million and \$1.2 billion per year (Mitchell and Hoppe, 2006). Depending on assumptions, between 7 and 16 countries risk having food import bills increase by 5% or more.<sup>26</sup>

The existence of net losses for developing countries in some areas of reform should not imply that no reform is required – rather it suggests that a selective and gradual approach to agricultural liberalisation is needed and that considerable adjustment assistance may be required for the negatively affected countries. Even countries who receive net gains from agricultural reform will incur costs associated with managing the internal distributional consequences of higher food prices. The fundamental point is that consumers benefit from lower prices that result from large agricultural subsidies, and producers lose.<sup>27</sup> The producers are typically poor farmers,

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<sup>26</sup> See Eiteljorge and Shiells (1995), Tokarick (2005) and Phillips, Page and te Velde (2005).

<sup>27</sup> There is another reason to be wary of an *excessive* focus on agriculture. Development

often far worse off than the urban net consumers. Given the limited capacity of developing countries to effect redistributions, there can be a significant welfare loss from such adverse distributional impacts.

**Preference erosion:** Several developed countries offer non-reciprocal preferential market access which reduces the tariff rates on the goods of least developing countries below MFN rates. Many LDCs fear that reductions in MFN tariff rates through multilateral trade liberalization would harm their exports by eroding their preferential margins.

Preferential tariffs for LDCs have formed an important part of the global trade architecture since the inception of the Generalised System of Preferences (GSP) in 1968. Recently there have been a number of initiatives in OECD countries to further discriminate in favour of LDCs. Most notable among these are the EU's Everything But Arms (EBA) initiative and the US's African Growth and Opportunity Act (AGOA).

Estimates of the benefits of preferences for LDCs (often calculated as the costs LDCs would experience if they were eliminated) are different from estimates of the costs of preference erosion through reduced MFN tariff rates. The chief difference is that in the case of preference erosion LDCs are compensated for the loss of competitive advantage in donor countries by increased market access in all other countries. As a result the costs to LDCs of preference erosion through MFN tariff reductions are likely to be smaller than the costs of preference elimination. The net effect on LDCs of preference erosion through reduction in MFN tariffs depends on whether the loss of 'trade diversion' (the negative switching or substitution that occurs as the margin of their preferences declines) exceeds the gains from 'trade creation' (the increase in global trade resulting from improved market access).

Most research (See Waino and Gibson (2003), Low, Piermartini and Richter (2005)) indicates that the average effect of preference erosion on LDCs is unlikely to be large. However this is not true for all industries in all countries. Industries that are particularly reliant on preferences could be seriously damaged by preference erosion. Large effects on a small group of

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requires less developing countries to move into sectors with higher rates of potential productivity improvements, to develop their *dynamic* comparative advantage, not just their static comparative advantage.

countries and a small group of sectors cannot be ignored. While preference erosion is not a consideration that should impede multilateral liberalization, it does suggest that the small group of net losers will need assistance to manage adjustment.

In general the higher the dependency of countries on preferences, the larger the potential loss from MFN tariff cuts. Addressing the problems of adjustment in critical industries in vulnerable countries should be a key component of any multilateral reform proposal. There are many examples of critical industries – particularly in small countries – which face large negative consequences from preference erosion.

Assistance for critical industries and their workers is a preferred solution to the maintenance of preference margins. There are two reasons to prefer assistance to delayed MFN liberalization. First, delayed liberalization discriminates against developing countries which do not benefit from preferences. The second reason for preferring assistance is that the maintenance of long term preferences induces beneficiaries to specialise in activities in which they may never be competitive once preferences are removed. This discourages industrial diversification and increases adjustment costs when the preferences are eventually removed.

At the same time, it should be recognized that sometimes, providing even temporary preferential access can provide long term gains. By excluding some critical products (particularly bananas, rice, and sugar) from immediate zero tariff under the EBA in 2001, the EU may be missing the opportunity to provide these industries with a foothold in their markets in advance of MFN liberalization.<sup>28</sup>

**Implementation costs:** Implementation costs are another example of how WTO agreements may impact differentially poor and rich countries.

There are few reliable estimates of the implementation costs associated with multilateral trade reform. Finger & Schuler (2000) produced extrapolations based on case studies from the Uruguay round. Their research concluded that while tariff reductions are relatively easy to implement, regulatory changes

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<sup>28</sup> Though, to be sure, for some of these products, it is unlikely that there will be MFN liberalization any time soon. Moreover, market “loyalty” is likely to be less important in “commodity” trade than in trade in manufacturers.

imposed a burden on developing countries which may in some cases have been large compared to the benefits they received from new market access opportunities.<sup>29</sup>

Compliance with WTO agreements is harder for developing countries whose administrative systems usually require larger reform to meet agreed standards. In addition developing countries have the weakest government institutions and most constrained public resources. Implementation of an agreement incorporating regulatory changes requires expenditure on system design and drafting of legislation; capital expenditure on buildings and equipment; personnel training; as well as the ongoing costs of administration and enforcement.

