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ELEMENTS FOR THE ARCHITECTURE OF AID FOR TRADE

SYNOPSIS

The underlying message of this paper is that aid for trade is important to mitigate trade-induced adjustment costs and to bolster supply-side capacity in developing countries. However, aid is only second-best to balanced, fair and equitable trading rules. The Aid for trade architecture should, thus, be crafted to make trade supportive and not a substitute to a pro-development outcome in the multilateral trade negotiations.

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I. Introduction

1. In its Policy Brief entitled "Aid for Trade"[1], the South Centre depicted its concern about the likely 'use' or 'misuse' of the Aid for Trade initiative to lure developing countries to accept 'bad deals' or to influence their negotiating positions in the WTO. It also portrayed the possible implications that could result if the architecture of the initiative was explicitly or tacitly linked to developing countries undertaking ambitious trade liberalisation commitments.

2. In this paper, the South Centre intends to contribute to the debate about the architecture - the institutional arrangements and elements - of the Aid for Trade initiative so that it is beneficial to the developing countries. The architecture of the initiative determines the extent of the contribution of the initiative to the development dimension of the Doha Development Agenda. This paper argues that trade-related adjustment costs are a serious and growing concern for developing countries since they are often obligated to undertake trade liberalisation and trade policy reform commitments at levels and paces that are neither commensurate with their respective development level nor supportive of their development priorities. The underlying message of this paper is that aid for trade is important to mitigate trade-induced adjustment costs and to bolster supply-side capacity in developing countries. However, aid is only second-best to balanced, fair and equitable trading rules. The Aid for trade architecture should, thus, be crafted to make trade supportive and not a substitute to a pro-development outcome in the multilateral trade negotiations.

3. The rest of the paper is organised as follows: section II provides a brief background of the Aid for Trade initiative, its objectives and the current state of play. Section III analyses the cost of trade liberalisation faced by developing countries and the supply-side constraints that hinder developing countries from fully benefiting from market access opportunities. Section IV makes suggestions and recommendations on the architecture of the Aid for Trade initiative. Concluding remarks are given in section V.

II. Current State of Play of the Aid for Trade Initiative

II. 1. Background

4. In response to requests by Finance Ministers of the G7 and the G8 leaders, who met in Gleneagles in 2005, the World Bank and the International Monetary Fund (IMF) jointly prepared a proposal for the expansion of Aid for Trade. The proposal envisaged the expansion of financial and technical assistance for developing countries to address the adjustment costs of trade liberalisation and trade-related supply-side capacity constraints.

[1] South Centre, 2005, "Aid for Trade," T.R.A.D.E. Policy Brief No. 2, November.

5. The high adjustment costs of trade liberalisation have been a major obstacle for trade reforms in developing countries while supply-side capacity constraints have undermined developing countries' ability to benefit from market access opportunities. Both of them are real challenges faced by developing countries, and addressing them simultaneously will greatly contribute to economic and human development. When read at face value, this is what the Aid for Trade initiative envisaged to undertake. However, concerns about the likely use or misuse of Aid for Trade to influence developing countries' negotiating positions in the multilateral trade negotiations and their domestic trade and development policies have abounded both in the run up to, and in the aftermath of, the Hong Kong Ministerial Conference.[2] As a result, some analysts have viewed the Aid for Trade initiative as a 'Trojan Horse'.

II. 2. The Objective and the Scope of the Mandate on Aid for Trade

6. The Sixth WTO Ministerial Conference in Hong Kong incorporated Aid for Trade to the Doha Work Programme. The Aid for Trade initiative is enshrined in paragraph 57 of the Ministerial Declaration. However, the wording of the paragraph does not place any binding obligation on donors.

7. The objectives of the Aid for Trade initiative could be extracted from the relevant sentence, which reads:

> *"… Aid for Trade should aim to help developing countries, particularly LDCs, to build the supply-side capacity and trade-related infrastructure that they need to assist them to implement and benefit from WTO agreements and more broadly to expand their trade. …"*

8. From the text above, it could be extrapolated that the objective of the Aid for Trade initiative is to provide assistance to developing countries for building supply-side capacity and trade-related infrastructure. The assistance is such that developing countries: (i) "implement" WTO agreements; (ii) benefit from opportunities arising from WTO agreements; and (iii) expand their trade.

9. A recent document by the Organisation for Economic Co-operation and Development (OECD) reported that the objective of the Aid for Trade programme proposed by the World Bank and the IMF is broader than the objective enshrined in paragraph 57 of the Hong Kong Ministerial Declaration (HKMD).[3] The World Bank/IMF proposal argued that the aid for trade initiative should encompass both trade adjustment costs as well as assistance for supply-side capacity building (including trade-related infrastructures). According to the OECD analysis, paragraph 57 of the HKMD limit the objective of the Aid for Trade agenda to help developing countries build supply-side capacity and trade related infrastructure. The OECD document stated that:

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[2] See, for example, South Centre, 2005, "Aid for Trade," T.R.A.D.E. Policy Brief No. 2, November; and Oxfam, 2005, "Scaling up aid for trade: how to support poor countries to trade their way out of poverty," Oxfam Briefing Note, 15 November.

[3] OECD, 2006, "Aid for Trade: Support for an Expanding Agenda," COM/DCD/TD(2006)2.

