

SOME TOUGH LOVE ON "AID FOR TRADE"

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Abstract:

Proposals for additional funds to support the adjustment of developing countries to trade reforms and to further integrate them into the world economy attained considerable prominence during 2005. I examine the rationales for such "aid for trade" and find that some of them need clarification or reformulation. Even so, I conclude that aid for trade can be an important vehicle to reduce the opposition of certain developing countries to the conclusion of the Doha Round, should that ever come to pass.

1. Introduction.

Recently, the staffs of the World Bank and the International Monetary Fund wrote the following in a memorandum to their respective Development Committee:

But while there are real gains for developing countries from active participation in the Doha Round, gains will not necessarily be automatic, and some countries may experience transitional adjustment costs. Increased international assistance will be required to help countries overcome supply-side constraints in order to take advantage of new trade opportunities from the Doha Round, or to address transitional adjustment costs from liberalization. This "aid for trade" is an essential element of a successful, pro-development Doha package. (Development Committee 2005, page 7).

In this short essay I examine several of the claims made in this quotation, including the rationales advanced for aid for trade (AFT). I also ask what this statement implies about our understanding of the effects of trade liberalisation over time and about the appropriate role of the World Trade Organization (WTO).

Before examining in detail the rationales for AFT, which is the subject of the second section of this essay, a number of contextual observations are in order. The first is that the factors identified in the above quotation--namely, adjustment and integration--are not new, even if proposals for AFT are. Why, then, have proposals for AFT only been advanced recently? A combination of the following factors may go a long way to answering this question: the adop-

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tion by WTO members at the Doha Ministerial meeting of the so-called development mandate (which, for the first time, elevated the performance of developing countries to be an important objective of a multilateral trade round); the expansion of preference regimes in the mid-to-late 1990s and the belief that any across-the-board tariff cuts negotiated in the Doha round could substantially reduce the value of the preferential market access to industrialised country markets enjoyed by some developing countries; and the widespread perception encouraged by some non-governmental organisations and found in certain World Bank reports that many developing countries did not benefit from the Uruguay Round of multilateral trade negotiations and, on this view, the causes were circumstances external to, or imposed on, these developing countries. Taken together these factors imply that some developing countries--as many as 100 according to some trade experts in Geneva--see themselves as victims of the last trade round and likely losers from this round.² This, it is said, they find galling especially in a round which is supposed to be devoted to taking their interests seriously. Proposals for AFT, then, can be seen as one way to persuade these developing countries that the further liberalisation of the multilateral trade system is in their interests as well.

2. Assessing the rationales for AFT.

The advocates of AFT have identified at least five possible uses to which additional support for developing countries could be put. These quite disparate uses are:

- To cover, in whole or in part, the likely adjustment costs and losses that result from so-called preference erosion (Prowse 2005).
- To cover, in whole or in part, the likely adjustment costs and losses felt by net food importing countries should certain agricultural trade reforms be implemented (Prowse 2005).
- To cover, in whole or in part, adverse macroeconomic adjustments in developing countries that may be triggered by multilateral trade reforms, including the loss of tariff revenues and the costs of inter-sectoral labour reallocation (Prowse 2005).
- To finance, in whole or in part, the trade-related supply side and administrative investments that developing countries "must" make so as to benefit from the opportunities created by multilateral trade reforms or, more generally, by integrating further into the world trading system (Prowse 2005).
- To finance, in whole or in part, some of the new resource-intensive commitments that developing countries may take on as part of the Doha round (Development Committee 2005 and Switzerland 2005).

Proponents of AFT go on to note that, should the Doha round be concluded with a high degree of ambition, then this would generate (in absolute terms, if not necessarily as a percentage of national incomes) substantial benefits for industrialised countries. It is argued that a small fraction of those gains should be put aside to fund AFT projects in eligible developing countries. Prowse (2005) and others suggest that the Integrated Framework programme could be expanded in scale to administer the AFT funds, but do not rule out other organisational modalities.

An exclusive focus on aggregate welfare effects of the successful conclusion of the Doha multilateral trade negotiations is misplaced, advocates of AFT contend. The distribution of those gains across countries is an important determinant of the political viability of multilat-

² It should be remembered that not every developing country stands to benefit from agricultural trade liberalisation, which has been the focus of most of the trade negotiations in 2005. Indeed, from time to time the African, Caribbean, and Pacific (ACP) group of nations signals to other WTO members that the successful conclusion of negotiations on agricultural trade matters, should that ever come to pass, in no implies that these countries' negotiating objectives have been met.

eral trade liberalisation. The existence of preference erosion, potential losses to net food importers, and the possible difficulties in replacing some tariff revenues with other sources of governmental income in countries without well developed taxation systems, implies that one cannot dismiss *a priori* concerns that some of the elements of national welfare could be detrimentally affected by the conclusion of the Doha round on ambitious terms. Having said this, proponents of AFT are quick to note that although some of the elements of national welfare may be adversely affected, if only temporarily, by the conclusion of the Doha round, it is the effect of the round on a nation's overall level of welfare that should influence the eligibility of a nation for AFT.