Finger (2000) points out that the implementation of regulatory agreements will often draw money from the development budgets of poor countries. For this reason such agreements should be analysed in terms of their rate of return and compared to the alternative development priorities on which the same money could be spent. Finger estimated the implementation of three of the Uruguay Round's six agreements that required regulatory change (customs reform, intellectual property rights, and sanitary and phytosanitary (SPS) measures). His analysis suggests that the average cost of restructuring domestic regulations in the 12 developing countries considered could be as much as \$150 million. In eight of these countries this figure is larger than the entire annual development budget.

Many developing countries have been unable to meet their Uruguay Round obligations because of these high costs. By January 2000, up to 90 of the WTO's 109 developing country members were in violation of the SPS, customs valuation, and TRIPs agreements. Estimates of the cost of compliance to the Uruguay agreements vary widely depending on the quality

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The costs of implementing the regulatory agreements that could potentially emerge from the Doha Round will vary widely across countries. However these costs are likely to be smaller than for the Uruguay Round, because the agenda is smaller, the developing countries are being asked to do less, and there are fewer regulatory issues on the table (particularly since three of the Singapore issues have been dropped).

However the costs of the remaining Singapore issue, trade facilitation, could be large for some countries. For example, the World Bank assisted Tunisia in its program of streamlining and modernising its customs procedures. The total value of World Bank loans to Tunisia for this purpose was \$35m in 1999. Similarly the World Bank lent \$38m to Poland for upgrading physical and managerial infrastructure of its port facilities.<sup>30</sup> Projects to implement the WTO Agreement on Customs Valuation, which also includes broader customs reform, have been estimated to cost between US\$1.6 million and US\$16.2 million. For example, a six-year programme in Tunisia to computerize and simplify procedures cost an estimated US\$16.2 million (Finger and Schuler, 2000). However, Bolivia implemented a broad customs reform programme that cost US\$38.5 million.

The important lessons from the Uruguay Round is that regulatory changes imposed a large and (in the case of the many non-compliant countries) unacceptable burden on developing countries. The rules seemed to be developed with little awareness of development problems and little appreciation for the institutional capacities of least developed countries.

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<sup>30</sup> Wilson (2001)

#### 4. Building capacity needs

*“The LDCs have neither the surplus of exportable products nor the production capacity to take immediate advantage of new trade opportunities. They will need substantial investment and technical assistance in order to expand their production”* Kofi Annan<sup>31</sup>

Market access on its own is not sufficient to bring the benefits of trade to developing countries. LDCs are in many cases unable to take significant advantage of new trading opportunities because their supply capacity and competitiveness are extremely limited. LDCs have been granted new market access opportunities in successive rounds of trade negotiations, as well as in a range of preferential market access schemes. In each case, studies are produced to assess the potential benefits of these opportunities and invariably make large claims about the anticipated effect on LDCs exports and welfare. These studies make a number of optimistic assumptions about supply elasticity in LDCs and in most cases, ex post analysis has found that new market opportunities have led to little increase in LDC exports. Time and time again we learn that without decent roads, efficient ports, and the technical capability to produce and distribute goods of sufficient quality, new trading opportunities are meaningless for the poorest countries.<sup>32</sup>

Despite decades of multilateral liberalization and increasingly ‘generous’ preferential schemes, LDC’s share of world trade has been falling over the past twenty years. There can be no doubt among WTO members that tariff reductions must be accompanied by concerted efforts to ensure that poor producers are able to capitalise on new trading opportunities. In the context of low productive capacity, a deficient policy environment, poor infrastructure, poor access to technology, and missing/imperfect markets (especially financial markets), liberalized markets will not stimulate the required development to take advantage of new trading opportunities.<sup>33</sup>

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<sup>31</sup> Quoted in Financial Times, 5 March 2001, in the context of Annan’s response to the European Union’s “Everything But Arms” initiative.

<sup>32</sup> Fugazza (2004) shows, for example, that Africa’s ability to reap benefits from improved market access has been constrained by the poor development of supply capacity factors.

<sup>33</sup> One way of understanding the problem is the following: there are both natural (economic) barriers to trade and man-made barriers to trade (tariffs). Trade liberalization reduces the manmade barriers. For developed countries, with good roads and ports, these are the *major* barriers, while for developing countries the natural barriers are the major

There has been some attention given to this issue within the WTO since the commencement of the Doha Round. The final Declaration of the WTO Doha Ministerial meeting – which was warned by the G77 countries about the lack of technical assistance in recent years – in Paragraph 41 reiterates the importance of technical assistance and “reaffirms ...the important role of sustainably financed technical assistance and capacity-building programmes”. Easing supply constraints requires a broader interpretation of the responsibilities covered by technical assistance – i.e. going beyond bolstering public institutions to promoting private enterprise and financing infrastructure.