> "*There is even less agreement on whether, compensation/assistance with adjustment costs should be part of the [Aid for Trade] agenda. The IMF/WB note on aid-for trade argued for its inclusion in the agenda. … However, the issue is not a part of the Hong Kong Declaration, and the Development Committee considered that existing assistance mechanisms [mostly under the World Bank and the IMF] might be sufficient if better utilised."*[4]

10. The OECD excluded adjustment costs from its analysis. The exclusion of adjustment costs is contrary to the general understanding that portrays them as part of the Aid for Trade agenda.

11. According to the OECD, the possibility of doubling the share or the volume of Aid for Trade (under a broader definition which, in addition to technical assistance and capacity building, encompasses assistances for economic infrastructure, production and competitiveness) in the context of the scaling-up of official development assistance (ODA) is unrealistic.[5] As a result, the OECD emphasised on the need for establishing a consensual and realistic definition of Aid for Trade[6]

12. The Aid for Trade mandate enshrined in paragraph 57 of the HKMD should be broadly interpreted in light of its intent and objective. From developing countries' perspective, the object and purpose of the Aid for Trade initiative encompass adjustment costs of trade. As such, the scope of the Aid for Trade initiative would likely be among the most contentious issue in the Aid for Trade initiative. The exclusion of adjustment costs and the narrowing of the scope of the supply-side capacity and the trade-related infrastructure mandate of the HKMD would undermine the usefulness of the Aid for Trade agenda for developing countries. This paper strongly argues that costs of adjustment are within the scope of the mandate of the Aid for Trade agenda and no one type of adjustment cost should be *apriori* excluded. The paper also argues that the scope of the Aid for Trade agenda should be broad enough to encompass productive and competitive capacity of the private sector in addition to support to reducing transaction costs of trade (trade facilitation), technical assistance and capacity building and trade-related infrastructure. However, as the OECD observed, the parameter of such a broader definition of the Aid for Trade agenda should be cautiously defined to address substantial part of the trade-related challenges of developing countries without being overambitious or unrealistic.

13. In order to craft the Aid for Trade architecture in ways that address the concerns of developing countries requires the understanding of the type, nature and magnitude of the adjustment cost and the supply-side limitations that developing countries with various levels of economic development and with different economic structures could face. Section III of this paper addresses both of these issues.

[4] Ibid.
[5] Ibid.
[6] Ibid, p. 5.

II. 3. Current State of Play: Where are We Now?

14. Acting upon the mandate enshrined in paragraph 57 of the Hong Kong Ministerial Declaration, the Director-General of the WTO, Pascal Lamy, established a Task Force on Aid for Trade in February 2006. The Task Force is composed of 13 countries.[7] It is mandated to provide recommendations to the General Council by July 2006 on how to operationalise the Aid for Trade and on how Aid for Trade might contribute most effectively to the development dimensions of the Doha Development Agenda.

15. In their first meeting on 3 March 2006, members of the Task Force have agreed to commence their work with a stock-taking exercise on what has been done on trade-related development assistance so far, what needs to be done in the future, and how to structure such work in order make recommendations in time for the July deadline.[8] However, the specific subjects to be addressed by the Task Force are yet to be decided.

III. Adjustment Costs and Supply-Side Limitations in Developing Countries

16. The structure and pattern of international trade widely varies among developing countries with the same level of economic development as much as among developing countries with different levels of economic development. As such, a "one-size fits all" policy approach for developing countries is, thus, doomed to fallacious generalisation, hence to failure. In order to avoid the fallacious generalisation trap, the architecture of the Aid for Trade initiative must be cautiously crafted to address the particular trade-related concerns of each developing country.

17. The first subsection maps out and briefly analyses the type of adjustment costs faced by various groups of developing countries; the second subsection briefly points out the supply-side capacity constraints in developing countries.

III.1. Adjustment Costs

18. Trade-induced adjustment costs are generally regarded as transitional costs, induced by the implementation of trade reforms that result from either unilateral trade policy reforms or from compliance to bilateral and/or multilateral trade agreements. Higher adjustment costs could hinder trade policy reforms and could lead to reversals of trade policy reforms already undertaken.

[7] The 13 members of the Task Force in alphabetical order are: Barbados, Brazil, Canada, China, Colombia, the European Union, Japan, India, Thailand, the United States and the coordinators of the ACP, the African Group and the LDC Group. At her personal capacity, Ambassador Mia Horn Af Rantzien, the Permanent Representative of Sweden, is appointed chairperson of the Task Force.
[8] Bridges Weekly Trade News Digest, 2006, "WTO Aid for Trade Task Force Starts Mapping Future Work," Volume 10, Number 8, 8 March.

19. Trade-related adjustment costs are a serious and growing concern for developing countries in the multilateral trade negotiations. This is mainly because developing countries are often obligated to undertake trade liberalisation and trade policy reform commitments at levels and paces that are neither commensurate with their respective development level nor supportive of their development priorities. Despite the recognition by the preamble to the Marrakesh Agreement Establishing the World Trade Organisation and, more pronouncedly, by the preamble to the General Agreement in Trade in Services, of the development asymmetry among different countries, little practical relevance is attached, in the trade negotiations, to balance commitments that countries undertake with their levels of development. In essence, the principle of proportionality of obligations to levels of development has been neglected in the WTO trade negotiations.

