Christian Aid briefing

The Opportunities and Risks of Aid for Trade

Christian Aid has been a vocal supporter of the multilateral system of trade rules, of bolstering developing countries' position within it and of increasing those countries' capacity to benefit from their participation in world trade.

To date, results for developing countries have been disappointing. They face persisting problems within the multilateral trade system - despite majority membership of the World Trade Organisation (WTO) since its inception and a significant increase in openness of their economies, many have failed to make any significant gains from their participation.

Aid for trade can be a part of improving this picture, but negotiators must be aware of the risks as well as opportunities of the initiative and make their decisions in light of these.

It has been perhaps surprising to those that feel aid for trade is at worst benign, at best the answer to the problems of poor countries in world trade, that it has received such a mixed reception since first discussions at the World Bank and International Monetary Fund (IMF) annual meetings in 2005.

However, if aid for trade is not properly implemented it could simply repeat mistakes from earlier decades of donor- and International Financial Institution (IFI)-assisted trade reforms in developing countries that had a devastating impact on developing country economies and especially the poorest groups within them. It could also undermine the likelihood of a good deal for developing countries from the "development" round of world trade negotiations and therefore ultimately the credibility of the WTO.

This brief outlines the risks and opportunities that the initiative presents, and the principles that must underlie its implementation in order to minimize the former and maximize the latter.

The Opportunities: Spending where it is needed and rethinking critical relationships

The first obvious opportunity of aid for trade is that there is real need in developing countries for additional finances to boost the terms of their integration in world markets. Some key areas of spending would be:

Assistance to address supply-side constraints

As the limited success of preference schemes has shown, better market access for developing country exports is not sufficient to bring benefits from trade if economic agents in those countries cannot produce goods or get them to market efficiently.

Without the right conditions in place, developing country producers fail not only to take advantage of new opportunities overseas, but also to withstand competition as they open their own markets.

Supply-side constraints are wide ranging from levels of health and education of the workforce to the state of institutions and infrastructure to the production technology of individual firms.

Aid for trade must expressly address the production and trading constraints affecting the sectors and industries important for the poorest groups. Assuming that poor people will eventually benefit is inadequate, the official assessment of the World Bank's support to trade reforms concluded that greater attention needed to paid to disaggregated impacts and the ability of poor people to benefits, since strategies to date had "not always helped enough to improve the job opportunities and living conditions of the poor"[i].

The forgotten beneficiaries of aid for trade[ii]

Achieving broad-based agricultural growth in low-income countries is essential to contributing to the welfare of a significant proportion of the world's poorest groups and also to the long-term economic prospects of those countries.

Marginal producers in rural areas form the majority of economically active adults in almost all African countries. A lack of investment in their productivity over recent decades has meant that they lack the technology, infrastructure and basic inputs to earn a decent living.

During the 1980s and 1990s state support to farmers and intervention to stabilize markets was generally withdrawn under the advice and conditions of the IFIs and donors. Optimistic assumptions that market forces would step in to ensure cost-effective access to inputs and the right prices for farmers were not borne out as markets failed.

The need for active support to build and support agricultural markets in developing countries, and not just rely on market forces, is increasingly recognized by donors and the World Bank. Nevertheless, support to agriculture in Africa has declined: the UK's Department for International Development cut its proportion of spending to the sector from 4.72 per cent in 2003/4 to only 1.37 per cent in 2005/6.

Assistance with implementation and to cope with the adjustment costs of trade reforms

Trade reforms, can require legal, institutional and personnel changes to implement. If countries cannot afford these, they might forego reforms that would bring benefits or implement them imperfectly so that benefits are reduced or even reversed. Implementation costs of past trade deals also still require financing.

Reforms also bring adjustment costs as labour and capital factors are put temporarily or even permanently out of production.

Aid for trade can help in these situations, for example by funding implementation or by providing social safety nets and retraining for unemployed workers.