Assistance to build supply capacity is of three types – each of which should be the focus of an expanded aid for trade agenda:

- Trade policy and regulations — to help countries participate in the multilateral trading system and reform their own trade policies
- Enterprise development — to help private sector enterprises to trade and create a favourable business climate
- Infrastructure — to assist in the identification of infrastructure bottlenecks and finance infrastructure projects.

**Trade policy and regulations:** A core need which should be addressed by aid for trade is the lack of trade policy capacity in many developing countries, which simply do not have the staff, finance, or the depth of skills to adequately represent their interests in trade negotiations and integrate their own trade policies to changing environments. This is particularly true as the number of demands on trade policy officials is expanded by the proliferation of bilateral trade agreements.

Trade policy capacity building is too often narrowly focussed on encouraging the developing countries to participate in the negotiations of interest to rich countries. Too often it is focussed on one off issues, rather than contributing to building national capacity to understand, negotiate and implement trade agreements in a way that maximises development. Perhaps the rich donor countries do not necessarily want to increase the knowledge

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barriers. In effect, trade liberalization reduces the barriers to trade by a much larger percentage for developing countries than for developed.

and negotiating skills of the developing country officials with whom they are bargaining?

Ideally trade policy capacity building would involve research, training and institutional funding with the aim of creating trade-related knowledge networks. Much of this is already occurring through bilateral donors and the World Bank – the challenge is to continue the development of national and regional institutions (e.g. the Caribbean Regional Negotiating Machinery (CRNM)) and to ensure that funding lead to long term results – whether in terms of trade policies, negotiations, implementation, or the resolution of supply-side constraints and the realisation of expanded market opportunities.

The WTO regulations designed to create a level playing field may, however, circumscribe traditional as well as innovative approaches to development. For instance, some are concerned that the kinds of strong industrial policies which played such an important role in the success of the East Asian countries might be circumscribed by current WTO rules.<sup>34</sup> Like any new and untested body of law, there is uncertainty about the interpretation, and developing countries are subject to pressure (especially when they are the recipients of preferences that can be taken away at will) to accept the interpretations demanded by the advanced industrial countries. There has been concern, for instance, about the pressure that was brought to bear when some countries have attempted to use the flexibilities that were built into TRIPs to issue compulsory licenses for life saving medicines. An important form of assistance is to help developing countries redesign their development policies in ways that are consistent with their broad development and social agendas.

Aid and trade policy advice should also encompass training government officials as to how to implement new trade agreements, and build capacity within institutions necessary to carry out the terms of the agreements.

**Enterprise development:** While public sector capacity-building is an important precondition, the ultimate objective of aid for trade programs is to

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<sup>34</sup> Others ask, is it possible for them to adopt versions of America's Community Reinvestment Act, requiring banks (whether domestically or foreign owned) to invest in underserved communities (or, in a slight extension, in small and medium sized businesses)? Still others ask, are the kinds of affirmative action requirements that Malaysia used so effectively in addressing its problems proscribed by the WTO.

enhance the capacity of the private sector to develop into new markets. Aid for trade schemes need to constructively promote the development of new productive capacity without crowding out private investment, promoting inefficient industries, or stifling entrepreneurial activity.

For many exporters in developing countries the costs imposed on them by tariffs, quotas or rules of origin, are small relative to the costs of doing business imposed on them by an unfavourable business environment and inadequate local financial development. The costs associated with setting up a business, acquiring credit, getting a reliable access to utilities, transporting goods from plants to ports, all impose a burden on the productive sector of most developing countries.

The aim of aid for trade should be to expand exports and enable companies to do a better job of responding to export opportunities. A key component of private sector development is improved access to finance -to take advantage of new opportunities for exports, there must be export finance. In countries with underdeveloped financial sectors, inadequate finance is a major constraint inhibiting exports. To the extent that the poor are involved in trading activities, they may struggle to obtain access to the trade credit they need because of particular difficulties in assessing the creditworthiness of exporting firms and because the firms do not have sufficient collateral.<sup>35</sup>

In addition to improving access to knowledge and credit, there needs to be more attention given to helping the development of competent institutions in developing countries – and removing the obstacles ineffective institutions place in the way of exporting firms -for example effective customs authorities, more accountable policing, more efficient port authorities.

