Trade Policy Implications for Small Vulnerable States of the Global Trade Regime Shift[1]

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Summary

1. Summary of Conclusions

a) Trade Regime Shift

The shift in the global trade regime resulting from the proliferation of regional free trade arrangements, the closure of the Uruguay Round and the creation of the World Trade Organisation (WTO) has resulted in a process of trade liberalisation that is eroding the trade preferences of small vulnerable states.

The trade liberalisation benefits of the Uruguay Round are unevenly distributed, have small negative impacts on African, Caribbean and Pacific (ACP) states and adversely affect many small vulnerable states that are net food importers and highly trade preference dependent.

The European Union's preferred choice as a way of resolving the WTO compatibility of the trade provisions of the Lomé Convention is the creation of regional free trade agreements. This, as a result of ***the web of implicit Most Favoured Nation (MFN) obligations*** *in the other regional trade preference arrangements, such as the Caribbean Basin Initiative (CBI), the Canadian Preferential Arrangement for Commonwealth Caribbean Countries (Caribcan) and the South Pacific Regional Trade and Economic Co-operation Agreement (Sparteca), will result in a fundamental* ***systemic change*** *to the global trade regime. This change will mean that regional trade preference regimes will eventually disappear and be replaced by Generalised System of Preferences (GSP) arrangements.*

The EU's negotiating mandate for the post-Lomé trade framework arrangement now goes well beyond issues of WTO compatibility to cover market access and the so-called 'new issues' proposed by developed WTO members for the 'Millennium Round' of multilateral trade negotiations.

Any possible WTO incompatibilities that may exist between the Commodity Protocols of the Lomé Convention and Articles XIII(c) and XVI of the GATT

[1]This paper was presented at the Commonwealth Secretariat/World Bank Joint Task Force on Small States conference held in St. Lucia in February 1999.

cannot be resolved by the creation of free trade areas. Instances of waivers from such obligations are exceedingly rare in the history of the GATT/WTO.

b) Adjustment Problems of Small Vulnerable States

The economic qualities needed to adjust to an open trading environment include the following:

- *a pool of freely traded and specialised land, labour and capital;*
- *an efficient information system that disseminates relevant market information rapidly and at low cost;*
- *physical infrastructure that permits an efficient movement of goods, services, resources and persons;*
- *a social and political infrastructure conducive to predictable legal outcomes.*

Small vulnerable states, along with other developing countries, suffer from ***policy-induced*** *as well as* ***exogenous*** *causes of their relative inefficiency. The* ***cluster of exogenous qualities inherent in many of them*** *makes the adjustment process of small vulnerable states particularly difficult. These qualities are well known and include:*

- *diseconomies of scale in production for both domestic and export markets;*
- *physical dispersion of small pockets of resources, products and persons (especially in island states);*
- *physical isolation from resource and export markets;*
- *a lack of trade and economic integration, permitting the acquisition of domestically scarce resources at competitive market prices;*
- *poor development of human resources, especially of skilled labour and entrepreneurial skills;*
- *poor physical and communications infrastructure;*
- *a high degree of vulnerability to the economic impact of natural disasters.*

As a result of high cost structure caused by exogenous factors, small vulnerable states, especially in the Pacific, have had to base their economic development on quasi-rent generating sectors.

c) Small Vulnerable States and the WTO

Small states and small producers are implicitly recognised in a number of ways at the WTO:

- *the Agreement on the Interpretation of Article VI (Anti-Dumping) through the* de minimis *volume provisions;*

- *an implicit WTO definition of 'small', as recognised in the Finance Committee of the WTO, which sets 0.03% of world trade as the minimum for purposes of subscription;*
- *special provisions for small producers in the Agreement on Textiles.*

*Attempting to gain political recognition at the WTO for small vulnerable states will be **politically difficult** and there will be resistance to this from least developed, developing and developed WTO members.*

Significant economic benefits to small vulnerable states would ensue from receiving special and differential treatment equivalent to those given to Least Developed Countries (LDCs). These include:

- ***Protection of trade preferences** under the Lomé Convention. Such special and differential treatment (SDT) would obviate the necessity for regional free trade areas with the EU in the Caribbean and the Pacific;*
- ***Exemption from Subsidies Disciplines**, which are necessary for economic transformation.*

Obtaining special and differential treatment will necessitate a simple definition that excludes small, high-income anomalies such as Iceland, Liechtenstein and Luxembourg. Solely demographic definitions of small vulnerable states are dysfunctional in a WTO context.

2. Summary of Recommendations

a) Post-Lomé Arrangements

In Brussels negotiations for post-Lomé arrangements, ACP states should avoid negotiating disciplines that can be construed as 'new issues', for example trade and labour standards, trade and competition, trade and investment. Negotiations should focus only on technical assistance needs of ACP states in these areas.

ACP states that are not members of the WTO should not be bound by any post-Lomé arrangement to disciplines that they have not accepted multilaterally.

*The framework agreement should contain **a regional MFN provision** for the regional free trade agreement, under which any general, as opposed to commodity-specific, market access or trade benefit negotiated in one region would be extended automatically and without negotiation to the others. This would help ensure ACP solidarity on trade issues, while allowing regional commodity specific arrangements.*

The defence of WTO incompatibility of the commodity protocols through waivers is unlikely to meet with success.

If ACP states accept the regional free trade area concept, they should negotiate

at the WTO special and differential provisions for the Interpretation of Article XXIV. This should make allowance for longer transitions (20 years or, if possible, an unspecified duration of transition) in the event of a free trade area between developing and developed countries.

b) Interventions to assist Small Vulnerable States deal with global economic liberalisation

The international community could assist small vulnerable states to adjust to the realities of a more open global trading environment through a policy that attacks both policy-induced and exogenous sources of inefficiency. The interventions should include:

- ***market-oriented** reforms through structural adjustment (World Bank/IMF);*
- *technical assistance for **niche market development** (UNCTAD/ITC);*
- *a market-friendly **investment preference facility** for the replacement of trade preference (IFC/World Bank) (see Annex 2);*
- *enhanced **Special and Differential Treatment** for Small Vulnerable States (WTO).*

c) WTO Issues

Defining 'small vulnerable states' at the WTO

*To find an appropriate definition of 'small vulnerable states' as a basis for obtaining special and differential treatment equivalent to LDCs at the WTO will require a definition that avoids high-income anomalies. The problem of small states is economic and an economic definition, based possibly on **a share of world trade**, may prove to be the politically easiest definition to agree on, as it is already accepted. Such a definition would require a **secondary criterion**, that the WTO member be a developing country.*

The current implicit definition of 0.03 per cent of world trade, which is accepted by the WTO, will create few anomalies but will exclude certain key Commonwealth small states, for example Papua New Guinea, Jamaica, Botswana and Mauritius. If the figure is raised to 0.05 per cent these will all be included but more high-income anomalies result.

*Should small vulnerable states decide to pursue special and differential treatment at the WTO, then **LDC-equivalent status** would be an optimal outcome. However, any recognition of smallness could bring significant economic benefits. This objective could be achieved directly through the WTO during the next round of multilateral trade negotiations or through obtaining recognition of the vulnerability index through the UN Economic and Social Commission (ECOSOC).*

***Political marginalistion** of small vulnerable states inside the WTO requires*

a recognition that they are at present unable to operate on an entirely equal basis with larger developed countries. Several measures are needed:

- ***The membership fee floor** should be lowered from 0.03 per cent of world trade to a floor corresponding to the UN General Assembly floor (0.003 per cent of world trade)*
- ***Accession** is extremely difficult because large WTO members see each accession as a precedent for large states such as Russia or China. In the case of LDCs and small vulnerable states, the protocol negotiations – dealing with internal reforms to assure WTO compatibility of the trade regime and a timetable for reform – should be established by a **committee of experts** and based upon recognised development status of the applicant. Bilateral negotiations should be limited to **principal suppliers** only.*
- *The **dispute settlement mechanism** of the WTO should recognise that LDCs and small vulnerable states are unable to make use of it because of the high legal fees. A **legal aid fund** should be established. In the event of a dispute between an LDC or a small vulnerable state and a developed WTO member, the developed WTO member should accept **binding arbitration for financial compensation** rather than retaliation if the transgressor is unwilling to bring its trade into conformity with its WTO obligations.*

*During the **Millennium Round** small vulnerable states should:*

- *Reject the proposal for **'round-ups'** or short rounds as these decrease the bargaining power of small vulnerable states;*
- *Avoid plurilateral agreements on goods or services liberalisation at the WTO, as they weaken the bargaining power of small states;*
- *Accept the inevitable demise of agricultural systems such as the EU's Common Agricultural Policy and the US sugar regime by 2010, and **seek negotiated financial assistance for the adjustment process**. Many small vulnerable states, those that do not benefit from agricultural quotas into the EU and the USA, would benefit from agricultural liberalisation in certain key sectors;*
- *Since the new round of multilateral trade negotiations will focus also on service sector issues, small vulnerable states should begin to focus upon sectors where they are exporters. Small vulnerable states are very often exporters of semi-skilled labour and receive considerable economic benefit from the remittances of their nationals. One important but politically sensitive issue is the establishment of **rights of temporary sojourn of unattached service providers, i.e. semi-skilled workers** in developed country markets. This could be dealt with by **bound annual quotas**.*

Introduction

The purpose of this paper is to review the trade policy implications for small vulnerable states of the change in the global trade regime. The change that has occurred in the early and mid-1990s has undoubtedly been the most dramatic change in the trade environment facing small vulnerable states since their independence. The intention of the paper is first to map out these changes and their expected speed and effect, and then to suggest reasons why small vulnerable states (SVS)are more likely to confront difficulties in adjusting to the new liberalised policy framework than are other countries. Policy responses by both national governments and the international community are suggested.