However, it is important to note the limitations of aid for trade and the continuing need to get trade rules right. Any reforms carry adjustment costs, but the costs of the wrong reforms can never be compensated by aid for trade. Experience of premature and inappropriate liberalization has shown that impacts are not simply short-term or easily overcome with mitigation measures. Results have been deindustrialization, mass loss of livelihoods and the stalling of the dynamic development of economy. It is for this reason that aid for trade should be used only to support country-designed and owned reforms and not to push a set of donor-preferred reforms or the pace of reform.

Assistance to identify trade interests and needs and to defend negotiating positions based on these

If the new process is to learn from the failures of externally designed and driven reforms, its first priority must be the development of home-grown trade plans by supporting mechanisms for ongoing consultation, monitoring and impact assessments.

The basis of sound trade policy is an understanding and balance of the interests of producers, consumers, and public policy objectives. In developing countries, the mechanisms to consult widely on trade policy and to integrate trade policy with wider development strategies remain a challenge. The task force has called for assistance in better data management and improved national processes to help overcome this.

On top of this, developing country trade negotiators must be able to defend positions so that trade agreements help rather than hinder the realization of their trade-development plans. They need to ensure sufficient flexibility and win appropriate concessions on market access and subsidy reform, for example, from their trading partners.

Part of the solution to the problems that developing countries have experienced in the current round of WTO talks, lies in WTO reform, however financial assistance is part of the solution to overcome the effects of vastly different negotiating resources on the outcomes of talks.

The second useful dimension of aid for trade is the opportunities for dialogue that it has generated between trading partners, donors and recipients. This creates an opportunity to right the past wrongs of trade and aid partnerships between rich and poor countries.

Debates on trade and development

The aid for trade process is a useful recognition that there are costs as well as benefits, losers as well as winners from trade reforms. It also addresses the need to put in place the proper conditions and accompanying measures before undertaking liberalisation in developing countries in order to maximize and not reverse effects on poverty eradication.

By providing a forum for countries to discuss as donors as well as trading partners, the aid for trade process should not just result in more money for particular spending areas, but also a review of the coherence of the aid and trade systems. This is essential, as changes are needed in both arenas. For example, aid for trade can help to put the conditions in place for developing countries to open their markets, but it cannot of itself allow countries the flexibility to properly sequence conditions, policies and liberalization. This requires a change in donor practice to cease pushing preferred reforms and to trade rules to allow appropriate flexibility.

A Debate on the effectiveness of trade-related assistance

Another constructive discussion that aid for trade has facilitated is that regarding the effectiveness of trade-related assistance and capacity building. It creates the opportunity to make aid more predictable and effective and to put developing countries firmly back in the driving seat of their trade and development strategies.

The problems experienced with trade-related aid have been significant and sometimes damaging, but do not differ in essence from those identified in wider aid debates. Therefore the “Paris Principles” to improve aid effectiveness have been rightly identified by the Task Force as the key to overcoming past problems.

Although flawed – for example by not tackling the problems of conditionality head-on – application of these aid effectiveness principles can improve trade-related assistance in the following ways:

Country ownership

The impact of trade reforms is notoriously diverse and unpredictable. Unintended impacts can emerge unless reforms are carefully managed, pace and designed locally.

A recent assessment of World Bank support to trade reforms pointed to the need to pay more attention to local conditions to do with aspects such as health, education, infrastructure in determining the impact of trade reforms to improving their disappointing track record.

It also highlighted the need for a “greater understanding of the local political economy. Trade reforms are also particularly sensitive to local political ownership, because of negative impacts for some groups. Imposing external reforms, for example through conditions, undermines this sense of ownership.

Alignment

This is the idea that donors must fall in behind countries' strategies and priorities. One of the major failings of the Integrated Framework (IF), the flagship aid for trade initiative, was due to a lack of application of this principle. Despite attempts to provide holistic, integrated, country-owned diagnostics of the problems of LDCs, the IF failed to achieve its lofty objectives partly because donors tended to fund those items in the new strategies that most appealed to them, rather than letting LDC governments prioritise policies and spending.

