

Aid for Trade

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Introduction

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. One reason is that donors are becoming more aware that increased aid flows may have unintended negative consequences for developing countries – especially 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 in developing countries.²

Another reason is that the next two years are also a critical period for the WTO, during which it hopes to reach a conclusion to the Doha Round.³ The imperative to make good on the development promise of the round, as a prerequisite for its conclusion, provides a political focus for aid for trade.⁴

Fifteen years after the Williamson's articulation of the Washington Consensus⁵, the world has come to acknowledge that free trade is not a magic wand.⁶ The old trade framework assumed

¹ This paper is based on a report prepared for the Commonwealth Secretariat. We acknowledge the comments of participants at the meeting organised by the Commonwealth and held at UNCTAD on Tuesday 21 and Wednesday 22 March. We also acknowledge comments received at the conference "An Assessment of the Doha Round after Hong Kong", 2-3 February, 2006, organized by the Initiative for Policy Dialogue at Columbia University and hosted by the Brooks World Poverty Institute at Manchester University. We have benefited from comments by Ricardo Melendez-Ortiz, Julia Nielson, Dan Curiak, Sheila Page, Susan Prowse, Hilde Johnson, Dirk Willem te Velde, Simon Evenett, and Roman Grynberg, without implicating them in the opinions expressed in the report.

² For a discussion of Aid for Trade, see Page (2006)

³ Although there are concerns that the round may not be finished within two years, see Evenett (2006).

⁴ for a broader discussion of the development potential of the Doha Round, see Stiglitz and Charlton (2005).

⁵ Williamson, J. [1990] "What Washington Means by Policy Reform," Chapter 2 in *Latin American Adjustment: How Much Has Happened?*, John Williamson (ed.), 1990, Washington: Institute for International Economics.

(i) trade liberalization would automatically lead to increased trade; (ii) increased trade would lead to faster growth and development; and (iii) trade-induced growth would lead everyone to be better off. Subsequent research has produced a new trade policy framework which has questioned each of these hypotheses. First, trade liberalization *may* be necessary for sustained expansion of trade volumes, but it is not sufficient because many factors other than tariffs contribute to the growth of exports and imports.⁷ Second, trade *may* be necessary for sustained industrial development, but it is not sufficient. Even if trade liberalization leads to more trade, even if trade leads to more growth, there are attendant costs to liberalization which have received insufficient attention. Finally, even if trade liberalization leads to more trade, and even if trade leads to more growth, and even if the benefits of trade liberalization exceed the costs for the country as a whole, particular groups may be worse off. Indeed, there may be more losers than winners. And even if the winners could have compensated the losers, they seldom do.⁸

The aid for trade agenda does not seek to resolve all of these problems. It focuses mainly on the first issue—ensuring the trade liberalization is more likely to lead to more trade. It reflects the realisation that, for developing countries, the investments that are necessary if they are to realize the full benefits of new market opportunities 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. This was put forcefully by Pascal Lamy, Secretary General of the WTO, when he was still the EU Commissioner for trade: “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).

The final Declaration of the WTO Doha Ministerial meeting in Paragraph 41 reiterates the importance of technical assistance and “reaffirms ...the important role of sustainably financed technical assistance and capacity-building programmes”.

Of course, in the Uruguay Round there was recognition that developing countries would need technical assistance to implement the agreement—and a promise that such assistance would be given (though, as the G77 has repeatedly noted, the assistance has not been forthcoming,

⁶ 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.

⁷ For example, the focus on trade facilitation measures reflects a recognition by the developed countries that their ability to sell goods to developing countries depends not just on tariffs. The discussion below will highlight the range of other barriers, which may be especially important in developing countries being able to get meaningful access to developed country markets.

⁸ The adverse distributive effects of trade liberalization for developed countries were predicted long ago by Samuelson and Stolper (1941). But it also seems to have adverse distributional impacts within developing countries. Some of the arguments for aid-for-trade do focus on these effects. For a fuller discussion of these distributional consequences and the appropriate responses, see J. E. Stiglitz, *Making Globalization Work*, New York: WWNorton, 2006.

at least to the extent promised.) But it is now clear that the extent and range of assistance required is far larger than was envisioned a decade ago.⁹

The first part of this paper sets forth the case for aid-for-trade, explaining why without such aid, it is unlikely that the promised benefits from trade liberalization will materialize. The second part of the paper discusses what an aid-for-trade program might look like.

I. THE CASE FOR AID-FOR-TRADE AND THE NEW TRADE POLICY FRAMEWORK

The new trade policy framework seeks to explain why trade liberalization has so often failed to live up to its promises, of increased trade, growth, or welfare.