Due to the paradigmatic changes of trade regime, some of the policy responses suggested to the global community include changes in thinking about policy measures to deal with the sources of economic disadvantage faced by small states. Many of these disadvantages are both substantial and exogenous in nature. A substantial portion of trade emanating from small vulnerable states remains dependent upon the existence of trade preferences. To avoid the economic marginalisation of these states in future as a result of the erosion of trade preferences, it is necessary to attempt to engineer instruments of a particular kind. They must be both WTO compatible and more market friendly than trade preference while achieving the same objective, namely creating a direct fiscal incentive for the private sector to locate in small highly disadvantaged countries. The instrument suggested is that of '*investment preference*'. It is an attempt to develop a global system of incentives that results in minimal economic distortions while still providing investors with a direct incentive to locate export-oriented industry in disadvantaged areas. The proposal emulates similar instruments of national trade policy under which national governments currently provide WTO-compatible incentives to move to disadvantaged regions within a particular country. There is no reason why such a facility could not be made available on a global basis to least developed and small vulnerable states as a group.

The WTO issues facing small vulnerable states are considered in detail in the final section of this paper. The greatest challenge facing small vulnerable states inside the WTO is the question of the recognition of their special status whilst at the same time developing initiatives that would enhance their ability to participate in the WTO and in the multilateral trading system. The WTO participation issues discussed relate to the question of political marginalisation, and specific measures recognising small vulnerable states as a group facing similar disadvantages to those of least developed countries are suggested. Raising the issue of special and

differential treatment for small vulnerable states immediately raises the question of an appropriate definition of such states. This taxing problem is considered in some detail. A WTO-compatible definition of 'small' is suggested. Definitional approaches that are likely to minimise political resistance to such a proposal are looked at in the context of the very considerable political constraints and objections to the implementation of the recognition of small vulnerable states.

The paper focuses upon trade policy issues. It does not seek to undertake a detailed economic analysis of the causes and consequences of each of these issues, which is beyond the terms of reference and the resources available for the current study. Moreover, substantial economic research has already been undertaken on the quantifiable effects of trade liberalisation. Revisiting these issues would be repetitious. Nevertheless, there is certainly need for more analysis of the implications for firms operating in small vulnerable states of those states' vulnerability.

The paper also emphasises the experience of small vulnerable states in the Pacific and Indian Ocean, drawing also on the cases of Caribbean and African small states. The Pacific and Indian Ocean small states, numbering 17 in all, are significant not only for the disadvantage of smallness but also for the presence of a very high concentration of least developed, isolated and physically dispersed nation states among them. Thus this group is disadvantaged by a combination of inherent qualities that often adversely affects enterprises operating in them and creates what often appear to be insurmountable sources of economic disadvantage for the development of the private sector.

However, this group of countries also contains two relative success stories. Fiji and Mauritius have managed, at least in part, to overcome the disadvantages associated with their physical characteristics and initial development status. These two countries provide important demonstrations to the international community that with assistance and relatively sound domestic economic policy even countries facing apparently insurmountable difficulties can develop new export industries and make substantial progress towards sustainable economic development. These two countries give some cause for optimism. They demonstrate that the endeavours of national governments and the international community to assist small vulnerable states to a future that is not dependent upon aid flows will eventually bear fruit and that the need for international assistance will not be of indefinite duration.

Small states and the changing global trade regime

Background

The emergence over a period of five years of the Single European Market (SEM), the North American Free Trade Area (Nafta), the World Trade Organisation and the Asian Pacific Economic Co-operation Council (APEC) has totally altered the political economy, as well as the legal rules, of the global trading system. The forces unleashed by the end of the Cold War, the globalisation of information and economic liberalisation, have created a new trading environment to which small highly vulnerable states will have to adjust. Many of these small highly vulnerable states base their international trade upon an extremely limited range of products, the concentration of which is often not substantially different from the concentration of exports during the colonial era. Moreover, much of this production remains dependent upon market access granted under several regional trade preference arrangements. In order to assure that even existing levels of market access into developed country markets are maintained, small vulnerable states in the Caribbean, and the Pacific and Indian Oceans will have to undergo a fundamental renovation of their trade regimes. In addition, the trade regime shift currently occurring will result in a more liberalised trade environment, which will necessitate a fundamental reform of both the domestic economy and traditional sources of government revenue generation.

In essence, the shift in trade regimes has been a movement towards a global regime based on reciprocity within regional liberalisation areas (EU and Nafta) or global trade liberalisation (APEC and WTO). This shift is predicated upon the principle that the products of nations that are part of the free trade area or the multilateral system are to be treated in a like manner. The trade regimes of developing countries have been linked to the former metropolitan powers and to regional free trade areas through non-reciprocal systems that have existed through such initiatives as the CBI and Caribcan in the Caribbean. In the Pacific, Sparteca and the Compact of Free Association between Pacific Islands and the USA have provided similar non-reciprocal regional trade preferences. Virtually every one of the major trade preference arrangements from the pre-Uruguay Round era exists under WTO waiver or suffers from the same definition of WTO incompatibility.

The shift of trade regimes has to be seen in the context not just of the actual agreements and the liberalisation of market access that has occurred, but also the increased legal significance of these trade agreements. The new WTO dispute settlement mechanism (DSM) has meant that the rules of the WTO are now legally enforceable and even small

countries now have access to a quasi-judicial procedure where their international trade rights are protected.[1] Certainly the evidence of the impact for small highly vulnerable states of the WTO's DSM is clear. The WTO complaint by the USA and several Central American countries against the EU banana regime, which threatens to force a complete change in the trade provisions of the Lomé Convention and by extension the entire system of regional trade preferences available to developing countries, leaves no room for doubt.

The change in the trading environment resulting directly from the creation of the WTO has occurred simultaneously with the development of regional free trade arrangements. While the effect of the liberalisation is significant, it will not impact as rapidly upon the trade regime confronted by small states as will the implications of the banana dispute in the coming years. This dispute and the resulting need for a transitional waiver, along with an obligation that the post-Lomé IV trade provisions eventually be brought into conformity with WTO rules, will result in the rapid demise of the regional trade preference regimes that have in the past benefited small vulnerable states. It is argued here that *the web of MFN obligations* implicit, and at times explicit, in these regional trade preference regimes offered by other developed trade and aid partners will mean that *reciprocal free trade areas as proposed by the EU will result in a systemic shift and the elimination of non-GSP trade preference systems*.

Uruguay Round effects

There have been numerous studies of the implications of liberalisation resulting from the Uruguay Round (for example Goldin, Knudsen and Van der Mersbrugghe, 1994; GATT, 1993; Commonwealth Secretariat, 1997; Page and Davenport, 1994; Martin and Winters, 1996). Most have concluded that the benefits of trade liberalisation will be relatively large but unequally distributed, and that there are likely to be countries that are net losers from the round. These groups include:

- *Highly trade preference dependent economies* such as those in the Caribbean and in the Pacific (Davenport, 1996; Grynberg, 1994);
- *Net-food-importing countries*. In particular, OECD studies have indicated that countries that are net food importers and exporters of cocoa and coffee, the post-Uruguay Round prices of which are expected to decline, will experience a clear deterioration in their terms of trade (Goldin, Knudsen and Van der Mersbrugghe, 1994). However, many

[1] In the context of NAFTA an even more dramatic DSM has been developed. For the first time in an important international trade treaty private parties have rights that are enforceable by law.

of the small highly vulnerable states are net food importing states (Commonwealth Secretariat, 1997) and many of the small states in the Pacific and Africa are exporters of the range of tropical tree crop products whose prices are expected to fall as a result of the Uruguay Round agreement.

The net economic effect of Uruguay Round trade liberalisation upon many small vulnerable countries that are also ACP members is likely to be negative (Page, Davenport and Hewitt, 1991; Page and Davenport, 1994), though this will certainly vary from country to country. On the basis of the evidence, those countries that are trade preference dependent and are net food importers are those most likely to be net losers. *The net trade creation effects of Uruguay Round liberalisation will flow to those countries most able to make the economic adjustment to a more open trading environment*. The world will move through successive rounds of trade liberalisation at the WTO to a more open trading environment, and tariff barriers will become less commercially significant. As this happens, *investment decisions will come to be based upon the commercial consideration of which region and country has the lowest operating cost*. As this occurs, investment will tend to move away from those small vulnerable states that are high-cost centres.

The most significant institutional effect of the Uruguay Round on the trade regime of small vulnerable states has been through the increased power of the Dispute Settlement Mechanism. The main impact has been the post-Uruguay Round challenge to the EU's banana regime. For Caribbean countries the experience of the challenge and the possible loss or erosion of preference in the EU banana market has resulted in a frequently negative view of the DSM. However, there can be little doubt that the DSM has increased the power of the small states because it has made it possible for small states to challenge larger WTO members in a forum where the outcome is largely determined by the rule of law.

However, the creation of the WTO and the challenge to the WTO compatibility of the EU's banana regime have together been the harbinger of the regime shift being experienced by those small vulnerable states that are signatories to the Lomé Convention. The legal elevation of the MFN principle of the WTO has meant the undoing of the region-specific and non-GSP non-preferential trade agreements that violate the Tokyo Round Enabling Clause and the Part IV provisions that brought them into existence.

