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## Aid for Trade

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If developing countries are to realise gains from a multilateral trade round then aid for trade will be an important complement to tariff reduction. In many of the poorest countries tariff barriers are not binding constraints to export growth. Rather, a range of internal barriers act to prevent the expansion and diversification of trade. These countries will need aid to ease these supply constraints. Moreover, many of the poorest countries in the world will require assistance to meet the costs of adjusting to a new global trading system.

*Keywords:* Aid for Trade, Developing Countries, Tariff Barriers

*JEL-Codes:* F13, F15

### 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. 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,

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1 PETER MANDELSON (2006). 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, 13 December 2005.

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 50 billion US\$ 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 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.<sup>5</sup>

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 ques-

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2 This goes beyond the traditional concerns of aid dependency.

3 For a discussion of Aid for Trade, see PAGE (2006)

4 Although there are concerns that the round may not be finished within two years, see EVENETT (2006).

5 for a broader discussion of the development potential of the Doha Round, see STIGLITZ and CHARLTON (2005).

tion: “In what form should the money be given?”; and an institutional question: “Who should manage the transfer?”.

## 2 Aid for trade for what?

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>6</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>7</sup>

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.

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6 GARY HUFBAUER of the Institute for International Economics. Comments at a meeting of trade experts hosted by International Trade Canada, Ottawa, 3 March 2006.

7 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 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>8</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

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8 PAGE (2005): “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.”

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

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.

### **3 Aid for trade vs. development aid**

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.

### **4 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 pre-

dictability, 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: on the one hand, one does not want to duplicate what already exists; and a new 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>9</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>10</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>11</sup> However the IF has extremely limited resources – its mandate to date has been es-

9 In the IMF, it has effective veto on important matters, given the requirements for supermajority votes on important matters.

10 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.

11 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.



sententially 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 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>12</sup>

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12 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.)

Indeed the proposed funds would be slow to develop the institutional experience and in-country presence necessary to manage and implement complex trade 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. 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 favour of the new institution.

## 5 Governance and funding

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, higher tariffs on the products of developing than developed 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 distur-

tion 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>13</sup>

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" (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.

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13 Reconstruction activities are important, but they should not be at the expense of the broader commitment to development.

## **6 Political economy considerations**

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.

## **7 Conclusion**

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. 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.

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