20. Certain flexibilities available to developing countries under the principle of special and differential treatment have been made integral parts of the Doha Work Programme. However, the flexibilities have neither been sufficiently flexible nor fully operational to reflect the differences among countries' levels of development. As a result, most developing countries have ended up undertaking ambitious trade liberalisation and trade policy reform commitments that, by far, exceed their capacity, as dictated by their levels of economic development. They are, thus, incapable of absorbing the costs and benefits of such reforms. These commitments are often made at very high and long-lasting cost. Hence, it must be underlined that the first-step to assist developing countries to cope with trade-induced adjustment costs is for developed countries not to do any more harm by imposing on developing countries commitments that are incommensurate with their level and priorities of development.

21. Six major types of adjustment costs that developing countries with different levels of economic development and with different structures of international trade may face are identified and analysed below. However, these types of costs are only indicative, do not purport to be exhaustive and do not suggest headings under which Aid for Trade assistance should be based. These costs are: costs of preference erosion; costs of higher food prices; costs of compliance to product standards, costs of tariff revenue losses; and costs in factor of production (mainly labour and capital).

III.1.1. Cost of Preference Erosion

22. A number of developing countries, particularly least-developed countries (LDCs) and the African, the Caribbean and Pacific (ACP) countries, have been dependent on trade preferences for their competitive advantage. The degree of dependence on a narrow range of products and on preferential markets is higher among most countries in the ACP and the small island economies.

23. The basic objective of trade preferences has been to improve the ability of developing and least-developed countries to competitively and fully participate in world markets by providing them lower import duties than those applied to the products of other countries under the importing country's most-favoured-nation

(MFN) tariffs.[9] More concretely, the ideas underlying trade preferences are that the small-scale of industry and the low level of development in developing countries lead to higher costs, which, in turn, reduce their ability to compete in global markets, and to diversify their economies through industrial growth.[10] Hence, trade preferences have been important means of transferring price premiums to developing countries; and have had vital relevance for raising export earnings and for stimulating manufacturing activities and competitiveness in some of these countries.

24. Preferences have been crucial for many of the preference-receiving countries. As a result, preference erosion from multilateral trade liberalisation and unilateral MFN tariff reductions or quota expansions has been worrisome to them. Two recent studies[11] show that the problem of preference erosion is particularly serious for LDCs and low income developing countries that heavily depend on exports of sugar, bananas, textiles, tobacco, fisheries and cocoa.[12] For these countries, the benefit from trade liberalisation is lower than the cost arising from preference erosion. This is particularly the case if one goes beyond static cost consideration and incorporates the cost of 'policy-space' loss for economic diversification. As a result, LDCs and ACP countries have joined forces to form the Group of Ninety in order to ensure that concerns of preference erosion are reflected in the final text of the Doha Round.[13]

III.1.2. Cost of Increase in Food Prices

25. The Marrakesh Decision on "Measures Concerning the Possible Negative Effects of the Reform Program on Least Developed [LDCs] and Net Food Importing Developing Countries [NFIDCs]" was adopted by the Marrakesh Ministerial Conference that concluded the Uruguay Round in 1994. Seventy three countries, 50 LDCs and additional 23 countries[14] are considered as net food importing developing countries (NFIDCs) and, thus, are covered by the Marrakesh Decision. One study found that out of the 73 countries covered by the Decision, 46 countries, of which 34

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[9] Brenton, P. and Ikezuki, T., 2005, "The impact of agricultural trade preferences, with particular attention to the least-developed countries," in Aksoy, A. M. and Beghin, J. C., (eds.), "*Global agricultural trade and developing countries,*" The World Bank, Washington DC.

[10] Ibid, 2005.

[11] Subramanian, A., 2003, "Financing of Losses from Preference Erosion," Paper prepared for the World Trade Organisation, WT/TF/COH/14, Geneva; and Alexandraki, K. and Lankes, H., 2004, "The impact of Preference Erosion on Middle-Income Developing Countries," *IMF Working Paper*, WP/04/169, Washington D. C.

[12] The most affected LDCs, according to the study by Subramanian (Op. Cit.), in alphabetical order are Bangladesh, Cambodia, Cape Verde, Haiti, Malawi, Mauritania, Sao Tome and Principe and Tanzania; while the most affected low-income developing countries, according to Alexandraki and Lankes (Op. Cit.), in alphabetical order are St. Albania, Belize, Dominica, Fiji, Guyana, Jamaica, Serbia and Montenegro, Seychelles, St. Kitts and Nevis, St. Vincent and the Grenadines, and Swaziland.

[13] Alexandraki, K., 2005, "Preference Erosion: Cause for Alarm?," *Finance and Development*, IMF's Magazine, March.

[14] The additional developing countries are Barbados, Botswana, Cuba, Cote d'Ivoire, Dominica, Dominican Republic, Egypt, Honduras, Jamaica, Jordan, Kenya, Mauritius, Morocco, Namibia, Pakistan, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Sri Lanka, Trinidad and Tobago, Tunisia, and Venezuela.