There are two reasons that it is especially important to underscore the principles of country ownership and alignment in the trade arena:

- First, the controversial nature of the reforms themselves – donors tend to prefer reform programmes that favour liberalization policies, although experience of several countries shows that heterodox policies are those that achieve success[iii].
- Second, donors are simultaneously, trade and investment partners with their own commercial interests at stake.

Thus applying these principles is essential to avoid conflicts of commercial or even ideological interests with the need to support local strategies.

Mutual Accountability and Predictability

Predictability is important as the trade reform process is a lengthy one with benefits realized over the long term – even decades. During that period, countries need to be confident that they will receive timely and sufficient assistance to put in place the necessary conditions and accompanying measures to derive the benefits from reforms and maintain support for them. Without this, the value of trade reforms is undermined and even reversed.

Mutual accountability is especially important in the context of trade because of the different weights of aid and trade commitments. Non-binding "best endeavour" clauses pledging assistance for implementation have been ineffective in securing adequate support for developing countries. In addition, there is no strong framework to make donors accountable for their aid delivery – even the Paris Principles themselves have been heavily criticized for the weakness of their implementation and enforcement. On the other hand, developing countries sign up to binding commitments to carry out trade reforms backed up by dispute settlement provisions. They therefore risk sanctions for failing to implement commitments undertaken on the promise of aid never delivered – a far cry from mutual accountability.

Learning lessons[iv]

Botswana, Lesotho, Namibia and Swaziland (BLNS) have experienced the dangers of aid for trade first hand.

When South Africa signed up to a free trade agreement with the European Union (EU) – the trade and development cooperation agreement (TDCA) - as members of the region's customs union SACU, these countries automatically faced increased EU imports and loss of revenue from tariffs within the union.

Recognizing the adjustment costs these small and vulnerable economies would face, the European Commission (EC) initially designed a comprehensive assistance package, but on condition that SACU members accept the same terms as South Africa's agreement. Namibia was particularly vocal in rejecting an agreement that it had not negotiated and without being able to consider the implications for its own economy.

Consequently, the EC withdrew its programme, and the four countries were each left to seek an additional share of EU aid funds to help with the inevitable extra costs brought by the TDCA.

The dangers of aid being used to leverage trade agreements or reform programmes in countries is clearly very real. Because of their resistance, BLNS were deprived of a comprehensive support package to improve the competitiveness of their enterprises and retrain and support workers who would have been affected by increased competition with EU imports.

Even after this setback, BLNS countries experienced further problems deriving from the unpredictable nature of aid delivery undermining their ability to successfully manage their adjustment and their inability to hold the EC to account for the effectiveness of its assistance.

Each of the four countries was promised funding to help cope with the loss of revenue to SACU's coffers from the tariff elimination on European goods. The amounts involved are significant – accounting for nearly 60% of Swaziland's government revenue, for example. Backloading of South Africa's tariff elimination commitments means that the effects on SACU's earnings would begin to be felt in 2010. Swaziland sought cooperation with the EC on fiscal adjustment from 1999 and a programme worth €5.6 million was agreed in 2002 to bolster the country's tax administration and help to diversify its tax base. The programme quickly fell behind schedule and by 2006 had achieved none of its main objectives. The EC then withdrew from support to fiscal adjustment in Swaziland, recognizing the issue was still relevant but that its own programme had had little impact and was over-ambitious. Calculations by the Commonwealth Secretariat show that the amount pledged by the EC was around one-sixth of that which would have been needed to successfully support fiscal adjustment over the first five years, and that sustained engagement over ten years, at a cost of €60 million would have been more appropriate.

Aid for trade could have been helpful to the BLNS, if the process could have assured them predictable aid, delivered without conditions attached and in a mutually accountable manner. This was clearly not the reality. A shift in the risks and incentives of donors and recipients in aid and trade cooperation is clearly essential – at present developing countries shoulder the risks, whilst there are few real incentives for donors to behave responsibly.