WTO compatibility of the Lomé Convention

The central tenet of WTO law is Article I (MFN) as adapted by the Enabling Clause of the Tokyo Round and Part IV provisions. With the

exception of Free Trade Areas (FTAs), Customs Unions and interim arrangements, the exports of WTO members of a similar development status should be treated by other WTO members in an identical manner. The current Lomé trade regime clearly violates this provision as it discriminates in favour of some developing and least developed countries (i.e. the 70 ACP states) and against other countries of a similar development status (for example Latin American countries). The current Lomé Convention exists under a WTO waiver which will expire, with the Lomé Convention itself, in February 2000. It will need to be revised and possibly a further five-year transitional waiver to facilitate negotiations will have to be negotiated. The present Article I violations, as opposed to other possible violations of GATT provisions, are covered by the current WTO waiver.

In order to assure WTO compliance, the EU has proposed, in the Green Paper on the Future of Relations with the ACP, a fundamental change in the post-Lomé IV trade regime. The EU's proposal suggests both the creation of FTAs for non-LDC ACP states and the provision of non-reciprocal preferences on an MFN basis (i.e. to Lomé Convention as well as non-Lomé Convention signatories) to all LDCs. This dichotomy between Lomé-equivalent preferences for all LDCs, and FTAs for the rest, would assure WTO compatibility of the Lomé Convention with Article I. It would, though, do nothing to assure the protection of the Commodity Protocols which, it could be argued, are in violation of other provisions such as Articles XI, XIII(c) or XVI.

The evolving EU negotiating position does not reflect just a desire for WTO compatibility: it has shifted since the publication of the Green Paper and has come to reflect *a fundamental shift of the EU's trade interests in the ACP*. The original Lomé Convention (1975) was drafted at a time when the EU and much of the developed world were concerned with resource security. Provisions such as Stabex, which originally tied stabilisation payments to the supply of raw materials to EU, are now slated for elimination under the post-Lomé IV trade arrangements; and commodity protocols, which once assured EU's supply of basic raw materials, are now seen as anachronistic. Two components to the new EU trade proposals for the post-Lomé IV framework are now important:

- the WTO compatibility of the trade preference regime and the commodity protocols;
- the advancement of EU market access and trade objectives in the Millennium Round.

The proposed resolution of the WTO compatibility question also happens

to further the second objective of enhancing EU market access. While marginal improvements in access may be possible in Africa, given the dominance of the EU as a development and trade partner, the MFN obligations in the Caribbean and the Pacific will mean that no effective margin of trade preference will result. Thus the EU's trade interest has shifted from the concern for *raw material supply* in the 1970s to concerns about *increased market access* for EU exports. The EU's negotiating mandate for the post–Lomé IV trade regime reflects these new concerns.

The EU negotiating mandate: from WTO compatibility to the Millennium Round agenda

The ACP negotiating mandate rests upon the natural desire of any recipient of aid and trade preference to build upon the *acquis* that has already been negotiated over four Lomé Conventions. While the ACP wants to see improvements in the Convention, there are no ACP proposals that seek any fundamental change from the Convention's Lomé IV format.

The EU position on the Lomé Convention was first outlined in the EU's 1996 Green Paper on its relations with the ACP states. Much, but not all, of the discussion in the trade section of the Green Paper was preoccupied with the question of WTO compatibility of the trade preference regime. In the Green Paper the EU also expressed its interests in developing a multilateral investment agreement with the ACP, but there was no explicit elaboration on the content of the proposed arrangement.

The EU offered three non-mutually exclusive routes to assuring WTO compatibility of the existing trade regime:

- the creation of up to *six regional free trade areas* in which ACP regions would reciprocate to the EU (i.e. compatibility with Article XXIV);
- the offer of a *super-GSP to all LDCs* (including nine non-ACP states) and the placement of developing countries on the existing EU-GSP (to be revised by 2004) which, under current rules, would result in greatly diminished access (thus rendering trade preference regimes compatible with Part IV provisions and the Enabling Clause);
- seeking a continuation of the existing waiver arrangements under Article XXV.

In fact the EU has, to varying degrees, offered all three options to the ACP. At the Singapore Ministerial Conference of the WTO in 1996 the EU indicated its intention to extend the Lomé-equivalent preferences to all LDCs, including nine countries that were not members of the WTO. The offer of the extension of Lomé-equivalent preferences to all LDCs was made formally at the High-Level Meeting on Least Developed

Countries at the WTO in October 1997. Given WTO rules, this in effect determined the form of the rest of the post-Lomé trade regime. By offering to extend EU preferences to all LDCs, the Article I violation as it pertains to LDCs had been eliminated. All LDCs would now be treated the same. The problem that remained for the EU was to assure a WTO-compatible treatment for non-LDC ACP states, i.e. for the developing countries. To deal with this group of countries the EU has offered what are, from an ACP perspective, either of two relatively unpalatable options:

- the creation of regional FTAs or regional economic partnership arrangements (REPAs) with an obligation to eventual reciprocity for non-LDC ACP states; or
- the diminution of market access rights by relegation to the EU-GSP for those countries unwilling to accept reciprocity. GSP, unlike Lomé, is voluntary and non-contractual in nature and can be unilaterally withdrawn.

Between the publication of the Green Paper in October 1996 and the publication of the EU's negotiating mandate in June 1998, it became clear that the EU negotiating position was *not simply aiming to resolve the question of WTO compatibility*. Its goal was to *improve EU access into ACP, or more accurately African, markets* and push forward its own Millennium Round agenda. In his opening of the Lomé negotiations in September 1998 Commissioner Pinhero was quite explicit about the overall EU objectives:

. . . *Set against the background of resolving the world's problems, the relationship between Europe and the ACP countries is particularly significant*. It could act as a catalyst, particularly in areas in which the multilateral system is not making enough headway. *The EU-ACP partnership could prove particularly fruitful in terms of genuine and significant progress in fields such as codes of conduct, respect for labour and environment standards, a common approach to competition rules and giving a sense of responsibility to people involved in economic activity and civil society whose field of activity transcends borders (emphasis added)*.

The EU negotiating mandate itself stated quite clearly what the EU wanted to negotiate:

- achieving a satisfactory and effective level of protection for intellectual, industrial and commercial property (TRIPs Agreement);
- fulfilment of commitments on standardisation and the application of the WTO's Sanitary and Phytosanitary Measures (SPS) and Technical Barriers to Trade (TBT) Agreements;

- promoting competition policy;
- ensuring that trade is undertaken in a manner that is environmentally sustainable;
- confirming parties' attachment to internationally recognised labour standards;
- establishment of a suitable regulatory environment for telecommunications and the fulfilment of obligations under the WTO Agreement on Basic Telecommunications;
- right of establishment of enterprise on an MFN basis along with general principles on the protection and promotion of investment, along with free repatriation of FDI.[1]

There is an obvious and demonstrable similarity between the EU's agenda in the post-Lomé negotiations, the existing WTO rules and the EU's bargaining objectives for the next round of multilateral trade negotiations scheduled to begin in the USA in late 1999. The inevitable conclusion to be drawn is that the EU's objectives for post-Lomé negotiations go well beyond the issue of WTO compatibility of existing trade arrangements. They appear to have the objective of enforcing the existing WTO disciplines and also creating a possible precedent for new disciplines that the global community has not yet accepted.

The irony of the EU proposals for the creation of regional FTAs with the ACP is that in an attempt to render its regional trade preference arrangement compatible with its WTO obligations, it is likely to bring about the demise of all such arrangements.

WTO issues in the EU negotiating mandate

The Framework Agreement

The EU's negotiating mandate extends to both framework agreements, which will be negotiated with all ACP countries before February 2000, and the Regional Economic Partnership Arrangements, i.e. regional FTAs, which will be negotiated once the framework agreements are completed. The EU's objective in the Framework Agreement is to negotiate existing WTO disciplines into the revised convention, as well as covering new issues, i.e. trade and environment, competition policy and labour standards disciplines. This creates at least three problems for small and vulnerable ACP states.

It would be diplomatically and politically imprudent if the ACP were to

[1]EU Negotiating Directive, pp. 24–5.

negotiate a post-Lomé trade arrangement based upon the EU's negotiating mandate prior to (at very least) the conclusion of the negotiations in Geneva over the agenda for the Millennium Round. Negotiations in the new round based only upon the so-called 'built-in agenda' of the Uruguay Round, i.e. mainly agriculture and services, are emerging as the modal position of the developing world and such a position should not be undermined by negotiations in Brussels that pre-empt decisions at the WTO. Any ACP/EU negotiations in these so-called 'new areas' should be confined to possible areas of technical assistance in the application of any WTO disciplines that may be negotiated at a multilateral level.

There is an implicit assumption in the EU negotiating mandate that ACP countries are WTO members and accept WTO disciplines. While this is true for more than 52 of the countries, it is not true for all of them and it is by no means evident why these non-WTO countries should be asked to accept multilateral disciplines in trade to which they have not agreed. Any post-Lomé arrangement should not bind ACP countries that are not members of the WTO to WTO disciplines.

Agreement to negotiate on the so-called 'new-issues' prior to the completion of the WTO negotiations could create the possibility that what will be negotiated will also not be compatible with as yet incomplete WTO disciplines in this area. In light of the experience of WTO incompatibility with the existing Lomé trade provisions, one would imagine that all signatories of the Lomé Convention would be reluctant to rush into areas where the negotiations over WTO disciplines are not complete.