LDCs, had food trade deficits during 1998-2002.[15] Small island economies have, on average, the highest volume per capita net food import and would be most affected by high food prices as a result of cuts in subsidies.[16]

26. The Marrakesh Decision was envisaged to address the effects of rising prices of imported foods on LDCs and NFIDCs as a result of cuts or elimination of subsidies in food-exporting countries. The Decision provided four response mechanisms to address the negative effect of increased food import prices. These four mechanisms were food aid; short-term financing of normal levels of commercial imports; favourable terms for agricultural export credits; and technical and financial assistance to improve agricultural productivity and infrastructure. However, the implementation of the Marrakesh Decision has not been satisfactory because of the absence of operational mechanisms for carrying out the support measures in the Decision.[17]

27. As a result, the LDCs and the NFIDCs have remained highly concerned about increased food prices and the ensuing deterioration in their terms of trade that could result from Doha Round. These concerns are compounded by at least two factors: first, by the absence of any operational international mechanism to mitigate the challenges that these countries face; and second, by the fact that many of the LDCs and NFIDCs will see their export earnings fall as a result of preference erosion and due to the downward nature of primary commodity prices on which most LDCs and NFIDCs depend for a substantial share of their export earnings.

III.1.3. Cost of Compliance to Product Standard Requirements

28. Large numbers of developing countries heavily rely on exports of agricultural primary commodities, including foodstuff commodities. Stringent Sanitary and Phytosanitary (SPS) requirements have been increasingly applied on tradable agricultural commodities originating from developing countries.[18] New standards have been proliferating both at the public level (i.e. Codex Alimentarius, regional blocs, and individual countries) and at the private level (through supply-chain requirements and due to the increasing consumer-driven nature of market). The proliferation of standards is driven by a combination of factors including health, safety and public morale concerns, scientific advances, consumer preferences, and strategic commercial interests.

29. Standard requirements have been particularly stringent on dynamic products, such as fresh and processed fruits and vegetables, fish, live animals and meat, nuts, and spices – which are characterised by a relatively higher income elasticity and a lower price volatility than those of traditional primary commodities.

[15] Mitchell, D. and Hoppe, M., 2006, "From Marrakesh to Doha: Effects of Removing Food Subsidies on the Poor," in Newfarmer, R., (ed.), "*Trade, Doha and Development*," Washington D.C., The World Bank.
[16] Ibid.
[17] UNCTAD, 2000, "Impact of the Reform Process in Agriculture on LDCs and Net Food-Importing Developing Countries and Ways to Address Their Concerns in Multilateral Trade Negotiations," TD/B/COM./1/EM.11/2 and Corr.1, Geneva.
[18] Stringency in food standards can be assessed by the degree of tolerance to certain pesticide chemicals on or in foodstuffs.

Stringent standard requirements on these dynamic products and the process by which they are produced and traded have undermined the opportunity for the horizontal diversification that these products would have created for large number of producers in developing countries. Similarly, SPS standards are in general more stringent on processed than primary products, thereby limiting developing countries capacity to move into high-value added segments of product value-chains.

30. The cost of stringent standards is, therefore, not limited to the actual cost of compliance and to the resulting erosion of the comparative advantage, but rather include foregone additional income from trade in dynamic and high-value added products. It is difficult to *ex ante* estimate the compliance cost of, and the forgone income from, standards and technical requirements. Nonetheless, a number of case studies show that the cost of compliance is generally high and disproportionately so to small-scale and subsistent producers in developing countries. For example, the cost for shrimp exporters and processors in Thailand of complying with EU's zero tolerance on banned antibiotic residues was approximately US$328/tonne.[19] Roughly, the cost of compliance is 1.6 percent of the total shrimp export value to EU or US$111 million, and the cost for the government sector amounts to US$4,301,790.[20] Generally speaking, stringent SPS standards are serious impediments to the agriculture and food exports of developing countries.[21]

III. 1. 4. Cost of Implementation of WTO Agreements

31. Unlike previous rounds of the GATT negotiations that limited their scope to border measures of international trade, the Uruguay Round incorporated areas that were traditionally regarded as domestic regulation. Most notable among these are the Agreement on Customs Valuation, the Agreement on Trade-related Intellectual Property Rights (TRIPS) and the SPS Agreement. These three agreements put disproportionate burden on developing countries, since they only served to internationalise systems that were already in place in developed countries. For example the SPS agreement requires conformity to relevant international conventions (such as the Codex Alimentarius and the International Plant Protection Convention), which for the most part are generalisations of developed countries' practices and standards.[22]

32. While obligations taken on border measures, such as reductions of duties, can be relatively less costly implemented, conforming to obligations under the agreements on customs valuation, TRIPS, TRIMS, SPS, TBT as well as GATS (particularly on domestic regulations) involves high cost. For many developing countries, meeting these obligations requires changes in policies, installation of new systems and enforcement laws. While implementation of obligations on tariff

[19] Manarungsan, S.; Naewbanij, J. and Rerngjakrabhet, T., 2005, "Cost of Compliance with SPS standards: Thailand Case Studies of Shrimp, Fresh Asparagus, and Frozen Green Soybeans," *Agriculture and Rural Development Discussion Paper*, Washington D.C., The World Bank.
[20] Ibid, 2005: 3.
[21] Henson, S. and Rupert L., 2000, "Barriers to agricultural exports from developing countries: The role of sanitary and phytosanitary requirements," *World Development*, Vol. 29, No.1, 85-102.
[22] Finger, M. J., 2000, "The WTO's Special Burden on Less Developed Countries," *Cato Journal*, Vol.19, No.3. p. 425-437

reduction and removal of quantitative restrictions only require legislators' approval, the implementation obligations on customs reforms, TRIPS, TRIMS, SPS, TBT and domestic regulatory changes in services costs enormous sums of money and requires investment in equipments and training.