**Internal barriers/infrastructure:** Inadequate infrastructure is also an important source of supply constraints. Poor transport infrastructure can prevent local farmers from accessing large domestic markets and

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<sup>35</sup> Where there is an absence of private credit, there may be a role for publicly funded institutions to increase access to finance for low-income producers. For example, the Development Bank of Mauritius (DBM) played a key role in providing finance for the expansion of existing business and the establishment of new firms in Mauritius. Among several activities the DBM was involved in building industrial estates to encourage development in export processing zones (EPZs), setting up foreign exchange schemes for small and medium sized enterprises, providing working capital through micro-credit, and extending preferential credit schemes.

international ports; poor storage facilities can increase inventory costs; and bad energy and water supplies can disrupt production or increase costs. In addition, institutional capacity can affect trade costs if customs procedures, inspections, certifying bodies are run inefficiently.

For example, in Uganda, poor infrastructure cripples local exporters. More than 50 per cent of Ugandan roads are in poor condition<sup>36</sup> placing a large burden on farmers. Increased transport costs associated with poor roads add the equivalent of an 80 per cent tax on exported clothing. Most companies rely on generators to bridge periods of blackout and to avoid damage to equipment from power fluctuations. This is far less efficient than grid power. For example, the average generator installed by small-and medium-sized enterprises in Uganda costs about \$25,000 to purchase and requires considerable ongoing maintenance and fuel costs.<sup>37</sup> Power generation can increase business start up costs by more than 30 per cent. For businesses in countries without decent infrastructure tariff barriers are inconsequential when compared to the costs imposed by domestic obstacles. EU commissioner Pascal Lamy acknowledged that “duty-free access alone is not enough to enable the poorest countries to benefit from liberalized trade. We need to help them build their capacity to supply goods of export quality and we reaffirm the Commission’s commitment to continued technical and financial assistance to this end” (European Commission, 2000).

Despite the importance of these “behind the border” costs, aid for infrastructure has been falling for a decade. There is now recognition in development quarters that donor-supported public funding is an essential prerequisite for boosting or upgrading supply capacity and infrastructure building in LDCs. Improved infrastructure combines with strong macroeconomic conditions complements investment in supply capacity building and increases export competitiveness. The increased focus on infrastructure needs is reflected in the World Bank's plans to increase infrastructure lending by \$1billion per year to around \$10 billion by 2008 and the Gleneagles agreement by the G8 "to boost growth, attract new investment and contribute to Africa’s capacity to trade” through the establishment of the Infrastructure Consortium for Africa, jointly supported

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<sup>36</sup> IMF (2004) Uganda Poverty Reduction Strategy Paper, Progress Report, IMF.

<sup>37</sup> Donaldson, D. J., F. Sader and D. M. Wagle. 1997. Foreign Direct Investment in Infrastructure – The Challenge of Southern and Eastern Africa. Foreign Investment Advisory Service Occasional Paper 9. The World Bank. Washington.

by African countries and by the European Commission, G8, and key multilaterals.<sup>38</sup>

However, in order to achieve trade related policy objectives, infrastructure improvements have to be coupled with good policies. Research indicates that returns to infrastructure projects can vary widely and are affected by the quality of the business environment. For example good roads and port facilities alone do not guarantee an expansion of trade. The value of infrastructure projects are easily eroded by poor economic policies, or inefficient and corrupt customs services.<sup>39</sup>

## **5. New mechanisms for aid for trade?**

In recent years a number of institutions have made concerted efforts to deal with trade adjustment and capacity building. These include the Integrated Framework for Trade-Related Assistance (IF) and the IMF's Trade-Integration Mechanism (TIM). At the same time bilateral aid for trade has been increasing and multilateral development banks have stepped up their technical assistance programs and increased support for trade-related investments.

As aid flows begin to significantly increase and the scope of trade development projects widens, it is appropriate to consider alternative mechanisms to deliver aid for trade more effectively – in particular to ensure predictability, coherence, country ownership, and additionality. There are three options:

- Continue with existing mechanisms
- Create a new trade specific fund
- Reform existing mechanisms

Institutional design reflects a number of competing considerations: one the one hand, one does not want to duplicate what already exists; and a new

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<sup>38</sup> EC (2005) "Conclusions of the Council and of the Representatives of the Governments of the Member States Meeting within the Council on Aid for Trade, Brussels, 14 December 2005.