1.1. Trade liberalization may not lead to more trade

In the right circumstances, trade liberalisation creates opportunities for trade and development, but other factors determine the extent to which those opportunities are realised, and whether the increased trade leads to an increase in welfare and overall growth. However the lessons from the EBA and AGOA experiments – which gave LDCs free access to American and European markets, but resulted (in most cases) in disappointing increases in exports – indicate that this has not happened to any meaningful degree.¹⁰

Similarly, 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. Indeed, despite decades of multilateral liberalization and increasingly ‘generous’ preferential schemes, LDC’s share of world trade has been falling over the past twenty years.

Trade has not increased both because of the absence of “export infrastructure” and other *internal* barriers to trade and “supply constraints.” Of course in the past the hope was that new market access by itself would spur investment in new supply capacity in the LDCs. Time and time again we learn that without decent roads, efficient ports, and the technical capability to produce and distribute goods of sufficient quality (which collectively may be thought of as the exporting infrastructure), new trading opportunities are meaningless for the poorest countries.¹¹ By the same token, without access to credit, it will be difficult for new enterprises to be created or old enterprises to expand to take advantage of any new opportunities. The public and private investments are, of course, complementary: even were finance available, without the necessary infrastructure, the internal barriers to trade will remain large.

⁹ The developed countries have unfortunately not even lived up to the commitments for technical assistance that they made.

¹⁰ For a survey of some of the evidence, see Charlton and Stiglitz, *op cit*

¹¹ 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.

The reason that the benefits reaped by LDCs so far have been so much smaller than those received by developed countries is simple: the “internal” barriers to trade are much more important for LDC’s, so the elimination of tariffs represents a much smaller change in the *total* barriers to trade..¹²

1.2. More trade may not lead to more growth

Even when exports do increase, they may not lead to robust growth: Brazil’s exports have doubled in the last three years, while its growth remains anaemic. There has, more generally, been a reassessment of the overall benefits and costs, resulting in a far more nuanced understanding of the role of trade in development than has previously been presented by many international institutions.¹³

While most of the economic theory of trade liberalisation has focussed on static welfare gains, the long term effects of trade liberalisation are determined by its effect on the economy’s rate of growth. Recent models of growth have important implications for the theoretical relationship between free trade and economic growth. Greenwald and Stiglitz (2006) show in some circumstance developing countries maximise their welfare by supporting industries outside their static comparative advantage. If advanced industrial sectors drive innovation and this innovation is determined by the size of the industrial sector, and especially if the productivity gains are transmitted between industries, but not across national borders, then developing countries may benefit from policies to support these industries and sectors.

1.3. Large adjustment costs

Any ‘gross’ welfare gains from trade liberalisation must be balanced against their associated costs. Liberalisation results in countries facing large 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. The costs of these adjustments are particularly large for developing countries—while their ability to bear them is limited. Money spent on adjustment is money that could have been spent on high return investments elsewhere in the economy, which is perhaps part of the reason why the growth benefits of trade liberalization appear so limited.

There are a range of adjustment costs, including fiscal losses, preference erosion, the direct and indirect costs of industrial restructuring, and the costs of implementing new regulatory

¹² 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 barriers. In effect, trade liberalization reduces the barriers to trade by a much larger percentage for developing countries than for developed.

¹³ The IMF’s former First Deputy Managing Director, Stan Fischer (2000), boasted that the “Fund is a powerful voice and actor for free trade” and suggested that this is because “integration into the world economy is the best way for countries to grow”.

regimes.¹⁴ 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.¹⁵ Sixth, developing countries are more dependent on tariffs as a source of revenues—and for good reason: the costs of alternative sources of revenue are high. Tariff reductions force them to shift the burden of taxation to these alternatives.¹⁶ For all of these reasons, the adjustment to new trading rules is a radically different experience for developed and developing countries.

Moreover, the adjustment costs may not be just a one-time. Trade liberalization may, for instance, expose developing countries to more shocks, their economies may be less capable of absorbing the shocks and their people may be less able to cope with the consequences.¹⁷

1. 4. The empirical evidence

¹⁴ See Stiglitz and Charlton (2005) for further evidence of these costs.

¹⁵ Even in developed countries, there is evidence that less well educated workers that are displaced experience greater adjustment costs.

¹⁶ For instance, while the V.A.T. is an efficient (though regressive) tax for developed countries, it is typically inefficient for developing countries, because of the difficulties (impossibility) of taxing the large informal sector. See Emran and Stiglitz [2004]. By the same token, tariff protection may be a relatively efficient method of encouraging the development of the industrial sector; forcing developing countries to resort to other instruments may be costly. See Greenwald and Stiglitz, *op. cit.*

¹⁷ There are other on-going costs, such as the incremental burden of shifting from tariffs to other third-best revenue sources.