33. One study that reviewed implementation costs in 'more advanced developing countries' reported that "just three of the Six Uruguay Round agreements (TRIPS, SPS and the Agreement on Customs Valuation) that involve restructuring of domestic regulations [the cost of implementation for one country on average] totaled $150 million".[23] The cost could likely be much higher for LDCs and low-income developing countries due to the big difference between the required "minimum" obligations in customs system and intellectual property protection and the actual systems existing in these countries.

34. The challenge posed by the implementation of WTO agreements is one major component of the so-called "implementation-related issues" that developing countries, since the GATT years, have demanded to be addressed. Unfortunately, the implementation concerns of developing countries have been grossly neglected. Moreover, additional obligations resulting from the Doha Round could further exacerbate the problem.

III.1.5. Cost in Tariff Revenue

35. The extent of the tariff reduction, particularly in non-agricultural products, that developing countries may undertake could easily wear away the potential benefit that they expect from the Doha Round. Therefore, the adoption by the Hong Kong Ministerial Conference of a Swiss harmonizing formula (the Swiss Formula with coefficients) for tariff reduction on non-agricultural products is worrisome.

36. The second indent of paragraph 14 of the Hong Kong Ministerial Declaration stipulates a 'less than full reciprocity' in non-agricultural tariff reductions by developing countries. However, the argument by developed countries, particularly the U.S., is that the reduction coefficients for developing and developed countries to be used in the Swiss tariff reduction formula should be "*within sight of each other*". This implies that the flexibility for developing countries in the NAMA tariff reductions could possibly be too small to address the concerns of developing countries. As a result, developing countries may have to bear a disproportionate burden of the NAMA tariff reductions given that tariffs on non-agricultural products in developing countries are, on average, higher than in developed countries. This is due to the harmonizing nature of the Swiss formula, which deeply cuts higher tariffs vis-à-vis lower tariffs.

37. The tariff revenue implications of tariff reductions vary from country to country depending on the ambition of the reduction and the relative weight of tariff revenue on the countries' fiscal policy.[24] Attributed to the ease of collecting import

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[23]. Ibid.

[24] South Centre, 2004, "Revenue Implications of WTO NAMA Tariff Reductions," *South Centre Analytical Note*, SC/TADP/AN/MA/1.

duties rather than other forms of taxes, many developing countries have based their tax systems largely on tariffs.[25]

38. Tariff reductions may not automatically lead to tariff revenue losses. When import demand is elastic, reductions of tariff up to an optimal revenue maximisation point may, in theory, increase tariff revenue. Moreover, countries with high waters in tariff (i.e. difference between bound and applied tariffs) would not experience tariff revenue losses in so far as the tariff cuts do not affect the applied rates. However, the level of tariff reduction that developing countries are pressurised to undertake, through the emerging "effective market access" concept under the NAMA negotiations, is such that most developing countries could experience substantial revenue losses leading to fiscal deficits and resulting in substantial cuts in public expenditures on social overhead capital and institution building.

III.1.6. Cost related to Factors of Production

39. International trade liberalisation creates losers and winners. The simple Ricardian model of comparative advantage overlooks this aspect of trade since, according to it, trade does not affect the distribution of income. As a result of its assumption that labour is the only factor of production and that it moves freely from one production sector to another, the model leads to the conclusion that no economic agent will be hurt by trade. The Ricardian model suggests that not only all countries gain from trade, but also that every individual is made better-off as a result of international trade.

40. However, in reality, international trade affects income distribution because factors of production cannot move immediately and costlessly from one sector to another. Even within the same sector, resources moved out of one industry cannot be readily absorbed by another similar industry due to differences in the factors of production they demand.[26]

41. Successive phases of unilateral (due to Structural Adjustment Programmes) and multilateral trade liberalisations in developing countries have caused shifts in their structure of production and trade. These shifts in trade structures have, in turn, created losers and winners. One of the results of trade liberalisation in developing countries has been the reduction of industrial tariffs. This, in combination with market deregulation and the adoption of "neutral" industrial policy, has led to deindustrialisation in developing countries, resulting in rising urban unemployment and underutilisation of capital. Further, reduction of industrial tariffs as a result of the NAMA negotiations would exacerbate deindustrialisation, leading to rising levels of unemployment and to capital underutilisation. In addition, the imposition of ambitious trade liberalisation commitments in agriculture on developing countries

[25] In countries such as Swaziland, Uganda, Madagascar, Dominican Republic, Congo D.R, and Cameroon, tariff revenue accounted for a third or more of total tax revenue in 2003. See, South Centre, 2004, Op. Cit.

[26] This aspect of international trade is captured by the specific-factor-model of international trade that Paul Samuelson and Ronald Jones pioneered in 1971. .

could result in lower farm-gate prices, thereby causing unemployment among farm and plantation workers, as well as in the destabilisation of small-scale producers.