<sup>39</sup> Anke Hoeffler, 1999, "Challenges of Infrastructure Rehabilitation and Reconstruction in War-affected Economies" Background paper for the African Development Bank Report 1999.

institution would open up one new institution to be coordinated in the driving need for policy coherence. On the other hand, the success of the market economy is based on competition, which often entails duplication—there cannot be competition if there is a single producer of a product. The gains from competition in general outweigh the costs of duplication. This is all the more so in the international arena, where while different institutions may administer aid, governance structures are similar—the advanced industrial countries predominate in all, though in some, like the IMF, the power of the United States may be greater than in others.<sup>40</sup> Given this, it is not surprising that there is a certain similarity in perspectives on development strategies, with the failed Washington consensus policies long dominating.<sup>41</sup>

Existing mechanisms have been relatively successful in managing the policy dimension of aid for trade – they have made some progress in integrating aid for trade into national poverty reduction strategies, and they have increased the coherence of programs run by multilateral institutions. The Integrated Framework (IF) emerged from the 1996 WTO Singapore Ministerial Conference, as part of the WTO Action Plan for least developed countries (LDCs) boost the participation of LDCs in the world trading system. The Framework is made up of six multilateral institutions: the World Bank, WTO, IMF, ITC, UNCTAD and UNDP. Its objectives are to embed a trade agenda into national poverty reduction strategies (country ownership); and to assist in the coordinated delivery of trade-related technical assistance from multiple donors (coherence).<sup>42</sup> However the IF has extremely limited resources – its mandate to date has been essentially one of policy advice. But without funds to back its recommendations, the IF has a hard time convincing developing countries to include large unfunded trade-development projects in their poverty reduction strategies. Moreover, even if the IF was equipped with funds, its institutional structure is ill-equipped to translate policy into delivery and implementation of aid for trade. Its

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<sup>40</sup> In the IMF, it has effective veto on important matters, given the requirements for supermajority votes on important matters.

<sup>41</sup> Again, there are differences—the World Bank, at least under President Wolfensohn, distanced itself from these strategies as their failures became more evident; but the IMF was far slower in responding.

<sup>42</sup> In this way the IF mechanism embodies many features of the “new aid framework” which aims to improve harmonisation between the providers of trade assistance and place trade within the context of a country’s broader development strategy.

management is too diffuse and it has insufficient in-country presence to manage projects. Existing structures would not be effective in managing the delivery of large volumes of funds earmarked for trade development, and are unlikely to be the best mechanisms through which to deal with specific concerns of developing countries arising from the prospective Doha Round agreement.

By the same token we are sceptical about the merits of a new stand-alone fund dedicated to aid for trade. Page and Kleen (2004) propose that a new fund be established within the WTO to deal with preference dependent economies. Its funding would come from contributions from developed countries which would be determined by various criteria and commitments would be 'legally irrevocable'. Funding would be allocated to recipient countries according to the estimation of their loss of preferences. Similarly Grynberg and Silva (2004) suggest the creation of a Special Fund for Diversification to benefit preference dependent countries. An attractive feature of this scheme is that a share of funds would be allocated for a private sector development including start-up financing for small and medium sized enterprises. However a dedicated fund would be costly to set up. It would lack coherence with existing efforts, and would be less likely to consider adjustment needs in the context of broader development efforts and policy reforms which constitute a holistic approach to development assistance.

A second attractive feature of dedicated funds is that by identifying specific costs to developing countries arising from the trade round (i.e. preference losses), these proposals create well-defined obligations on the rich countries. However these obligations are ultimately forms of compensation. This means that there is no reason in principle that the aid should be related to trade development rather than channelled as direct transfers.<sup>43</sup> Indeed the proposed funds would be slow to develop the institutional experience and in-country presence necessary to manage and implement complex trade

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<sup>43</sup> There are other problems with adopting compensation as the basis underlying the aid-for-trade program. Compensation should really be directed at the individuals that are hurt. Aid for trade may in fact fail to reach those individuals. If compensation were directed at the country, one could argue for an offset for the gains, resulting in a contentious analysis of the magnitude of the *net* losses. There are further problems: many of the preferences have always been temporary, though they were continually renewed. Does the country (individual) need compensation *as if* they were permanent (which could be large), or only for the period of the explicit program (in which case they might be very small.)

development programs effectively. There is also a concern that if aid for trade is conceived of as compensation for one specific set of losses (preferences), assistance will be focussed on those countries who are most disadvantaged by preference loss, rather than those countries who are most in need overall. Those who have the most to lose from preference erosion are not necessarily the poorest or most vulnerable – and it is unclear why countries which have benefited from a historical preference should be compensated above those whose needs are greater now. While we believe that the problem of preference erosion is important and will require funds to overcome, a new aid for trade facility should encompass broader objectives.

For this reason we propose significant reform to existing mechanisms, rather than the establishment of a new fund. The concept of the Integrated Framework should be retained, but rather than being controlled by a cumbersome alliance of six institutions, its management should be more firmly concentrated within one institution. In particular, dedicated funds for aid for trade – donated through specific binding commitments in the final Doha agreements and subsequently enforceable within the WTO – should be allocated to a special facility to be administered by UNCTAD, much as the Global Environment Facility is administered by the Bank. A small Global Trade Facility secretariat could be established (independently, and within UNCTAD), which would have oversight over the GTF program, allocate funds according to an agreed set of principles and priorities, monitor their usage, evaluate performance, and ensure that the developed countries have complied with their obligations, bringing cases of failure to the WTO for sanctions (using the system of auctionable sanctions discussed earlier.) They would not directly administer the assistance programs, but would review proposals from countries, multilateral institutions (including the World Bank and regional development banks), and NGO's for assistance. This would encourage competition among aid recipients and deliverers to develop the most effective and efficient aid-for-trade projects and programs.