The Regional Economic Partnership Arrangement

The EU's REPAs are problematic in terms of ACP solidarity in that the EU may be able to negotiate better terms from one region than from another. There is a legitimate concern that this would lead to the break-up of the ACP Group, which affirmed at the Libreville Summit of 1997 that it wished to remain in being. Perhaps as significantly, it would lead to weaker regions negotiating access arrangements that result in a deterioration in access provisions. One resolution to this problem lies in including an *MFN provision in the framework agreement* stating that any non-commodity specific concession granted to one region will be available to all ACP regions.

A second important issue is that the *economic cost of the transition to free trade may be very high* for those 'small' but non-export enclave countries that are large enough and sufficiently highly developed to pursue monetised production for the domestic market. In these cases the loss of tariffs may have very adverse effects upon the development potential of these

countries. It is, however, unlikely to affect those that have pursued, on the basis of the size of the domestic market or on resource availability, a purely export-oriented trade policy.

Perhaps the most significant difficulty of the REPA is economic rather than political. In October 1998 the EU had already produced studies using very restrictive assumptions and terms of reference. *It is by no means evident that a REPA with any of the African, Caribbean or Pacific countries is feasible*. Indeed, as has been argued above, its implementation would almost necessarily invite MFN *demands from other large trading and development co-operation partners such as the USA, Japan and, in the case of the Pacific, Australia*. The political reality is that a REPA with Europe would imply the complete elimination of tariffs in what would almost certainly be 90 per cent of trade. The developing ACP countries may have no choice if they wish to maintain Lomé access to the EU market.

The REPA arrangements also have a number of very important WTO implications that the ACP countries should consider.

The most obvious difficulty is whether the EU and the three or possibly even six ACP regions will have sufficient time to negotiate a REPA. The EU has stated that it will attempt to negotiate a further five-year WTO waiver for the existing Lomé trade preference provisions, to allow time for the negotiation of a REPA. Given the current heightening of trade tensions between the USA and the EU over the EU banana regime, *it is by no means certain that the EU and the ACP will achieve consensus at the WTO over a further five-year waiver* without considerable concession to the Central Americans and other parties that have expressed concern over various aspects of the existing Lomé Convention trade regime.

The WTO's dispute settlement mechanism allows for 'situation' disputes as well as 'non-violation' disputes.[1] Since these are becoming more common, assuring WTO compatibility will not guarantee that a WTO member's trade regime will necessarily remain unchallenged.

The EU may be able to achieve an Article I waiver but it could be argued, as it has been in the three banana panel reports, that the extent of WTO incompatibilities may go well beyond just Article I to Article XI, XIII, or XVI. In the case of *the commodity protocols, which are arguably still the most commercially valuable components of the Lomé trade regime*, there is very

[1]Under a non-violation dispute such as Fuji-Kodak, the USA claimed that even though Japan was not violating any of its WTO obligations, the US trading benefits had nonetheless been nullified or impaired. A successful outcome of such a 'non-violation dispute' implies a right of retaliation or compensation as the trade regime is by definition in conformity with its WTO obligations.

little likelihood that the WTO will agree to waivers that will cover possible WTO violations in the area of tariff quotas and quantitative restrictions. Such waivers have rarely been given in the past. Thus *the REPA will provide no protection for any possible non-Article I violations of the WTO agreements that may stem from the commodity protocols*.

The transitional arrangements envisaged in the REPA are of ten years' duration. For many small and highly vulnerable states this may prove to be too short a period for the economic and structural change required. Given the terms of the WTO's *Understanding on the Interpretation of Article XXIV*, transitions to FTAs should take no more than ten years. It may require the negotiation of a special and differential provision in the next round to permit longer (20-year) transitions for FTAs between developed and developing countries.[1] (The Bogor Declaration (1995) and the effective 25-year transition allowed for APEC liberalisation for developing countries should be a precedent for such arrangements.)

REPAs in the Pacific and the Caribbean

The changes that have occurred with the creation of the WTO and the contemporaneous shifts in regional trade regimes resulting from the Single European Market (SEM), Nafta and APEC have resulted in the lowering of MFN and regional tariffs by developed and developing countries. This has lowered the margins of trade preference available to small vulnerable states. But it is argued that the creation of the WTO's powerful DSM and the challenges to the EU banana regime (leading to the subsequent need to transform Lomé trade rules) will, through MFN demands of other trading partners, result in the phased elimination over time of the tariffs of the small states of the Pacific and Caribbean. Because of the '*web of implicit MFN obligations*' found in existing treaty obligations between Caribbean states and the USA on the one hand and the similar but implicit MFN obligations between the Pacific island states and Australia, New Zealand and the USA on the other, regional trade preference arrangements will disappear. The section below considers these trade treaties in greater detail.

Caribbean

The Caribbean is involved in a number of important regional non-reciprocal and reciprocal trade arrangements. While the Lomé Convention

[1]Until now the WTO Committee on Regional Arrangements has not applied stringent rules and has not rejected any regional arrangement that has been brought before it. However, there is increasing pressure inside the committee to develop more stringent terms and to review FTAs, Customs Unions and interim arrangements.

has been crucial to the states of the Caribbean, relations with Western Hemisphere trading partners are becoming significant. In particular the US Caribbean Basin Economic Recovery Act (CBERA), more commonly known as the Caribbean Basin Initiative (CBI), of 1984 (renewed in 1992) has provided duty free access for Caribbean products into the US market. The provisions of this agreement stipulate quite clearly under Section 2702 of the US Code that the President of the USA shall not designate a country to be the beneficiary of the CBERA:

[i]*f such a country affords preferential treatment to the products of a developed country, other than the United States, which has, or is likely to have, a significant adverse effect upon United States commerce, unless the President has received assurances satisfactory to him that such preferential treatment will be eliminated or that action will be taken to assure that there be no such significant effect, and he reports those assurances to Congress.*

While there is no explicit demand for MFN treatment, it seems clear that the US intention is to assure that US exporters are not disadvantaged in Caribbean markets by concessions that the Caribbean might make to other developed countries. The USTR is required by the US government to undertake a review of the CBERA every three years to ascertain whether US exports have been put at a competitive disadvantage in Caribbean markets.

However, the CBI is not necessarily the most important preference arrangement for the Caribbean region, either economically or statistically. To Jamaica the 807 US Offshore Assembly Program and the 807A Special Regime have been important in facilitating export oriented manufacturing activities. While the CBI excludes garments and textile products, these programmes deal specifically with these types of products and have been the basis for exports of these products from the Caribbean.

Canada has also offered a series of programmes that provide non-reciprocal trade preference arrangements for the Commonwealth countries of the Caribbean basin. Traditionally this was offered through the British Preferential Tariff (BPT), which continued until early 1998 when it was discontinued. Side-by-side with the BPT arrangement, the Canadian government developed the Caribcan initiative in 1986. This was extended in 1996 and received a ten-year waiver (until 31 December 2006) at the WTO. While Caribcan excludes large sections of the Canadian tariff schedule,[1] it has offered essentially duty free access for

[1]The most important exclusions include:
- goods of HS Chapters 50 to 65 inclusive (all textile and clothing products);
- goods of HS 42.02 (suitcases, handbags etc.) other than leather luggage of tariff item 4202.11.00;

most Caribbean exports. Thus while the Caribcan scheme is not written with explicit MFN conditionality, it does contain provisions that would permit Canadian revocation of preferential access provisions.[1]

These explicit or implicit MFN obligations in the CBI and Caribcan mean that once the Caribbean begins negotiating a REPA with the EU it can almost certainly expect similar demands from its other trading partners that have traditionally offered trade preference. The creation of the Free Trade Area of the Americas (FTAA) thus stands as one way to deal with the issue of the MFN obligations of the Caribbean states towards their North American trading partners. However, the FTAA is by no means the only way, and it may be possible to engineer less wide-ranging trade arrangements with Nafta in the event that the FTAA proves difficult to negotiate. It is clear that the EU proposals for a REPA will mean that the Caribbean will be faced with no option but the eventual elimination of import duties on substantially all trade. What 'substantially all trade' will mean precisely, and over what period, will be the subject of negotiations, but with import duties removed from imports from the EU, the USA and Canada, the remaining system of import duties would be highly distortionary. Thus in the Caribbean, the resolution of the WTO incompatibility of the Lomé trade provisions will mean that through MFN effects in the Western hemisphere, there will be a complete realignment and economic restructuring of the system of trade and revenue generation in the highly import duty dependent economies of the Caribbean.

The Pacific Islands

In the Pacific Islands region trade preference issues remain just as complex – possibly even more so – than in the Caribbean. The region is still heavily dependent upon trade with its former metropolitan powers. The 14 independent island states of the Western Pacific that are members of the South Pacific Forum maintain with their former colonial powers a series of non-reciprocal preferential arrangements similar in nature if not in scope to the Lomé Convention. Under the terms of the Sparteca Treaty Australia and New Zealand have, since 1981, granted non-reciprocal access to exports originating in the 14 Forum Island countries.

- goods of tariff item nos 2710.00.20 (aviation gasoline), 2905.11.00, 3403.11.10 (lubricants), 3403.19.10 (lubricants, grease, oil etc.) or 4203.10.00 (leather apparel); and
- goods subject to an MFN rate of duty of more than 35 per cent.