Standard economic theory, of course, never claimed that trade liberalization would lead to increased growth; it simply argued that it would lead to welfare gains, and that the winners *could* compensate the losers. There was a one time gain in efficiency from trade liberalization—during which growth would be higher. It is difficult to identify the original evidentiary source of the bullishness for unqualified trade liberalisation during the era of the Washington Consensus. Certainly there were several studies in the early 1990s which purported to show a positive relationship between trade openness and economic growth (see Dollar, 1992; Ben-David, 1993; Sachs and Warner, 1995), but even these were careful to qualify their results.¹⁸ Meanwhile Francisco Rodriguez and Dani Rodrik (1999) have persuasively shown that the conclusions of these studies should be interpreted with extreme caution.¹⁹ Most importantly, most of these studies focus on the consequences of *trade openness*, not *trade liberalization*; the export oriented countries of East Asia promoted trade, and grew rapidly, but their focus was on exports, and most did not liberalize quickly. Their periods of most rapid growth preceded trade liberalization. One study that focused explicitly on trade liberalization itself showed no relationship with economic growth.²⁰

To recognise the weakness of the empirical evidence in this field is not to argue that trade protection is good for growth but it does suggest that the relationship between trade liberalisation and growth is not simple. For instance, trade liberalization may have positive effects on some countries (e.g. those with low unemployment rates and fewer market imperfections), but negative effects on others (e.g. those with high unemployment rates, weak credit markets, and incomplete markets).

II. AID FOR TRADE FOR WHAT?

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

¹⁸ In the conclusion to their paper, Jeffrey Sachs and Andrew Warner point out several of the important caveats to their study.

¹⁹ They found that the indices of openness used in these studies conflated the effects of trade policies with other phenomena. In particular the studies were identifying the negative effects macroeconomic imbalances, instability, and geographic location, and misattributing them to trade restrictions. Rodriguez and Rodrik pointed out that because of these methodological weaknesses, the policy conclusions drawn from these studies are not strongly supported by the data they present.

²⁰ UNDP *Making Global Trade Work for People*: New York, UNDP, 2003.

this view conceives of aid for trade as a "normal negotiating side payment"²¹ 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.²²

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".

There is a further question: is it countries or individuals who should be compensated? Compensation to the country which (as a whole) may be worse off may not reach the individuals who bear the costs of adjustment. On the other hand, designing aid mechanisms that actually deliver assistance to those adversely affected may be extremely difficult. Few of the aid-for-trade advocates seem to have this individual compensation in mind.

All of these 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.

²¹ Gary Hufbauer of the Institute for International Economics. Comments at a meeting of trade experts hosted by International Trade Canada, Ottawa, March 3, 2006.

²² The potential 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) The fact that they acceded to the agreement shows that aid for trade may not be necessary to achieve agreement, reinforcing our conclusion that this should not be a rationale for aid-for-trade. (To be sure, the developing countries are far more aware of potential adverse effects of trade agreements than they were a decade or more ago, and Cancun showed their heightened willingness to resist.

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.²³ 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?).²⁴

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. 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 and the other problems noted earlier are barriers 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.”

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.

2.1. Aid for trade vs development aid

²³ 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.”

²⁴ By the same token, there is a question of whether the gains from trade liberalization should be used to offset the adjustment costs..

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. There is a value in focusing explicitly on these market expanding expenditures—certainly that must be the case if the rhetoric that trade is good, or even essential, to the growth of developing countries is to be taken seriously. 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.

2.2. Building supply capacity

The central rationale for aid-for-trade then is that 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 is extremely limited and because internal barriers to trade, such as lack of infrastructure (ports and roads) are severe. Easing supply constraints requires going beyond bolstering public institutions through technical assistance 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.

These needs are outlined in more detail in Stiglitz and Charlton (2006). Private sector development, for instance, centers around 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 instruments to mitigate risk and through assistance to improve local financial markets.

Here, we focus on infrastructure. Poor transport infrastructure can prevent local farmers from accessing large domestic markets and 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 condition²⁵ 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.²⁶ 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.

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. The increased focus on infrastructure needs is reflected in the World Bank's plans to increase infrastructure lending by \$1 billion 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 by African countries and by the European Commission, G8, and key multilaterals.²⁷

Of course, in order to achieve trade related policy objectives, infrastructure improvements have to be coupled with good policies (including good macro-economic policies.) This means not only avoiding high inflation, but achieving *real stability*, with low and stable real interest rates.²⁸ Research indicates that returns to infrastructure projects can vary widely and are affected by the quality of the business environment. It should be obvious that 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.²⁹

III. NEW MECHANISMS FOR AID FOR TRADE

²⁵ IMF (2004) Uganda Poverty Reduction Strategy Paper, Progress Report, IMF.

²⁶ 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.

²⁷ 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.