To be sure, the World Bank might welcome additional funding, especially in an era of fiscal stringency; while others might resent the increase in its monopoly power (market share) in the aid business. But we should not be surprised that many of the details of our institutional proposal will not be received by existing institutions. Everyone believes in competition— except for themselves. Everyone believes in good governance, in accordance with democratic principles—except for themselves. We have proposed a mechanism that would improve governance and competition. It is

conceivable that existing wisdom might be questioned; almost undoubtedly, it would weaken the “market power” of existing institutions. But these are arguments in favor of the new institution.

What is essential for a successful aid-for-trade program is governance and competition. There is a consensus by now of the importance of country-ownership. But inevitably, assistance programs designed by existing international institutions will suffer from their flawed governance structure, in which perspectives of the advanced industrial countries and their interests predominate. That is why it is essential that in the governance of the new GTF the developing countries predominate.

Because the GTF is the result of a negotiated global trade agreement, the governance structure should be different from that of the World Bank, where voting is dominated by the donor countries. Indeed, one of the principle responsibilities of the GTF is to enforce the obligations/commitments of the advanced industrial countries. We suggest the following as a possibility: A board of 24, with 8 seats reserved for the low income countries, 8 for the middle income countries, and 8 for the advanced industrial countries. 60% supermajority required for major decisions. Seats to be held by WTO members, on a rotating basis, chosen to ensure a diversity of geography and economic interests, e.g. no more than 3 seats (within any of the groupings) to be held by countries in any one region, with at least one seat for an agriculture exporter.

Any aid-for-trade initiative, including the proposal here for a Global Trade Facility, enforceable within the WTO framework, would require developed countries to make commitments. While the size and distribution of those commitments will inevitably be a matter of intense negotiation among the members of the WTO, the following proposal suggests a set of principles which might guide those discussions.

Any meaningful aid-for-trade facility must be large enough that it could actually make a difference, yet not so large that it would overwhelm other aid initiatives, including those for social purposes (like health), for maintaining the environment (the GEF). The international community has made a commitment to provide .7% of advanced industrialized countries' GDP for assistance.

It makes sense too to relate the aid-for-trade commitments to the size of the benefits from global trade, and particularly trade with developing countries. Finally, those countries that impose large costs on developing countries through their failure to liberalize (eliminate agriculture subsidies) should make additional commitments. Overall, the failure to achieve fair liberalization (eliminating agricultural subsidies and higher tariffs on the products of developing countries) accounts for much of the disappointment with liberalization in many developing countries. Such a levy would have the further advantage of providing an incentive to eliminate the distortionary and inequitable policies.

Hence we propose a three-part commitment:

- a) The advanced industrial countries would contribute 0.05% of their GDP to the GTF. This means that the aid to trade facility would comprise approximately 7% of the total commitment (of 0.7% of GDP) to developing countries, an amount that seems balanced within the framework of overall development needs.
- b) There would be an additional commitment of a small percentage of the value of their exports to least developed countries. One can think of this as a partial substitution of the revenues that would have been received as tariffs; but it takes advantage of the greater administrative capacity of the developed countries, and avoids all of the distortionary and political economy “costs” associated with tariffs. The advanced industrial countries need not actually levy the amount as a tax on exports, but simply pay the amount (small relative to GDP of the advanced industrial countries) out of general revenues.
- c) There would be an additional commitment of 5% of all agricultural subsidies and 15% of all arms sales to developing countries, partially reflecting the costs that these impose on developing countries.

There are many voices resisting proposals to earmark funds for particular purposes because they believe it to introduce rigidities or inefficiencies into aid programs. Why should trade not compete with other priorities for the general pool of aid funding. Our proposal is sufficiently modest that we do not believe that the earmarking will result in any significant distortion in the efficiency of the overall aid program. On the other hand, the focus on trade would be salutary, and bring needed funds to a neglected area.

We believe that the middle income countries should also make a contribution directed towards those with lower incomes. It might be appropriate for the contribution to be at a significantly lower rate (say a half or a quarter of the rate of that for the advanced industrial countries), and that some of their contribution might be in kind rather than in dollars: for instance, designing training programs for the less developed countries to explain what they have done to expand and facilitate trade.