[1]The 1986 legislation states:

Withdrawal of Benefits: The Governor in Council may, by order, from time to time withdraw the benefit of importation free of duty . . . in whole or in part, from any country to which that benefit has been extended (GOC Parliament, 1986).

This agreement has been notified to the WTO under the terms of the Tokyo Round Enabling Clause.[1]

The three former US Trust Territories of Marshall Islands, the Federated States of Micronesia and Palau also benefit from the Compact of Free Association with the USA, which provides, *inter alia*, for free market access for all products except tuna, the one natural resource the region has in abundance. These three countries along with Niue, Nauru and Cook Islands have sought membership of the ACP group. The request, which was endorsed by the Forum Heads of Government in 1997, has been forwarded to the ACP and the EU. The accession of the four Micronesian states (Marshall Islands, Federated States, Palau and Nauru) is important in the process of redefining the relationship between the EU and the Pacific on a new economic basis of mutual interest.

The South Pacific remains one of the few regions in the world where the fisheries effort in the main species of skipjack tuna is well below maximum sustainable yield. At present the estimated catch in the Exclusive Economic Zones (EEZs) of the countries of the Forum Fisheries Agency is approximately 1.2 million tonnes of skipjack This can readily be raised to the approximately two million tonnes that is conservatively estimated as the maximum sustainable yield. The EU is now actively considering negotiating a fisheries access arrangement with the Pacific islands. This would mean that there would develop a new foundation for the relationship based upon mutual advantage. The four Micronesian states are the most 'resource rich' in the Western Pacific in terms of tuna stocks because they are all located in the tropical zone where tuna stocks are plentiful. The commercial value of EU access into the region would be greatly diminished if its vessels did not have access to the EEZ of these Micronesian states.

If the Micronesian states were to enter into the ACP group and were to want the benefits of preferential access into the EU market currently available to the other ACP states under the Lomé Convention, they would eventually (2015–20) have to reciprocate to the EU, for they are all classified as developing rather than least developed countries. Unlike those other Pacific island states that have been members of the ACP for many years and have developed their economies partly upon the basis of Lomé trade preferences, there would no immediate losses to the Micronesian states in the event that they accept the GSP option.

[1]The fact that Sparteca was notified does not mean that it is consistent with WTO rules. It suffers from the same WTO incompatibility as the preferential tariffs of the Lomé Convention. Australia also has a non-reciprocal bilateral agreement with Papua New Guinea, Pactra.

However, just as in the Compact of Free Association, they would then not have preferential access into the EU market for the one resource that exists in abundance, i.e. tuna. However, given the importance of the US as an aid donor, if the Micronesian states were to reciprocate to the EU they would have little choice but to reciprocate to the USA. They would then be in precisely the same situation as those countries benefiting from the Caribbean Basin Initiative.

In the Pacific the difficulties created by a post-Lomé trade regime based upon reciprocity to the EU are not limited to the relationship between the three Micronesian states. They extend to the very important trading and aid relationship that exists between the South Pacific island countries and Australia and New Zealand. The Lomé Convention states that the EU expects MFN treatment in the event of an ACP state offering improved access to another developed country. This position has been reiterated in the Green Paper: the EU has stated unequivocally that it will not accept being discriminated against in ACP markets. However, the same is true for Australia and, to a much lesser degree, New Zealand. Both have provided duty free access to their markets under the Sparteca agreement to all 14 Forum island countries and for Australia, in particular, the Pacific islands market is important.[1] The potential for trade diversion created by a regional arrangement with the EU may disturb the dominant Australian position in the Pacific market for consumer and investment goods. While there are no explicit MFN provisions in the Sparteca arrangement, it is clear that there exists an implicit or *de facto* MFN obligation, given the dominance of Australia as both a trading and development aid partner. In the case of New Zealand, which plans to phase out all tariffs by the year 2002, the Sparteca treaty will offer no margin of preference to the Pacific island states. Consequently, it has played a low-key role in the development of a post-Lomé trading arrangement with the Pacific ACP.

The Pacific Islands region remains one of the few regions in the world where there is no comprehensive regional integration agreement such as the Southern Africa Development Community (SADC).[2] The Pacific island countries have been debating for almost two years the creation of

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[1]Australian exports to the Pacific islands totalled AUD1.5 million in 1996, which consisted very largely of manufactured exports. While this was only 4 per cent of total Australian exports, the Pacific islands region is considered by Australia to be a small but very profitable market for Australian exporters.

[2]The Melanesian states have created a regional FTA called the Melanesian Spearhead Group Trade Agreement. It was negotiated in 1992 and has made only very limited progress towards trade liberalisation. It now includes the four largest economies in the region – Papua New Guinea, Solomon Islands, Vanuatu and Fiji.

a regional free trade arrangement. Without such an agreement it will be difficult, but not impossible, for Pacific island countries to form a REPA with the EU.[1] The formation of a free trade area was proposed by the Forum Heads of Government meeting in Rarotonga 1996. The Forum Trade Ministers meeting scheduled for mid-1999 will consider the establishment of such a free trade arrangement. If the non-LDC Pacific ACP states (which currently include Tonga, Papua New Guinea and Fiji, and could include Samoa and Vanuatu if they are graduated by ECOSOC in 2000), are to continue having Lomé preferential access to the EU market then they should create a regional free trade area.

If the Forum Free Trade Area includes Australia and New Zealand, who are important members of the Forum, then this will create some measure of difficulty as a basis for a REPA with the EU. The technical problem stems from the fact that Australian originating products would clearly not be acceptable to the EU. *Any EU concerns over the potential for 'preference contamination' in such an arrangement can be dealt with by an appropriate definition of qualifying area content and cumulation rules. In this way an FTA that includes Australia and New Zealand on an MFN basis with the EU may be technically possible as a basis for the REPA.*

Globalisation and the adjustment problems of small vulnerable states

Characteristics of efficient national economies in a global market

In the previous section it was argued that the combined effects of MFN liberalisation at the WTO and at regional level will greatly diminish the commercial value of trade preferences. Bringing the EU trade preference regime into conformity with its WTO obligations by the creation of regional free trade areas will, however, serve to erode trade preference even more dramatically and quickly, as the web of MFN obligations in other regional trade preference arrangements will mean that small states will be forced to reciprocate to other large trading partners. This in turn will mean that small states will have little choice but to confront a more competitive trading environment. *The societies that will be most able to take advantage of the market opportunities created by a more liberalised market*

[1]It is possible to create a series of bilateral free trade arrangements under which all present and future ACP developing countries reciprocate to the EU over 10 to 15 years on a bilateral basis. This would mean that the EU would enjoy a greater margin of preference in these markets than that of neighbouring countries.

environment are those best able to move and change with changing market opportunities.

Economists normally associate the following features with societies that are best able to adjust to the market:

- a pool of *freely traded and specialised* land, labour and capital that is mobile, with low transaction costs in its inter-sectoral mobility;
- an efficient information system that disseminates relevant *market information* rapidly and at low cost;
- a *physical infrastructure* that permits efficient movement of goods, services, resources and natural persons;
- a social and political infrastructure conducive to *predictable legal outcomes.*

In all economies, two types of factors are responsible for the absence of these characteristics. The first are *domestic policy induced factors* and the second, *exogenous or inherent factors* that are beyond the immediate policy purview of national governments. Market-oriented structural adjustment programmes are necessary to deal with the policy induced sources of inefficiency and market failure. Nevertheless, it will be argued, other (possibly multilateral) forms of policy intervention by the global community are necessary if small states are to cope with those of their inherent cost disadvantages that induce economic marginalisation.

Adjustment problems of small states

Through a combination of historical circumstance and the evolution of commercial advantage, exports from small countries have tended to remain largely confined to a limited number of products. Small states face fundamental barriers to adjustment that stem from the high cost of sectoral shift from what are often agricultural monocultures to economic structures attuned to a more liberal economic environment. What makes small states and enterprises in those states so fundamentally different from those in larger states is the very limited pool of specialised domestic resources available to firms. The absence of such a pool in turn raises the costs of sectoral and structural change. Moreover, the high degree of economic specialisation resulting from limited export and domestic market production has meant that adjustment away from these sectors is all the more difficult.

A well known and understood list of inherent characteristics is at play in many small and highly vulnerable economies. These characteristics or factors, when operating together, render markets in small economies less

capable of adaptation to global market change. They include:

- diseconomies of scale in production for both domestic and export markets;
- physical dispersion of small pockets of resources, products and persons (especially in island states);
- physical isolation from resource and export markets;
- lack of trade and economic integration permitting the acquisition of domestically scarce resources at competitive market prices;
- poor development of human resources, especially of skilled labour and entrepreneurial skills;
- poor physical and communications infrastructure;
- a high degree of vulnerability to the economic impact of natural disasters.

This list of characteristics is frequently produced, but less common is an understanding of the dynamic interaction between these characteristics in creating cost disadvantages for firms operating in this environment. The interaction between these disadvantages is not necessarily linear, and often produces exponential increases in the costs of production facing firms operating in small isolated states. An example may suffice to demonstrate the nature of the interaction. In the early 1990s the Government of Fiji was considering diversification into the export of cut flowers. The cost of airfreight of cut flowers from Hawaii (one of the principal Pacific suppliers) to Tokyo is approximately US$1/kg. To export a similar quantity of cut flowers from Fiji to Tokyo costs US$4/kg. In other words, while the distance between Fiji and Tokyo is double that between Hawaii and Tokyo, the airfreight is quadrupled. However, as is well understood in transport issues, economies of scale are often more important than distance in determining freight rates. Export from Hawaii to Tokyo is frequently done in large specialised air freighters because the economies of scale exist to permit this type of development. In Fiji the export of cut flowers (and chilled fish) could only be done in the cargo hold of passenger flights. Thus diseconomies of scale combine with isolation and distance from markets to render sub-economic the development of an export oriented cut flower industry. This problem can be overcome, as was the case with some Asian exporters, who developed a cut flower export industry by subsidising airfreight in the initial stages, until volumes were adequate to assure the development of specialised air services. However, under WTO rules direct export subsidies are prohibited for all members except LDCs or countries with a GNP of US$1,000. Fiji, by virtue of its

GNP/capita, is prohibited from providing such export subsidies.