²⁸ In that sense, the macro-economic policies advocated by the IMF have often been counterproductive. See Ocampo *et al* *Growth with Stability*, Oxford University Press and the Initiative for Policy Dialogue, forthcoming.

²⁹ Anke Hoeffler, 1999, “Challenges of Infrastructure Rehabilitation and Reconstruction in War-affected Economies” Background paper for the African Development Bank Report 1999.

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 institution would complicate further the problems of coordination required for achieving donor 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.³⁰ 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.³¹

Existing mechanisms have been relatively successful in managing the policy dimension of aid for trade – they have, for instance, 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).³² But the IF's institutional structure, designed to provide and coordinate advice, not to administer aid, means that it is ill-

³⁰ In the IMF, it has effective veto on important matters, given the requirements for supermajority votes on important matters.

³¹ 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.

³² 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.

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.

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 private sector development, including start-up financing for small and medium sized enterprises. But more than offsetting these advantages are the problems it would present: 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. We consider this an essential feature of any trade-for-aid scheme. However, these proposals for dedicated funds link aid-for-trade to the rationales based on compensation, which we argued should not underlay aid-for-trade.³³ While we believe that the problem of preference erosion is important and funds will be required if these countries are not to find themselves worse off at the end of the Development Round, as we have argued earlier in this paper, a new aid for trade facility should encompass broader objectives.

Our proposal represents a balancing of these various institutional concerns. Rather than the establishment of a new fund, our proposal relies largely on using existing institutional arrangements. In particular, dedicated funds for aid for trade – provided 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 an international organisation (like UNCTAD), much as the Global Environment Facility is administered by the World Bank. A small Global Trade Facility secretariat could be established, 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, for instance, the system of auctionable sanctions.) The GTF secretariat would not directly administer the assistance programs, but would review proposals from countries, multilateral institutions (including the World Bank and regional development

³³ This means that there is no reason in principle that the aid should be related to trade development rather than channeled as direct transfers. There are other problems with adopting compensation as the basis underlying the aid-for-trade program, discussed earlier. 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.)

banks), and NGO's for assistance.³⁴ This would encourage competition among aid recipients and deliverers to develop the most effective and efficient aid-for-trade projects and programs. And the secretariat would evaluate the outcome of these projects, assessing both success in promoting trade and in enhancing development.

3. 1. 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.

There is another reason that the governance structure should be different from that of the World Bank, where voting is dominated by the donor countries: the GTF is the result of a negotiated global trade agreement. Indeed, one of the principle responsibilities of the GTF is to enforce the obligations/commitments of the advanced industrial countries. This means that it *cannot* be controlled by 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). 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.

³⁴ The GTF secretariat might be housed within UNCTAD, in order to ensure that the perspectives of the developing countries play a larger role than they do within existing aid institutions. The diversity of perspectives might complicate the problem of aid coordination, but the gains from diversification likely would more than offset the any incremental coordination costs.

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) of assistance that the developed countries have made 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 of the belief that it introduces 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. The basis of the maintenance of effort commitment 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, to include assistance *exclusive of reconstruction activities in war zones and exclusive of all military assistance*.³⁵

³⁵ Reconstruction activities are important, but they should not be at the expense of the broader commitment to development.

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. 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. We believe that the proposal we have suggested has the potential of meeting these criteria.

3.2. Political economy considerations

Finally it is important to consider how an aid for trade agreement would affect the political context of the negotiations. 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 by the aid-for-trade initiative. 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.³⁶ 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.³⁷

IV. 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 of the benefits from these agreements 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. Any 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. 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

³⁶ In that sense, it opens up the possibility of Pareto superior outcomes.

³⁷ It is important, accordingly, that the rules for allocation of aid be set broadly enough that aid-for-trade cannot be used to offset particular discriminatory trade policies, e.g. America’s 97% opening to the least developed countries, widely viewed as targeting exports of textiles and apparel from Bangladesh and Cambodia.

We have argued that increased aid is vital for the poor countries if they are to grasp the opportunities provided through trade and absorb the costs of adjustment. 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.

In arguing that there should be additional assistance to enable developing countries to expand their capacities to trade, we are not suggesting 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. But we are arguing that without such aid, the prospects of trade liberalization bringing the benefits which its advocates have promised are dim.

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 discussion of intellectual property moved to the WTO because WIPO had no effective enforcement mechanism. But finance is even more central to trade. For the first time, the aid for trade proposal brings the power of commitment and enforcement to promises of aid.³⁸

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.³⁹ 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 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

³⁸ The importance of enforcing such commitments for assistance is highlighted by the failure of the developed countries to deliver on the promises of technical assistance within the Uruguay Round.

³⁹ Actually, the agenda of trade-for-development is much broader than just agriculture, as we point out in *Fair Trade for All*. But most of the key issues were not on the agenda of the Development Round.

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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