We emphasize in our discussion that these contributions for an aid-for-trade facility cannot be made at the expense of other forms of assistance. There has to be some Maintenance of Effort Commitment. There are several problems in defining an appropriate commitment; one should not, for instance, count debt write-offs, especially for debts that would not in any case have been repaid. They should, perhaps, be defined in terms of net flows of funds to developing countries for assistance purposes (as a percentage of GDP) over the last five years. We are concerned with development assistance, not military assistance. We suggest that the Maintenance of Effort should be defined, accordingly, of assistance *exclusive of reconstruction activities in war zones and exclusive of all military assistance*.<sup>44</sup>

## **6. Instruments**

There are many factors constraining export growth in developing economies. A broad “aid for trade” effort should focus on removing these and creating a favourable environment for private sector development. Of course ongoing support for institutional capacity building is an essential complement to enterprise development. Support should be extended to programs to enhance in-country expertise and policy formulation, as well as research and trade development diagnostic studies. In the long run, regulatory and legal frameworks are essential to successful business environments.

But in the short run a key feature of an expanded aid for trade agenda should be to promote investments in new productive capacity. If new aid is to

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<sup>44</sup> Reconstruction activities are important, but they should not be at the expense of the broader commitment to development

catalyse rather than stifle private sector resources it must take a bottom-up approach beginning with action to create the a favourable business environment and effective credit market.

An aid for trade fund should prioritise programs to mitigate risk for enterprises in developing countries, and to promote the development of local financial markets. High levels of risk in developing countries are a major barrier to investment. In particular, political risk and exchange rate risk cause foreign investors to shy away from developing countries. There are several ways that multilateral finance could be mobilised to reduce risk and enhance credit in developing countries. For example a multilateral credit insurance facility could subsidise financial guarantee insurers -providing projects in developing countries access to monolines<sup>45</sup> which would facilitate access to large volumes of credit. Similarly, a multilateral securitisation facility could help national and subnational developing countries to bundle different cash flow streams into a single asset against which they could borrow at a lower rate. Currency risk is perhaps the greatest threat to developing countries ability to trade and attract investment. The development of multilateral assistance programs to pool currency risk and subsidise hedging costs should be the subject of research. The GTF could work with existing initiatives, e.g. the Asian Bond Fund, as well as expanding such initiatives to other regions. At the same time, the GTF could work with the World Bank and other Multilateral Banks to encourage bond markets in local currencies and/or baskets of local currencies.

Infrastructure projects to address specific bottlenecks need to be financed, but they also should be driven by local users. There is a critical need to ensure that good projects are identified and matched quickly to finance and implementation. This will require increased financial support for project development capacities: feasibility studies, demand assessments and project proposal documents. A wide range of different levels of government, civil society groups, and private interests should be eligible to apply for finance. And public-private-partnerships should be harnessed to expand finance for infrastructure. However in most cases projects will require significant subsidies – in many developing countries, basic infrastructure projects are

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<sup>45</sup> Financial guarantee insurance (monolines) is widely used in the developed world – particularly by municipal governments – to facilitate long term, low cost access to large amounts of credit.

either not commercially viable at all, or not profitable unless they charge fees which severely inhibit universal access.

One of the major changes in thinking about development during the past decade is the realization that what separates developed and less developed countries is not just a gap in resources, but a gap in knowledge. There is widespread concern that TRIPs, the intellectual property provisions of the Uruguay Round, may have impaired access to knowledge for development. This is reflected, for instance, in the initiatives taken within the World Intellectual Property Organization (WIPO) by the Friends of Development for creating a more development oriented intellectual property regime.<sup>46</sup> The Global Trade Facility could support the development of institutions capable of facilitating the transfer of technology (e.g. science and technology oriented universities, research centres, standards centres). It could help organize global internship programs, in which those from developing countries learn from the practices of the advanced industrial countries.

We referred earlier to the fact that one of the important adjustments facing developing countries arises from a reduction in one of their major sources of revenues, tariffs. Alternatives often have higher administrative costs, and are often less progressive. This is particularly true of the V.A.T. which is widely employed in the advanced industrial countries (outside the United States), but the regressive nature of the V.A.T. in these countries is mitigated by the existence of highly progressive income taxes. Most developing countries, however, do not have the capacity to administer effectively such a tax. The GTF should also engage in assistance in helping developing countries develop effective and efficient progressive tax structures, that can make up for the loss of revenues from tariffs. These (perhaps second best measures – appropriate for the second best world) may include the design of progressive excise taxes, progressive housing taxes (based on the square footage of a house), financial transactions taxes, severance taxes, excess or windfall profits taxes on natural resources (when prices suddenly shoot up), or taxes on monopoly/oligopoly profits.