Smallness per se is not necessarily an overarching barrier to a country's ability to shift resources and products between users and markets, which is the essence of the adjustment required in order to prepare for a liberalised market. It could readily be argued that more developed small states are in fact better able to shift resources because of the physical proximity of social and physical infrastructure. It is commonly argued that smallness is not a problem because resources required for change, but not available domestically, can be acquired through international trade from related or associated countries. However, their acquisition from global markets is often in small volumes, which in turn means that firms must pay a premium to world price. This high cost of imported inputs is a particular problem where firms need to acquire skilled labour and managerial talent, and this in turn results in relatively high unit costs in small and isolated locations.

Enterprises originating within those small states suffer from a further dynamic disadvantage in that they are unable to undertake what has long been considered a normal corporate development path in larger economies, i.e. from supplying the local market, usually with some measure of government protection, to supplying the export sector. This is not possible for firms in these very small states, as the domestic market in which they operate is very small. Hence, they are often unable to acquire the necessary experience and market skills before entering much more competitive international markets. Thus the natural learning curve that has been the basis for corporate development in larger economies is not available to firms located in small states. The denial of access to this dynamic process in small states constitutes one very important reason for the lack of entrepreneurial talent outside the agricultural sector.

Dealing with endogenous and exogenous causes of inefficiency

The traditional economic response to the inherent barriers of smallness, isolation and less developed factor markets, and indeed any other undesirable qualities, has been to argue that domestic factor prices in such economies must be adjusted downwards to reflect these cost disadvantages. Adjusting factor prices sufficiently to compensate for these disadvantages, it is argued, would induce firms operating in competitive industries to locate in small and highly disadvantaged states.

This raises an important empirical question. In small highly vulnerable economies, does there in fact exist sufficient domestic value added (over and above the subsistence reservation wage in the case of labour, the zero

risk rate of return on capital and a zero rent for land and resources) to compensate potential investors for the cumulative cost disadvantages faced by the private sector in such economies? In other words, the commonly noted absence of bankable private sector investment projects in small vulnerable economies may not be alleviated by normal structural adjustment programmes. Such programmes act to lower factor prices to market determined levels as there may be insufficient domestic value added to compensate for the plethora of inherent disadvantages associated with these economies.

If normal competitive industries cannot be readily established in these small highly vulnerable economies, this still does not necessarily justify any market distorting intervention by the international community. It is argued that small highly vulnerable countries may be able to develop their productive capacity in niche market sectors. Such a possibility is predicated upon the existence of quasi-rents, which will permit production at costs that are above normal competitive levels. However, *while in other economies these quasi-rents constitute a basis for high profits, in small states they are often a precondition for productive commercial activity as rents are necessary to cover inherently high operating costs.*

Examination of the history of the post-independence period in the Pacific islands – a region where many of the other disadvantages frequently associated with smallness are found – produces abundant evidence *that the emergence of virtually every new export sector has been associated with three different forms of quasi-rents.* These have been either market created or *de jure* rents. The market creates two different types of quasi-rent: either when markets boom or when a peculiar combination of circumstances makes the supply of a particular product difficult, i.e. niche markets. However, both national governments and the international community have created *de jure* sources of quasi-rent through tax incentive schemes and trade preference arrangements. The main sources of quasi-rent have included:

- ***Booming Sectors*** – Papua New Guinea oil and gold development (1980s) and Solomon Islands logging (1990s)
  The movement of resource developers into these Melanesian countries immediately followed a price peak that led to an expectation of quasi-rents. Both Solomon Islands and Papua New Guinea are considered very high cost locations for exploration for oil and gold and the development of logging. In the case of the development of gold mines and oil and natural gas deposits in Papua New Guinea, the main spur to exploration was the boom in oil and gold prices in 1979–80. The rapid expansion of logging in the Solomon Islands, and also in Papua

New Guinea, is a direct result of the contraction of supply from Sabah and Sarawak and a consequent price peak in the South Sea log market in the early 1990s.

- ***Niche Market Sectors*** – Squash exports to Japan from Tonga; sashimi from Fiji; kava from Vanuatu, Samoa and Fiji; and seaweed from Kiribati
  The Tongan squash export industry has relied on a two-month window of exports into the Japanese market, where premium prices are paid in the months of November and December. Tonga is one of the few countries that have been able to supply squash consistently at that time of year. The export of sashimi to Japan from Fiji, and to a lesser degree from the Marshall Islands and Solomon Islands, has been predicated on the high prices that are paid for premium tuna in Japan and Korea.

  The rapid emergence of the Pacific beverage kava as a natural sedative has been associated with very high export prices. The development of seaweed exports for pharmaceutical use from Kiribati has only been possible because premium prices are paid for these exports.

- ***Trade Preference*** – Garments from Fiji; canned tuna from Solomon Islands, Fiji and Papua New Guinea; electrical harnesses from Samoa
  Trade preference arrangements have been extremely important in the early development of tropical agricultural exports but have been less significant as liberalisation has eroded the margin of preference. This has been particularly so in the case of Melanesian tropical tree crop exports such as palm oil, cocoa and coffee.

The main contemporary impact of trade preference has been in the diversification into garment exports to New Zealand and then Australia from Fiji after 1988 under the terms of Sparteca. Canned tuna exports from three Melanesian countries (Papua New Guinea, Solomon Islands and Fiji) occur under the 24 per cent trade preference margin of the Lomé Convention. This has been one of the most conspicuous successes of export diversification of the Lomé Convention. Electrical harnesses for automobiles are exported from Samoa to Australia under Sparteca. At present employment is as high as 2,000 workers in Samoa's largest private sector employer.

Problems of quasi-rent based development

While these quasi-rents have been necessary in small vulnerable states in order to establish new industries, they have all, in quite different ways, created difficulties.

Booming sectors have been widely recognised as having negative impacts, through *Dutch disease effects* upon the non-traded goods sectors of the economy. This has certainly been true in the case of both Solomon Islands and Papua New Guinea. While in theory it remains possible to manage resource booms effectively through various macroeconomic instruments, small countries are particularly vulnerable to such phenomena. Even in sectors where small states have been successful in niche marketing, their small size renders them more highly prone to Dutch Disease effects, which often result in the destruction of non-booming traded goods sectors of the economy and even occasion deleterious effects upon the booming sectors themselves. For example, Tonga's squash boom drew labour away from the manufacturing sector, which resulted in a downturn in export oriented manufacturing activities as well as the state sector.

Niche market activity can constitute a commercial market based foundation for trade policy in small states. However, the *information flows* and international *marketing connections* that are necessary for such a form of development, i.e. the second condition listed at the beginning of this chapter, are often not available in small vulnerable states, particularly in isolated small island countries. As a result, some highly vulnerable small states, which may be more able to make the change to a niche market based economy, are not obvious candidates for the use of niche marketing as a foundation for trade policy. They are disqualified by the lack of a suitable information infrastructure and sophisticated and well established marketing links.

Niche market activities are by their nature highly variable and require rapid adaptation to emerging market conditions. The existence of quasi-rents, which by definition characterises niche markets, attracts the entry of competitors. Thus what in one year may be a highly profitable niche market may very soon become a crowded low profit activity associated with high private and social exit costs.

Trade preferences in the Pacific have played a vital role in providing a source of quasi-rents that have successfully induced investment in small vulnerable states. However, even large margins of trade preference had little effect in the case of the most vulnerable and disadvantaged economies, although countries such as Fiji, Samoa, Solomon Islands and Papua New Guinea have taken advantage of trade preferences. It is, nevertheless, clear from the evidence presented above that while trade preferences are extremely important to small states, they cannot for long remain a basis for the development of these states.

This is not to suggest that small states are inherently incapable of dealing

with globalisation, but rather that they face inherent or exogenous cost disadvantages that are not readily amenable to domestic policy change. Special transitional arrangements are needed to assist the shift to a more liberalised environment. Thus policy prescriptions predicated purely upon market-oriented structural adjustment are necessary but not sufficient conditions to assure that small vulnerable states become integrated into the global economy. The challenge for the international community is to design interventions that will facilitate the development of the private sector in countries that are inherently disadvantaged, without simultaneously subsidising the conduct of economic policy that retards the development of the private sector.

Interventions by the international community

The interventions proposed in this section are predicated upon the preceding analysis. This, in turn, is based upon the logic that while market-oriented reforms are necessary, further interventions that seek to address, or at least ameliorate, the inherent or exogenous problems confronting small economies are also necessary if any serious impact upon trade marginalisation is to be realised.