Although it is never stated this way, one way to think about the role of AFT is that it is to ensure that any Doha round package results in pareto improvements for each developing country. Here, AFT can be seen as effectively as a series of transfers that compensate (where appropriate) and facilitate adjustments in developing countries so that they do not lose from the conclusion of the Doha round. Seen in this way proposals for AFT may be well received by those economists (myself included) who are unwilling to see the interests of one group of nations (or interests within those nations) sacrificed to attain the greater good (however defined). Of course, ensuring that no nation is made worse off by the conclusion of the Doha round is not the same as arguing that each country should share in the gains created by the Doha round. The latter--perfectly legitimate--normative objective would require a different set of transfers to developing countries and I note that proponents of AFT have not made their case in these terms either.

Having stated by support for one form of AFT let me express some doubts about a number of the arguments used to advance these proposals. I make no apologies for relating these arguments to our understanding of resource allocation in economies open to trade because, from time to time, in discussions on AFT I wonder if those linkages are as extensive as they could be.

My first comment on the arguments for AFT is that it is important to distinguish between the erosion of rents and the costs of adjusting from one situation (equilibrium outcome) to another. I start by noting that, as an ethical matter, I suspect that many are far less willing to support compensation for rent loss than for adjustment costs, even though compensating the former may be necessary in some instances to assure the political viability of any trade accord.

However, my main concern here is that our understanding of the adjustment processes that developing countries go through during and after multilateral trade liberalisation is a lot less well advanced than the comparisons of the beginning or end points of rest, or equilibria. Is it any exaggeration to say that the number of studies reporting comparative statics estimates of the gains from multilateral trade liberalisation exceed the number of careful studies of trade-related adjustment processes in developing countries by a ratio of ten to one? Moreover, when adjustment costs are discussed by trade economists they tend to be reported (often dismissed) as small and therefore (so the argument goes) easy to accommodate with complementary national measures, such as job retraining.³ These claims, resting as they do on a limited body of evidence, are hard to square with developing country concerns about the magnitude of adjustment triggered by trade reforms. Rather than downplaying the latter, researchers might ask if they have missed something about the adjustment process.

In this respect, the adjustments often triggered (or the changes often recommended) relate to policy and institutional changes and not just to markets, which most economists tend to feel more comfortable analysing. For example, replacing tariff revenues with income from broad-

³ I note that proponents of AFT appear to have kept an open mind about the magnitude of adjustment costs.

based labour or value-added taxes may be an essential part of the adjustment process for some developing countries in an ambitious Doha round outcome. Are trade economists absolutely confident about the magnitude of the transition costs associated with what is essentially a public finance question? Similar questions could be posed about the labour market adjustment processes in developing countries. Here a little more humility may be in order.

Another logical possibility that tends to get overlooked is one that arises when preference erosion undermines the commercial viability of an entire sector in a developing country. Some poorer countries forcefully assert that, even with ambitious cost reduction programmes on the part of their producers, substantial preference erosion will result in the collapse of a major industry. Many models that are used to estimate the costs of preference erosion assume that the minimum marginal cost of production of the good in the preference-receiving country is very low, or even zero, and so do not generate complete industry collapse when preferences are eroded by substantial cuts in most-favoured nation (MFN) tariff rates in industrialised countries. Arguably, we need to know more about the likelihood of such collapse and about how developing countries have adjusted in the past to the elimination of industries that employ a substantial proportion of the national labour forces. How long did adjustment take before unemployment returned to its pre-collapse levels? What were the effects on wages and employment? What steps can be taken to reduce the transition costs of inter-sectoral reallocation of resources? What is needed here is more facts and more analysis of those facts, and less resort to first principles to dismiss the adjustment-related concerns. In sum, I suspect that our ability to cost and implement AFT will require a much deeper understanding of the adjustment processes that developing country workers, consumers, firms, and governments go through as result of multilateral trade liberalisation.

My second set of comments relates to an implicit assumption made in proposals for AFT; namely, that developing countries under-invest in the administrative, infrastructure, and other reforms that influence the extent to which they benefit from the opportunities created by trade reform and by open markets more generally. In my view it is appropriate to ask why such under-investment occurs, as the diagnosis may reveal something about the optimal cure. Perhaps the best attempt to address this matter can be found in Development Committee (2005 page 9) where it was argued:

There may be too little trade reform not only because the benefits of unilateral trade liberalization may be poorly understood by the general public, but also in part because MFN (non-discriminatory) trade reform has some of the characteristics of a global public good and is not adequately internalized in country processes. Trade policy reforms (such as lowering of tariffs) and investments in trade machinery (such as customs reform and ports) can have significant externalities. All countries benefit from one country's trade reforms and trade-related investments, and benefits are increased when undertaken by a number of countries concurrently. However, the full benefits of reform are not captured by the country itself, leading potentially to "under-investment" in reform.