It is important that the Aid-for-Trade program (e.g. the Global Trade Facility) not be subject to the usual conditionalities, in particular, that there

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<sup>46</sup> In particular, the endorsement of that initiative by the General Assembly of WIPO in October 2004. Developing countries believe that while their access to knowledge may have been impaired, TRIPs provided insufficient protections for Traditional Knowledge.

be no macro-economic or political conditionality.<sup>47</sup> The only exception to this principle should be for enforcing matters vital to the well-being of the entire world, e.g. nuclear proliferation and global environmental agreements (in particular, those affecting global warming). Countries do not have to be signatories to such global agreements for these matters of global concern to be used as conditionality.

In the first instance, funds should be directed to countries facing large adjustment costs, and to projects which will be of benefit to those most adversely affected by trade liberalization and any new trade agreement. Even though the Aid is not intended as compensation, appropriately designed aid programs can ensure that there are as few losers from trade liberalization as possible. The aid should be designed to facilitate job creation in areas most adversely affected, and to help who have lost their jobs obtain alternative employment.

In the longer run, projects and proposals should be evaluated in terms of (i) their economic and social rates of return; (ii) the income of those who benefit from the program; (iii) the magnitude of the adverse trade shocks (liberalization) to which those who benefit (or their country) have been subjected. This takes into account that countries that have been more adversely affected are in a poorer position to provide adjustment help for those individuals and firms that have been adversely affected.

Administratively, it may turn out best to allocate money using three baskets: one devoted to countries and areas which are most adversely affected; another based on broader metrics of income and trade; and a third, where countries would be encouraged to submit innovative projects which would be judged competitively. The relative allocation of funds to those three baskets could change over time, with more money being allocated initially to the first basket.

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<sup>47</sup> Concerns about macro-economic conditions in the country may, of course, shape the nature of the lending program. But it is important that the new facility be viewed as another instrument for leveraging into particular policy stances.

## **7. Conclusion**

For several years, the governments of many developed countries have argued that “trade not aid” is the answer to the problems of the developing countries. The insincerity of their approach has been revealed in successive rounds of trade negotiations in which they have been reluctant to open their markets to poor countries. And more recently their claims have also been exposed as fundamentally inaccurate as liberalization fails to result in either export growth or development for the poorest countries. This poor outcome is not the result of a Machiavellian plot to cheat the developing countries, but certainly the outcomes of trade deals are determined by real politik and the special interests in developing countries. The good intentions of trade negotiators get lost along the way. The developing countries face enormous challenges in expanding exports, they face greater adjustment costs and greater barriers to seizing new opportunities, the international trade regime has not provided a level playing field, and that if we are to increase the chances of a development round leading to development, not only must there be a more level playing field, but also there must be aid to help developing countries

Increased aid is vital for the poor countries if they are to grasp the opportunities provided through trade and meet transition costs. Adjustment to a post-Doha trading regime will be disproportionately costly and difficult for developing countries because of the loss of preference margins, the loss of revenue from trade taxes, institutional weaknesses including the absence of adequate safety nets, implementation costs, lack of finance required to restructure the economy, and the limited ability of poor populations to manage short term unemployment.

Our proposal to provide new resources to meet adjustment needs however, does not suggest that trade, when combined with aid, will be a panacea for developing countries. Interactions between trade, aid, and broader development policies and reforms are important. Trade reform is just one of many potential shocks and opportunities faced by developing countries and internal as well as external reforms will be essential in ensuring that these countries realise their development potential.

What is new about our proposal? First, previous rounds of trade negotiations have expanded the purview of trade negotiations, going well beyond simply reducing tariffs. They have recognized the impact of domestic legislation in

areas related to investment and intellectual property can affect trade. These issues were brought within the ambit of the WTO precisely because of its enforcement mechanism. There already existed a World Intellectual Property Organization, but it moved to the WTO because WIPO had no effective enforcement mechanism. But finance is even more central to trade. For the first time, our proposal brings the power of commitment and enforcement to promises of aid.

Secondly, before, developed countries had little to offer developing countries – especially as they refuse to do little about agriculture – but had enormous powers to impose demands. They could do this not only within the context of WTO negotiations, but also outside. They could make liberalization a condition for aid. To be sure, in WTO negotiations, the developing countries are not negotiating as equals with the advanced industrial countries, and the role of the G-6 show that while the voices at the table may have expanded, the voices of the least developed countries may still not be heard. With aid-for-trade, for the first time, the developed countries have another bound and meaningful commitment that they can offer developing countries. We are hopeful that the outcomes of such a negotiation will be more favorable to developing countries – and perhaps may be even more favorable to liberalization itself. Third, it recognizes the limitations in the governance of existing institutions, and provides the beginning of an alternative.

Aid for trade offers the possibility that, instead of the developing countries' being worse off – as so many were as the result of the last round of trade negotiations – they will actually be better off. It offers the possibility of a trade agreement that will actually result not only in more imports and job loss in the developing countries, but more exports and job creation.

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