To date there exists no coherent international economic and trade policy on vulnerable small states as it is only now being recognised that the barriers to their economic development faced by such states may approximate those of the least developed countries. The least developed countries constitute the only group currently recognised explicitly by the WTO. The trade policy of the international community towards them has been developed as a result of the 1997 High-Level Meeting on Least Developed Countries, co-ordinated by the WTO and five other multilateral agencies including WTO, UNCTAD, the International Trade Centre (ITC), the UN Development Programme (UNDP), the World Bank and the IMF. The outcome of the meeting was based on three approaches to tackling the overall problem of marginalisation:

- Improvements in market access through the Generalised System of Preference by several developed and developing countries. The EU announced its intention to extend Lomé-equivalent market access to nine non-ACP LDCs;[1]

[1]This improvement in access for LDCs, announced by the EU at the High-Level Meeting, meant that the Lomé Convention trade access provisions for LDCs would now be WTO-compatible. Thus a major part of the EU's WTO/Lomé problems was resolved through this generous extension of preferences to cover all LDCs.

- Co-ordinated technical assistance programmes of the multilateral agencies to assure that countries are able to take advantage of the opportunities created by the multilateral trading system;
- The possibility of creating an insurance facility for LDCs and possibly small states, the only concrete measure involving resources, may be extremely useful, given the risks posed to the business community by natural disasters. Whether such a facility will be for public infrastructure or accessible by the private sector is not known.

The outcome of the meeting has been the development of a series of national action plans for each of the LDCs, many of which are also small states. Resources from the international community to implement these action plans have not, by and large, been made available. These action plans will provide LDCs with technical assistance in the design and implementation of trade policy. However, while LDCs do require technical assistance, this package of policies will provide little direct assistance for the private sector. *Little remaining in the current approach of the international community towards the problems of LDCs or small vulnerable states would directly address the fundamental constraints to the development of the private sector in those societies. The unstated assumption is that dealing with the fundamental constraints remains the responsibility of national governments and is to be dealt with solely through structural adjustment programmes.*

A series of consistent and positive interventions that can assist small highly vulnerable states in the development of their private sector does remain. However, in any such intervention it must be recognised that in the case of some countries their level of development and the extent of their disadvantage will mean that no immediate outcomes can reasonably be expected. Four essential components of international intervention will assist small vulnerable states in making the adjustment to a more competitive global economy. These interventions include:

- ***Market oriented reforms through structural adjustment (World Bank/IMF)***
  All further interventions by national governments and the international community would prove ineffective in the absence of a strategy assuring that small vulnerable states provide a suitable national policy framework. It must be one in which the private sector can thrive, which means it must include competitive exchange rates, a stable macroeconomic environment, transparent investment rules and a predictable legal framework. As has been argued above, this type of intervention is a necessary condition for the proper development of the private sector in small states

However, some multilateral institutions, increasingly faced with the failure of the private sector to respond to a series of difficult but otherwise politically feasible structural reforms in small states, argue that deeper and more politically sensitive and intrusive structural adjustments are now necessary. Only such measures will be able to ensure that investors will be willing to risk capital in such small highly vulnerable states. In the context of the Pacific, the Asian Development Bank (ADB) has argued that following structural adjustment programmes in Vanuatu and the Cook Islands, which addressed many of the problems of fiscal discipline but failed to attract foreign direct investment immediately, deeper structural reforms are needed. While no formal policy position has as yet emerged from the ADB, it is being increasingly argued in ADB publications and by ADB officials that land reforms and reforms of the labour market are now necessary conditions before investment will occur.

As desirable as land reform may be for the creation of a properly functioning market, in most Pacific island countries land is owned collectively by traditional land-owning groups. This issue is, without doubt, the most politically sensitive issue in the region. In the past, even relatively limited attempts at land registration have led to violence, as in the case of Papua New Guinea in 1996. *At this stage of the region's development, attempts by the international community to force in the Pacific islands land reform that will result in the creation of a market for land would run the very serious risk of politically destabilising the region.*

- ***Technical assistance for niche market development (ITC/UNCTAD)***
  One of the more important interventions of the international community has been to enhance the capacity of UNCTAD and ITC to assist LDCs, as well as small vulnerable states, to obtain international market intelligence directly through ITC facilities and training as well as new instruments such as Trade Point. Together these facilities are an important adjunct to the facilities that are available to LDCs and small vulnerable countries for finding and exploiting niche markets.

  The development of the market intelligence necessary for the development of niche markets extends beyond just the use of formal facilities. The experience of countries that have been successful in the development of this type of product shows that developing personal and business connections is crucial to the success of investment and the marketing effort. Thus facilities assuring that members of the business community are able to seek out connections in other countries would greatly facilitate the development of niche market activities.

- ***Market friendly investment preference facilities for the replacement of trade preference (IFC)***

  Trade preferences that developed with the GSP and regional trade preference arrangements, such as Sparteca, Lomé and CBI, were always meant to be 'investment preference' rather than 'trade preference', as it is known. It was the intention of the international community to provide a signal to both domestic and foreign investors that they would receive a subsidy through exemption from or lowering of duty rates on their exports to developed countries. This would be the case if they invested in export oriented industries in those developing or least developed countries that benefited from these schemes. A clear and at times distorting message was thus sent to investors that they would receive a *continual* flow of revenue through lowered tariffs if they continued to invest in and export from those countries that were beneficiaries of the trade preference regime. While trade preference regimes had enormously beneficial effects for small vulnerable states receiving benefits, they provided little incentive for firms to become more efficient, as they could rely upon the continual subsidy to maintain profits in the face of ongoing inefficiencies.

  Given that margins of trade preference are eroding, this instrument will, over time, decrease substantially in commercial value as an incentive to investors to locate facilities in developing countries. Then it may prove useful to consider engineering a financial instrument that is more market friendly than trade preference but achieves the same objective. One alternative modality for achieving this is through a direct *investment preference scheme*. The two components of such a scheme would provide:

  - low interest, long gestation loans; and
  - highly concessional risk capital funds.

  Both components could operate through the IFC. The facility would operate:

  - through IFC directly, for large projects;
  - through partner commercial banks, for smaller projects that could not be handled by IFC; and possibly
  - through NGOs, for a micro-project component.

Some of the problems associated with such a fund are dealt with in Annex 2.

- ***Recognition of the need to enhance Special and Differential Treatment for small vulnerable states (WTO)***

  The next section of this paper will argue that one of the key compo-

nents of a consistent package of policy instruments to assist small vulnerable states is the recognition at the WTO that their disadvantage is of such an order of magnitude as to place them on the same level as least developed countries. To recognise small vulnerable states in these terms would have two obvious benefits. It would enhance their ability to receive WTO-consistent trade preferences; and it would also allow access to key exemptions from WTO disciplines necessary to achieve export- oriented development, such as those found in the Agreement on Subsidies and Countervailing Measures (ASCM). The definitional issues of how to define a 'small vulnerable state' are also addressed below.

Conclusion

An appropriate policy mix to assist the development of small vulnerable states might well be provided by international community intervention. Such an intervention might focus upon feasible structural adjustment programmes, along with the provision of technical assistance in the development of niche markets, as well as market-friendly investment incentives to locate in small vulnerable economies. The current approach of the international community rests almost entirely upon the twin planks of technical assistance and structural adjustment. Until the international community recognises that this constitutes an inadequate response to the often substantial exogenous constraints faced by highly disadvantaged small states, the sole response to the failure of structural adjustment to attract investors will be to seek even deeper and potentially destabilising structural adjustment.

WTO Issues for small vulnerable states

Introduction

It was suggested above that one of the more important interventions of the international community to assist the development of small vulnerable states is to recognise their need for improved special and differential treatment. This is the issue that will be primarily addressed in this chapter. The Millennium Round issues will be addressed briefly at the end of the chapter.

The improvement of SDT for small vulnerable states immediately raises a host of important questions, which include:

- What real economic and political benefit for SVS is there in attempting to enhance SDT?

- Is it politically feasible to attempt to negotiate any heightened SDT?
- What is an appropriate definition of small vulnerable states that is likely to minimise political resistance to enhanced SDT?

The question of whether small vulnerable states are economically disadvantaged will not be discussed here. A substantial economic literature demonstrates that small states are highly vulnerable to external shocks. Moreover, this paper has already suggested that small vulnerable economies have a particularly difficult time adjusting to global change. What will be argued is that there exist particular SDT provisions for LDCs that would be useful in assisting SVS in their transition to a more open global economy.

It is important to begin by noting that the WTO already provides for SDT for small vulnerable states. As all such states are categorised as either developing or least developed, the existing WTO SDT provisions are applicable. However, it has been argued that SVS are particularly disadvantaged in their ability to adjust by virtue of the combination of circumstances they confront. This paper argues that enhanced SDT at the WTO is needed to assure that small states are represented and are able to participate effectively in the WTO process. The use of SDT provisions has been the subject of considerable debate among trade lawyers and economists, in particular whether trade preferences have been of any benefit to the LDCs and developing countries that have been beneficiaries of these schemes.

The issue of particular SDT provisions as discussed below relates to some, but by no means all, the numerous SDT provisions in the various Uruguay Round agreements. There is discussion of how SDT for SVS will deal mainly with the political marginalisation of these states inside the WTO. The question of how to provide such treatment to these states is considered and then three key components of SDT, relating to membership, accession and dispute settlement, are examined. Without reform in these areas small vulnerable states will remain politically handicapped and have only the most limited ability to participate in the WTO process.