What should one make of this argument?⁴ First, it seems to suggest that a difference exists between national and global returns/benefits at the margin. If the costs of investments in reform are borne entirely by a nation, then under-investment will result. Some reforms that are optimal from the perspective of world welfare will not be undertaken by the nation in question. If indeed this is the argument then the proper policy response is to offer a subsidy to the decision-maker equal to the difference between the national and global marginal benefits at the optimal level of investment--and not to offer a lump sum transfer, which one could conceive the current AFT proposals calling for. Having said that, one could conceive of a broader

⁴ Readers should note that space considerations only allow me to make a limited number of comments about this argument.

AFT programme having a subsidy-based component (to tackle under-investment) and, where appropriate, a transfer-based component (to compensate outright "losers" from multilateral trade reforms). The underlying point, however, is that AFT programmes need to be structured to remedy the sub-optimal decision-making in each area where policymaking and private sector decision-making critically impinges upon developing country export performance.

My second concern with this "internalisation" argument is that it is far too broad to be a convincing defense of AFT for developing countries. The argument, after all, does not discriminate between countries on the basis of their level of development. And it certainly does not show that under-investment is a more serious problem for developing countries than for other countries. Also, it is unclear that full internalisation occurs in industrialised economies, in which case shouldn't we be subsidising investments in these economies too (especially since developing country exporters will benefit from some of these trade-related investments)? I suspect that the implicit assumptions being made are that industrialised countries are rich enough to take care of themselves or that the development mandate for this round calls only for a focus on developing countries in this regard. Either way, it would be better to spell out any implicit assumptions in making the case for AFT, or to reformulate the argument so that it specifically relates to the circumstances of developing countries.

My third concern about this argument is that it may be misleading to think about the rationale for under-investment in a given activity or reform as essentially independent of the levels of investment in other areas that affect the ability of developing country firms to take advantage of the opportunities created by multilateral trade liberalisation. Here, so-called O-ring reasoning may be more appropriate, where sub-optimal outcomes in any one component of a nation's trade-related capacity reduces the returns to investing in other components. One could, for example, envisage that the returns expected from investing in a new port are reduced by the existence of a corrupt and inefficient customs service. This way of thinking about the problem suggests that the goal of AFT is to break a self-enforcing cycle of under-investment in supply side-related capabilities that has persisted over time. In a nutshell, the AFT programme that one might design if the internationalisation argument is employed may well differ markedly from a programme based on O-ring reasoning.

Proposals for AFT also bring to the fore a question that has not been resolved ever since WTO members adopted the development mandate at the Doha Ministerial meeting. That question is: given the pre-existing mandates of the WTO in what ways, if at all, does the adoption of the development mandate alter how the performance of the multilateral trading system is evaluated? One of the factors motivating AFT is the perception that developing countries need assistance to capitalise on the opportunities created by trade reforms. If AFT is adopted does that mean that the WTO in general, or the Doha round in particular, will be judged in terms of its impact on developing country exports--rather than on the opportunities created by negotiating lower trade barriers or by the implementation and compliance with new multilateral commitments? If so, where does this argument stop? There are plenty of ways of expanding the exports of developing countries that violate the non-discrimination principle (unilateral preference schemes are one example that comes to mind). Are we to start trading off departures from non-discrimination for increases in the exports of a subset of the WTO membership?

Or, given the development mandate, is the correct way to judge the Doha round in terms of the export growth it generates for developing countries recognising that the round seeks to reduce the degree of discrimination in the world trading system? If this is the correct formulation (and arguably there are more compelling objectives than export growth), then one might be able to assess the extent to which AFT contributes to the overall success of the Doha round. Some notes of caution, however, are merited. Export growth is affected by many factors, only some of which are under the control of the government. Is there a risk that lousy export growth after the Doha round could be misattributed to poor implementation of AFT,

possibly also tarnishing the reputation of the WTO? Moreover, is there a risk that some developing countries will perceive that the implementation of AFT implies that the multilateral trading system is taking responsibility for their economies' export growth, so absolving national policymakers of any responsibility in this regard? In short, the metrics for evaluation, expectations, and responsibilities associated with the parties to AFT programmes would have to be clearly spelled out to avoid a number of pitfalls.

A focus on promoting developing countries' abilities to capitalise on the opportunities created by multilateral trade liberalisation often appears to be silent on distributional issues, which would have implications for the likely design of a successful AFT programme. If the promotion of each developing country's exports is the objective, then surely the credibility of an AFT scheme will depend on assurances about the level and allocation of funds committed to AFT, assurances which I doubt donors and the multilateral development banks will be willing to give. This in turn raises the fear that discrimination against developing country exports could be replaced by discrimination in the allocation of funds for AFT. This is the minefield in which AFT proponents must tread if distributional equity concerns are to be addressed comprehensively.

3. Concluding remarks.

In this paper I have summarised and assessed selected aspects of recent proposals for Aid For Trade. In my view, when properly reformulated, these proposals could play a very important part in persuading many developing countries that they have a stake in the further liberalisation of the multilateral trading system and, therefore, that they should not block the eventual conclusion of the Doha round. I have also identified a number of weaknesses in the rationale for Aid for Trade and in the underlying factual base; deficiencies that can be readily rectified through further data collection and analysis.

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