The Risks

Aid for trade is not a benign initiative that at worst will be simply ineffective. If not properly implemented, aid for trade represents real risks for developing countries, jeopardizing their prospects to benefit from both aid and trade.

Aid for trade risks distorting spending priorities

The OECD has stated that aid for trade pledges will not be additional to promises of aid increases made in 2005 – promises that have yet to be delivered on. Ear-marking of aid for trade-related assistance therefore will divert funds from important social spending, unless additional money is made available.

This is especially problematic if aid for trade is narrowly defined. It risks incentivising a limited set of reforms, and not addressing the broad range of factors affecting a country's trading success.

Some developing countries have been reluctant to define aid for trade broadly, as there is a risk of any aid commitments being relabeled "aid for trade" to fulfill public promises. However, there are good reasons for keeping the definition open-ended. First because needs are varied. Second because if a specific pot of money is associated with a narrow range of reforms, there is a real risk that these are given undue attention by developing countries competing for limited funds.

The added value of aid for trade lies in mobilizing new funds and drawing attention to neglected areas of spending. Among donors there has been a reluctance to fund production, although improving the competitiveness of producers in developing countries is key. Patterns of donor spending on aid for trade show that there is a preference for spending on trade policy and regulation. However, UNCTAD has warned that support to the productive sector in least developed countries (LDCs) has experienced a significant decline that must be reversed.

Finally aid for trade risks being a double blow for the poorest groups if it is targeted at export-oriented industries only. This money could then bypass the significant proporition of poor producers and traders for whom domestic or regional markets are more important. Poor people will also suffer if social spending is reduced because aid for trade is not new money. This takes on increased resonance, in light of current concerns at the effects of increasing inequality.

Aid for trade risks distorting trade reform choices

Aid for trade raises the spectre of old, but not yet extinct controversies of donor activity in the area of economic policy. Grant and loan conditionality in the area of economic policy, especially trade, has been rife and frequently damaging – most notoriously during the 1980s and 1990s period of Structural Adjustment Programmes.

Although World Bank studies appear to show economic, especially trade conditions, in decline, countries still face strong pressures to adopt a checklist of donor-preferred reforms through technical assistance, project assistance rankings and bias in research (identified as problematic in a recent assessment of World Bank research).

This runs counter to good development practice where the importance of local conditions and political buy-in dictates that local design and ownership are critical to successful reforms. It also goes against the principles of mutual accountability and alignment already identified as essential to the sound implementation of aid for trade.

With respect to formal conditions attention has shifted to "second generation" reforms relating to business and investment regulations and conditions behind the border.

These are likely to be key areas of spending for aid for trade, and are no less controversial. For example, preferred reforms often relate to investor protection, fewer and lower taxes for businesses and more "flexible" labour rules. These kinds of reforms are arguably more politically sensitive than changes to border taxes, as they enter into country choices of how they regulate their domestic economy.

Aid for trade risks distorting trade deals

Aid for trade has links to the WTO Doha Round of trade talks, for example it is part of the Hong Kong Ministerial Declaration and the WTO Director General has been assigned an active role.

Developing countries were alive early on to the risks that this association poses. They expressed concern that aid for trade could only complement and not substitute a good WTO deal. A deal that delivered little in the way of subsidy reform or real market access improvements in rich country markets for developing countries or that used aid for trade to leverage more commitments from developing countries would work against developing countries improving their place in world markets and seriously undermine the usefulness of the initiative.

Christian Aid believes that aid for trade should not be associated with trade deals in particular or in general, but entirely driven by countries' own trade-development strategies. Associating aid with trade deals, for example at the WTO, generates the wrong drivers for negotiations – developed countries risk not giving enough and developing countries too much, because of the prospective aid carrot.