42. Labour and capital released by a losing industrial sector cannot be quickly and costlessly absorbed elsewhere in the economies of developing countries. In fact, some labour and capital resources could permanently remain unemployed. The standard interpretation of deindustrialisation as a reallocation of resources across sectors has been found to be misleading.[27] Workers that move out of a losing industry often get employment in another industry or expanding sector after being substantively retrained, and, usually, many years could lapse before that happens. Also workers who move from a losing industry or sector to another tend to earn lower wages than they used to.[28]

43. Thus, the adjustment costs of a worker that gets unemployed due to structural shifts caused by international trade includes foregone incomes from employment, obsolescence of skills and skill specificity, lower wage levels and retraining costs.[29] Structural unemployment is, perhaps, the major trade-induced social cost of trade reforms.[30] The opportunity cost of capital includes cost of forgone income from capital underutilisation, cost of capital rendered obsolete (capital write-offs) and transitional cost of capital from one activity to another.[31] In most cases, unemployed capital remains unemployed and deteriorates or obsoletes quickly, rendering the cost permanent rather than transitional. The cost for the public sector include shift in tax revenue base and social safety net spending (e.g. unemployment benefits). Also the cost of macroeconomic instability from trade-liberalisation induced unemployment and reduction in tax-bases are cost to an economy.

III.2. Supply-side Capacity Building

44. In order to benefit from trade liberalisation, firms need to competitively produce goods and services that meet market standards in quality, and delivery time as well as process requirements. Supply-side capacity constraints limit the ability of firms in developing counties to compete at high-value added segments of product chains, where competition is fierce and quality, technical and delivery requirements are stringent. In most cases, these firms lack the capacity to get relevant information about market conditions, including standard and quality requirements, and, when they do have access to information, they simply lack the capacity to meet the requirements.

45. The stated objective of the Aid for Trade initiative is to "… *help developing countries, particularly LDCs, to build the supply-side capacity and trade-related*

[27] Tchesnokova, T., 2003, "Immiserizing Deindustrialization: A Dynamic Trade Model with Credit Constraints," http://www.arts.cornell.edu/econ/cae/CreditConstraints.pdf.
[28] This is particularly the case in most developing countries where there is no minimum wage legislation or there is little, or no, capacity to enforce minimum wage legislation.
[29] Fernandez de Cordoba, S. Laird, S., Maur, J. and Serena, J., 2005 "Trade Liberalisation and Adjustment Cost," Paper presented at UNCTAD workshop on "*Coping with Trade Reforms: Implications of the WTO Industrial Tariff Negotiations for Developing Countries*", 18 and 19 January, Geneva.
[30] UNCTAD, 2006, "Market Access, Market Entry and Competitiveness," TD/B/COM.1/76.
[31] Ibid.

infrastructure that they need to assist them to implement and benefit from WTO agreements and more broadly to expand their trade".[32] But what are the major supply-side capacities and trade-related infrastructures that the private and the public sectors in developing countries need in order to utilise the potential benefits of trade and expand their trade?

46. Capacity to produce goods and services competitively and capacity to bring them competitively into the market are the two pillars of supply-side capacity to trade. Generally, supply-side capacity constraints could be seen as the lack of adequate, efficient and reliable physical infrastructures (such as transportation systems, including ports and roads, dams and irrigations, communication systems, safe warehouses for storage of goods); lack of efficient and reliable institutions (laws and regulations to ensure an enabling environment for business development); and lack of technical know-how.

47. Increasing access to technology and finance, business support services, managerial and technical skills and increased linkages to global supply chains are some of the measures that could enhance the productive capacity of businesses.[33] Limited access to sufficient, predictable and long-term finance has found to be the biggest obstacle to business expansion. As a result of lack of finance, many businesses with the potential to grow are forced to rule out large investment and remain below potential.[34] Also lack of adequate managerial and technical skills in developing countries limited their ability to benefit from regional and international market opportunities.

48. Competitive production of goods and services is only one of the two pillars of overall trade competitiveness. The second pillar of competitiveness is capacity to bring these goods and services to markets at competitive costs and within the required time. The second pillar is mostly determined by transaction costs, mostly by the cost of transportation. According to one study, exporters in East Asia could gain between 5 and 8 percent market share from a 1 percent reduction in shipping cost.[35] Also, the cost of storage, market information (i.e. the cost of research and marketing, such as identifying potential markets, standards and other trade regulations in those markets and so forth), and administration costs, such as the cost of product certification and labelling, account for a significant share of the overall cost of transactions. Exporting state-trading enterprises, which were mostly demised as part of aid-conditionalities of structural adjustment programs, in most developing countries, in providing market intelligence to small-scale businesses.

49. For the public sector, supply-side capacity constraints include the lack of negotiating capacity in international trade negotiations. The outcomes of the

[32] Para. 57 of the Hong Kong Ministerial Declaration.

[33] United Nations Economic And Social Council (UNESC), 2004, "Addressing Supply-Side Constraints and Capacity-Building," E/ESCAP/SCITI/3, Economic and Social Commission For Asia and The Pacific, Bangkok.

[34] Lack of collateral, high perceived risk of loans to small-scale businesses in developing countries as well high administration cost of lending to small-scale businesses push interest rates high making available loans too costly for small business enterprises (see, UNESC, 1994, Op. Cit.).

[35] Carruthers, R., Bajpai, J. N. and Hummels, D., ****, "Trade and logistics in East Asia: a development agenda," World Bank EASTER Working Paper No. 3, as cited by UNESC, 2004, Op. Cit.

multilateral trade negotiations are binding and shape the international trading environment for goods and services as well as the access to technology and technological outputs. As such, the outcomes of the multilateral trade negotiations determine developing countries' ability to trade. Therefore, the need for building capacity not only to adequately cover all areas of international trade negotiations but also to influence the outcomes of the negotiations in manners supportive to the trading interests of developing countries cannot be overemphasised.

IV. Architecture for the Aid for Trade initiative

50. The architecture of the Aid for Trade initiative can be defined as the institutional arrangement, including rules and procedures that govern issues such as fund contributions, disbursement of resources, and monitoring and enforcement mechanisms. The scope of the initiative should include both trade-induced adjustment costs and supply-side constraints.

51. The Aid for Trade initiative should have a clear institutional structure with simple, transparent and efficient procedural and regulatory framework for it to be effective, credible and meaningful. Hence, the answer to the question that the HKMD instructed the Task Force on Aid for Trade to answer, i.e. "how aid for trade might contribute most effectively to the development dimension of the DDA [the Doha Development Agenda],"[36] is fully tied up to the institutional form and elements of the architecture of the Aid for Trade initiative.

52. Although extremely crucial, the institutional arrangement of the Aid for Trade initiative (such as the allocation of responsibilities and coherence among different international organisations, including the WTO; the institutional independence of the initiative; decision making processes and structures; accountability; transparency and so forth) is out of the scope of this paper. Nonetheless, whatever institutional structure the initiative will have, it is vital to ensure that viable and efficient enforcement and monitoring mechanisms are established, so that the Aid for Trade initiative would be implemented in accordance with, *inter alia*, the elements of the architecture pointed out below.

Elements for the Aid for Trade Architecture

53. Elements that could make the Aid for Trade initiative supportive of the development dimension of the Doha Round could be considered as necessary and sufficient conditions. Conditions such as new and adequate resources, predictability and long-term financial resources could be regarded as the necessary conditions; while broader scope in coverage of cost and supply-side capacity building activities as well as easy and quick accessibility of resources under the initiative could be viewed as the sufficiency conditions.

[36] Para. 57 of the Hong Kong Ministerial Declaration.

IV.1. Necessary Conditions

54. The first important aspect in the architecture for the Aid for Trade initiative is the mechanism that it will have for securing financial resources. The Aid for Trade paragraph of the Hong Kong Ministerial Declaration envisages grant and concessional loans as appropriate mechanisms to secure additional financial resource for Aid for Trade. The Director-General of the WTO is instructed to consult on the appropriate mechanisms with Members and the Bretton Woods Institutions as well as with other relevant international organisations and regional development banks, and to report to the General Council.

55. In order to effectively contribute to the development dimension of the Doha Development Agenda, the Aid for Trade initiative must secure new and adequate, predictable and long-term financial resources.

IV.1.1. New and Adequate Fund

56. Availability of adequate additional financial resources is crucial. A number of otherwise helpful international initiatives have been aborted for lack of adequate, predictable and long-term funding.[37] Without adequate and long-term funding, the Aid for Trade initiative will remain non-operational. However, it must be emphasised that resources that would be made available for the Aid for Trade initiative must not involve reshuffling or recycling of already available development funds. Shifting development funds from elsewhere to the Aid for Trade initiative would only be a 'destructive construction' with a potential to cause more harms than gains to development aid-recipient countries. Therefore, the aid-for trade architecture should be based on additional or new financial resources.

IV.1.2. Long-Term

57. As already mentioned, all types of trade-induced costs are not shot-term enough to dissipate in few months or years. For example, the cost of adjusting due to preference margin erosion could last for decades for countries that heavily depend on few commodities with high preferential margins. Such countries need to adjust their economic and production structure, primarily through economic diversification. Similarly, the costs associated with the underutilisation of factors of production – labour unemployment and obsoleteness or underutilisation of capital – due to NAMA liberalisation and deindustrialisation could be lingering. Particularly, enhancing supply-side capacity demands long-term investment in human capital, physical infrastructure and institutions. If the Aid for Trade architecture is to contribute to the development dimension of the Doha Development Agenda, its design should ensure that financial resources would be provided to developing countries on long-term basis.

[37] For example, the Task Force on Commodities agreed in UNCTAD XI and the UNCTAD Commodity Diversification Fund have not been operational due to donors' reluctance to make financial resources available.

IV.1.3. Predictability

58. A salient feature of aid is its volatility, reflecting the vagaries of donor's budget allocations, donor conditionality, and other factors.[38] A recent study[39] found that aid volatilities result in substantial welfare loss in aid-receiving developing countries. The welfare-loss is particularly substantial for developing countries with limited access to international capital markets since shocks to aid are reflected in investment fluctuations in these countries.[40] The Aid for Trade architecture should, thus, be designed to ensure predictability of Aid for Trade assistance.

IV.2. Sufficiency Conditions

59. New, adequate, predictable and long-term funds are necessary but not sufficient conditions for the Aid for Trade initiative to effectively contribute to the development dimension of the Doha Development Agenda. The sufficiency conditions are determined by the scope of the initiative and the accessibility of the aid for trade resources.

IV.2.1. Scope

60. To effectively support development in developing countries, the architecture of the Aid for Trade initiative should be broad enough to cover all major trade-induced adjustment costs that developing countries face. Section III selectively, but non-exhaustively, depicted some of the major types of the adjustment costs that developing countries would face from the current round of trade negotiations. For an effective contribution to development, the Aid for Trade architecture should cover both short-term and long-term cost of trade. As such, narrow interpretations of the scope of the HKMD mandate on Aid for Trade, like the OECD's interpretation, which exclude adjustment costs, would make the initiative less worthy.