These problems have been evident in Economic Partnership Agreement (EPA) negotiations between the EU and African Caribbean and Pacific (ACP) countries. Rumours of aid bribes and countries competing to sign up first or to the most comprehensive deals have undermined faith in reaching the right negotiating outcome.

However, as the ACP have articulated, when developing countries do sign up to deals, they would benefit from greater confidence that they will have the necessary resources and conditions in place to implement and capitalize on them.

Existing measures in trade deals designed to secure assistance for implementation have had little effect. In addition, flexibilities intended to help countries to coordinate development strategies and trade reforms have not worked well.

A more constructive relationship between aid and trade commitments is possible and could be achieved under the remit of Doha negotiations that includes a mandate to improve special treatment provisions for developing countries in trade agreements.

Two examples of innovations that could overcome the problems mentioned and help to fulfill the Doha mandate would be:

Linking compliance to aid delivery
The Africa Group has expressed an interest to undertake commitments in the area of trade facilitation. However, trade facilitation upgrades that would be required are potentially costly to implement. Traditional best endeavour promises of assistance are unlikely to deliver results and the risk is raised of future sanctions for non-compliance for developing countries.

To avoid this problem, the Africa Group has proposed that developing countries should be immune from dispute settlement over non-compliance in this area, whenever lack of capacity is at the root of the failure to implement.

This principle of linking aid and compliance is a valuable one that should apply to any commitments in trade deals that will involve costly regulatory or other upgrades to implement.

It overcomes the weakness of best endeavour provisions – making aid more predictable and mutually accountable – without requiring donors to make binding aid commitments within trade deals, something they are reluctant to do.

Sequencing liberalization with development outcomes
Additional types of flexibility are needed as some reforms, like tariff reduction, are not expensive to implement but might require other reforms or preconditions to have best results. For example, a country that relies significantly on tariff take for government revenue might wish to have diversified its tax base before undergoing wide liberalization.

To date the flexibilities intended to take into account developing countries' need to integrate trade reforms into their development strategies have been exemptions and extended transition periods, both have been blunt tools.

Developing countries can need exemptions from trade commitments for legitimate development reasons – for example to accommodate their industrial or agricultural strategies. However, exemptions might be over-applied if countries use them when they might wish to make commitments but hesitate to do so because they cannot be confident to have the right conditions in place on time. Then the country in question loses the opportunity to bolster domestic reforms, leverage concessions from trading partners and risks making it more difficult to gain exemptions where they are really needed.

Extended transition periods are also inadequate to integrate trade commitments into development strategies. Although extended, these grace periods are still arbitrary – countries cannot be sure that reforms or development progress will move forward at a sufficient speed, or even in the right direction. Developing countries are then faced with the choice of negotiating further extensions at potentially high cost, facing sanctions or suffering sub-optimal results from liberalization.

Instead, WTO members could accept in principle that countries have a right to notify development aims or situations that require special treatment and that their progress in liberalization would be tied to these. This notification could take place for example within the committee on trade and development (CTD), or the committee on regional trade agreements (where RTAs are in question). During that process, other developing countries could raise any concerns regarding impacts on their own economies and negotiate how to deal with these. For LDCs the process could be automatic. Significant work has already been undertaken to identify the kinds of situation that might require special treatment along with qualitative and quantitative measures to monitor progress.

This approach would make WTO practice compatible with development best practice of country ownership and allow countries to tailor their commitments to their development strategies, to sequence reforms and to cope with any unintended impacts of liberalization. It would also avoid the need to define one list to capture all development needs for all times – an impossible task that would undermine bottom up national trade-development strategies, and raises the controversial topic of differentiation between developing countries.

These innovations are also entirely consistent with WTO principles and practice. Although its underlying principle is most favoured nation, which means that each WTO member must treat other indiscriminatorily, all its agreements contain language that recognizes the need for rules to be enforced in a flexible manner to take account of development levels and needs, and calls on developed countries to help with difficulties of implementation. The purpose of the WTO is to increase openness of markets in order to promote growth and development

The need for effective monitoring

In order for these innovations to work in practice, effective review and monitoring is essential – of delivery on aid and trade commitments and of development impacts. This would allow members to check progress towards development goals so that flexibility is not a "blank cheque" and aid assistance can be recalibrated as necessary.

Different monitoring mechanisms already exist at the WTO that could be useful in this respect– for example the Trade Policy Review – and new ones are proposed under negotiations for the new Round – for example within the CTD and RTA committees.

Institutional arrangements

In the context of getting the right relationship between aid and trade deals, it is also important to find the right institutional set-up.

In order for developing countries to truly be in the driving seat, the lead institution must be one where they have sufficient influence – for example that has a one country, one vote system, rather than voting linked to economic size or financial contribution.

Whilst this gives the WTO an advantage over institutions such as the World Bank, the experience of developing countries in practice has been that this is insufficient to bring them proportionate influence, because of the political and commercial pressures at play. The WTO should not be directly involved in brokering aid for trade or in helping to set spending choices or priorities, as this would result in too close an association between signing up to or implementing WTO agreements and aid for trade.

UN institutions have better governance structures, experience of aid delivery and trade reforms. Bodies such as UNCTAD should therefore be given a prominent role in aid for trade arrangements.

However, the WTO does have a role to play in providing a forum to monitor in a coherent manner the delivery and effectiveness of aid for trade, developing countries' progress in implementing their trade commitments and whether the impacts of these need to be taken into account either in need for aid for trade, or the further progression of implementation.

Conclusion: How to minimize the risks and maximize the benefits

It has been shown that aid for trade can be useful to developing countries, but in order to maximize the benefits of aid for trade it is important:

- To begin by improving mechanisms for designing local trade and development strategies to drive the aid for trade process according to local needs and priorities
- To provide funding for the broad range of developing country problems relating to trade, especially those that affect production and trade constraints of poor producers
- To adopt the Paris Principles to improve its effectiveness
- To change trade rules at the multilateral and regional levels to also improve mutual accountability, predictability and to allow flexibility to synchronise and integrate trade and development strategies.

In practical terms, achieving these objectives will involve:

- Designing aid for trade as a means to mobilize additional funds, especially for neglected areas of spending; not as a dedicated fund for a narrow set of trade-related reforms;
- Changing IFI and donor practice not only to end economic conditions, but also to overcome the identified bias and failings in research provided to developing countries, and to recognize that rankings and other tools can also be used to have an illegitimate influence on countries' trade-related policy choices;
- Negotiating the necessary changes to trade rules at the multilateral level so that these also accommodate the principles of sound aid for trade – for example linking compliance to effective aid delivery or market opening to development progress;
- Establishing appropriate institutional arrangements are also important – allowing institutions such as UNCTAD to play a prominent role and limiting that of the WTO to act as a monitoring and discussion forum.

Properly designed aid for trade could help poor producers and trader benefit from trade and contribute to their countries' economic development. It could also increase developing countries' participation in the multilateral trading system, as they will be able to undertake commitments in confidence that they will not face unfair sanctions for non-compliance and that undertaking commitments will not undermine their trade-development strategies. Trading partners still benefit from predictable and transparent reform processes, and the multilateral system itself is strengthened by their more active participation.

Wrongly implemented, aid for trade could simply repeat the mistake of earlier decades of donor- and IFI-driven reforms that had devastating impacts especially on the poorest groups. It could also jeopardize a fair result in trade negotiations and therefore ultimately undermine the credibility of the trade system and the WTO.

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[i] Independent Evaluation Group (2006), *Evaluation of World Bank support to trade reforms*
[ii] Taken from Christian Aid (2007), *Farmers left behind: How markets, governments and donors have failed Africa's greatest resource.*
[iii] See for example Christian Aid (2003), *What Works?*
[iv] Taken from ICCO (2006), *Moving Beyond Business as Usual.*