61. Similarly, a wider scope is needed, by and large, to address the major supply-side bottlenecks that have incapacitated developing countries from taking full advantage of market access opportunities and expand their trade. Particularly, the architecture should be designed in such a way that the Aid for Trade initiative would support economic diversification into high-value added activities. It should do this by providing sufficient assistance for infrastructure and institution building as well as by supporting innovation and high technological adaptation in developing countries with the aim of increasing not only production capacity but also for building competitive capacity for transporting goods to market.

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[38] See, Bulíř, A. and Lane, T., 2004, "Aid and Fiscal Management," in Gupta, S. Clements, B. and Inchauste, G., (eds.), "*Helping Countries Develop: the Role of* Fiscal *Policy,*" The International Monetary Fund, Washington, D.C.,; and Bulíř, A. and Hamann, J. A., 2003, "Aid volatility: An Empirical Assessment," IMF Staff Papers, Vol. 50, No. 1, Pp. 64-89.
[39] Arellano, C., Bulíř, A., Lane, T. and Lipschitz, L., 2005, "The Dynamic Implications of Foreign Aid and Its Variability," IMF Working Paper, WP/05/XX.
[40] Ibid.

IV.2.2. Accessibility

62. Accessibility of resources under the Aid for Trade initiative is the other sufficiency condition for the initiative to effectively meet its development objectives. Absence of easy accessibility and delays in disbursement of financial resources are the reasons for the less effectiveness of financial facilities such as the IMF Contingency and Compensatory Financing Facility, the EU's STABEX and FLEX compensation for loss of export revenues as well as financial facilities for LDCs and NFIDCs under the Marrakesh Decision. The Aid for Trade initiative will have a better fate, hence efficacy to support the development dimensions of the DDA, only when its architecture is designed in such a way that the initiative will have a quick resource disbursement mechanism. It is thus vital that the Aid for Trade architecture crafts a mechanism for quick transfer of resources by avoiding unduly complex and lengthy procedural and technical requirements.

IV.2.3. Conditionalities

63. Aid comes often accompanied by conditionalities. Historically, these conditionalities have reflected the economic and political interests of donors. In many cases, the conditionalities have been injurious to development in the recipient countries. The Aid for Trade initiative should, thus, not have conditionalities based on ideological premises that make developing countries indentured economies. The design of the aid for trade architecture should be founded on the understanding that aid is second-best to balanced, fair and equitable international trading system. Hence, aid should in no way be conditional upon developing countries' positions in international trade negotiations or on domestic trade and development policies, including macroeconomic policies.

IV.2.4. Demand-*Driven* Priorities

64. The architecture should be designed to make the initiative demand-driven. This means that aid-recipients, rather than donors, should identify and set priorities with regards to the use of aid resources. The architecture of the Aid for Trade initiative should give recipient countries the full prerogative to decide the sectors that the aid resources should go to in order to mitigate adjustment costs or bolster supply-side capacities. In order to ensure this, the institutional structure of the Aid for Trade initiative should have transparent and effective mechanisms that allow and encourage developing countries to participate in the decision-making processes of the initiative.

IV. 2.5. Monitoring and Enforcement

65. The Aid for Trade architecture should also have effective and strong monitoring and enforcement mechanisms. The mechanisms would be vital for ensuring that the initiative would be faithfully implemented and operationalised

under agreed conditions and manners. The monitoring mechanisms should, *inter alia*, include an annual review, followed by a publication, of the activities undertaken under the Aid for Trade initiative. The monitoring and enforcement mechanisms should ensure that the Aid for Trade initiative would: (i) not be used or misused for influencing developing countries' positions in international trade negotiations; (ii) not involve reshuffling of grants or concessional loans from other development activities; and (iii) address both trade-induced costs of adjustment and supply-side capacity constraints.

Conclusion

66. Trade-induced adjustment costs and supply side constraints are serious challenges faced by developing countries, and addressing them simultaneously will greatly contribute to economic and human development. High adjustment costs have been a major obstacle for trade reforms in developing countries while supply-side capacity constraints have undermined developing countries' ability to benefit from market access opportunities. Developing countries in general have obligated to undertake ambitious trade liberalisation and trade policy reform commitments that, by far, exceed their capacity, as dictated by their levels of economic development.

67. Aid is only second-best to balanced, fair and equitable trading rules. Therefore, in order to be supportive to development, the architecture of the Aid for Trade initiative should have strong monitoring and enforcement mechanisms such that: (i) the expansion of aid will be based on new and sufficient fund that would be available on long-term and predictable bases, and that there will be no reshuffling of resources from development aid; (ii) the expansion of aid will not be linked or made conditional to developing countries' positions in the multilateral trade negotiations or domestic development policy priorities; (iii) the scope of the Aid for Trade initiative will encompass both trade-induced adjustment costs and supply-side capacity building (including trade-related infrastructure); (iv) there will be easy and quick resource disbursement mechanisms that avoid unduly complex and lengthy procedural and technical requirements; and (v) aid-recipient countries, rather than donors, will have the prerogative to decide the sectors or activities that the aid resources should go to.

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