Small vulnerable states must recognise that explicit recognition of their status at the WTO, in whatever form, is likely to meet with considerable political opposition inside the WTO. Some least developed countries would see any recognition of small vulnerable states in a category similar or identical to their own as a threat to the dwindling technical assistance budgets provided by developed countries. Some larger developing countries would see this as a threat to their own trade position and some of the large developed countries would see this as further erosion of the unity of the

multilateral system. Nevertheless, while there are substantial political costs, there are also substantial and possibly immediate economic benefits to small vulnerable states from pursuing this particular course of action.

Why enhance SDT treatment for small vulnerable states?

The principal reason for seeking enhanced SDT treatment for SVS is that this would help deal with both economic and political marginalisation. The analysis below sets out why enhanced SDT would be such an important benefit. Justification of the enhanced SDT treatment is predicated upon the assumption that SVS, however these are defined, achieve an SDT based upon equivalence to LDC status in all WTO agreements. This immediately raises the issue of definition and the politically perplexing and possibly fatal problem of those 'border cases' that will be included and excluded from the SDT provisions. Unless a politically feasible way is found to deal with the issue, then the arguments about the benefits and costs of SDT to developing and least developed countries will remain purely academic.

Special and differential treatment and economic marginalisation

SDT provisions of the WTO fall into two main categories. The first are those that allow departures from Article I provisions. This has come to include the GSP and the regional trade preference arrangements. The second includes particular SDT provisions available to developing and least developed countries in various Uruguay Round Agreements. The extension of LDC equivalent rights to SVS would strengthen existing trade preference regimes and, as we shall see, obviate the necessity for REPA arrangements in the Pacific and the Caribbean for virtually all countries. The extension of SDT provisions in several agreements will have enduring implications for SVS in the way in which they develop.

◆ *Trade preferences and SDT provisions*

The SDT provisions currently available in the WTO agreements are not viewed with great favour by some of the larger WTO members. These critics have consistently argued that SDT provisions are unnecessary and often unhelpful as they allow developing countries to avoid making the painful economic choices necessary in order to assure their competitiveness and their long term economic development (Goldin, Knudsen and Van der Mersbrugghe, 1993). Some academics and developed country WTO members have argued that some aspects of SDT, such as the GSP and the regional trade preference regimes, have been particularly unhelpful because they have facilitated the development and perpetuation of uncompetitive industries.

There is some disagreement among economists about whether trade pref-

erence regimes, as the most overt manifestation of SDT, have had a significant impact upon development. Nevertheless, there has been little doubt about the economic benefits of this instrument in the capitals of those small developing countries that have benefited from it. The reason for this view is that those societies where the preconditions for successful use of trade preference exist have been seen by policy-makers as exhibiting one of the few commercial advantages that SVS possess as a location for investment. Trade preference as an instrument of development has been successful in inducing export diversification in only a relatively small number of countries (McQueen and Stevens, 1989). Some but not all of these countries are small vulnerable states. Two countries that have made most active use of these preferences have been Fiji and Mauritius, which have developed similar economic structures. That the number of countries benefiting greatly from trade preferences has been limited does not imply that trade preferences themselves have been unimportant. It implies only that the incidence in any particular country of those combined economic conditions necessary for taking advantage of export diversification through trade preference is exceptional. To those countries where these conditions do exist, trade preference has been of enormous benefit in providing the subsidy to industrial transformation that is very often necessary to overcome the costs of beginning new export- oriented activities in small remote and highly vulnerable countries.[1]

The experience of the SVS that have succeeded in making extensive use of trade preference arrangements suggests that several conditions appear to be necessary for the satisfactory marriage of the conditions existing in a particular country and trade preference regimes. These include:

- an investment and macroeconomic climate that is conducive to and welcoming of investment, both domestic and foreign;
- factor markets, in the relevant factors, that can provide basic inputs at prices close to internationally competitive levels;

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[1]An analogy to bio-history may explain the apparent contradiction in the observation that the success of trade preference is limited but often overwhelming in the case of those countries where it has been successful. The eminent bio-historian Jarret Diamond has noted that throughout history human beings have been able to domesticate only a score of animal species. The marriage of qualities of a particular animal species with human needs and capabilities in animal domestication is well known. However, if one were, purely on the basis of the number of species domesticated as a proportion of the total number of animal species in existence, to reflect on the success or otherwise of human efforts at animal domestication, then one would have to conclude that animal domestication was statistically insignificant and a thoroughly unsuccessful experiment. Such a conclusion would be erroneous, as the relatively limited number of successful attempts at animal husbandry totally transformed human existence, much in the same way as trade preference did in the few cases where there was a coincidence of conditions needed to make trade preference successful.

- a natural resource supply where a substantial margin of preference relative to cost disadvantage exists.

If this list constitutes those qualities required for the successful exploitation of the opportunities created by trade preferences then it is not surprising that few developing and even fewer least developed countries have made use of them. One of the stylised facts about trade preference regimes has been that they have tended to benefit the more developed countries and not the least developed. This observation would appear to be consistent with what has been argued above, because only in those more developed countries where there are sufficiently developed factor markets, especially for skilled labour, management and entrepreneurship, does diversification into export sectors where significant margins of trade preference are available occur. The least developed, unless they have an abundant supply of natural resources, are not likely to be beneficiaries of this trade instrument.

This raises a logical question: if LDCs have tended not to take advantage of such trade preferences because they lack the economic preconditions, why preserve this trade instrument for a group of countries that are unlikely to make immediate use of it? The reason is that even though trade liberalisation is diminishing, the commercial value of trade preference margins remains significant and will continue to be commercially significant in the foreseeable future. Thus as these LDCs and SVS develop and emerge, this instrument will become more significant in stimulating export oriented development.

The reason further highlights the definitional problem. The fact that the more advanced of the SVS and other developing countries have made extensive use of this instrument highlights the need to preserve it for a wider group of WTO members by ring-fencing that group of countries that find this instrument useful for the purposes of trade diversification. Thus a new, more inclusive definition of highly disadvantaged WTO members, one that includes the LDCs as well as the SVS, would serve to provide a basis for alleviating economic marginalisation of this group in future.

One of the most obvious and valuable benefits of extending to the SVS the existing SDT treatment available to LDCs would be that the European system of trade preference under the Lomé Convention, which has been amongst the most important to developing countries, would be available to small states without reciprocity. Hence regional free trade areas would not be necessary for the countries of the Pacific and the Caribbean.

◆ ***Uruguay Round Agreements and SDT***

The facilitation of trade preferences cannot in itself constitute an adequate justification for the very great expenditure of political capital that would be necessary to make a fundamental change in WTO rules by recognising yet another group of disadvantaged states. There is a secondary and more enduring reason why the SVS should pursue an enhancement of their existing SDT rights at the WTO and why it would be of particular economic benefit to these states. The provisions of several crucial agreements, the most important of which is the Agreement on Subsidies and Countervailing Measures (ASCM), contain measures that exempt least developed countries from key disciplines. Under the terms of Annex VII of the ASCM, LDCs and countries with a GNP/capita less than US$1,000 are exempted from the export subsidy prohibitions of the ASCM. Export subsidies are frequently necessary in developing new export industries and the extension of the exemption for the LDCs to small vulnerable states would be of enduring economic benefit.

Several WTO agreements recognise small producers and small countries, explicitly or implicitly. One that is of particular importance and reflects how SDT provisions can be of direct economic benefit to SVS is the Agreement on the Implementation of Article VI (Anti-dumping). This agreement provides for important *de minimis* provisions that specifically benefit small suppliers and small countries. The *de minimis* volume provisions of the anti-dumping code are not based on LDC status. They are nonetheless a most important demonstration of the potential for using special provisions benefiting small states and small producers as a logical basis for extension to other agreements. Under the provisions, individual firms with less than 3 per cent of market share, or firms that have collectively less than 7 per cent (Article 5.8), are considered below the threshold where anti-dumping action can be taken. This is one of the areas where there exists an explicit recognition of smallness. *The resulting benefit is the insulation from the (often devastating) effects of the application of an instrument of protectionist trade policy, a strategy most frequently used by large developed countries.*

Special and differential treatment and political marginalisation

A powerful reason for extending SDT to the SVS lies in strengthening the political authority of the multilateral trading system. Many large WTO members do not accept SDT and argue that the interests of all WTO members are best served when the full disciplines of the WTO are applied to all members equally. The fundamental presupposition of a multilateral trading system is the equality of nations and, by extension, the treatment of their exports. This is a basic principle of International Public Law. While the principle of complete equality of treatment may be debat-

able when it relates to the export of goods and services, it appears fundamentally flawed when one views it from the perspective of very small vulnerable states attempting to negotiate with large powerful WTO members. *In situations like this, it will be argued, where very large and very small WTO members are forced to negotiate, the inequality between nations is obvious. In fact it is so glaring that maintaining the political and legal fiction of equality implicit in WTO practice serves only to bring the multilateral trading system into disrepute.*

The multilateral trading system will not be served by assuming that large and small nations are equal in terms of their capacity to trade or to adapt to global change; and most particularly not in their ability to interact with other members inside the WTO. It is best served by a system that accepts that there are small vulnerable states requiring assistance similar in kind to that accorded the least developed. They need special treatment as a transitional arrangement until they are able to graduate to a level of development where that assistance is no longer necessary. It is thus in the interests of developed countries to pursue the strengthening of SDT provisions for small vulnerable states: these constitute a means of strengthening the multilateral trading system by demonstrating its flexibility in dealing with those less capable of adapting to global change. What follows deals with the issue of SDT treatment in the interaction with and participation in the WTO process and does not address specific SDT provisions with regard to particular trading arrangements.

A new round of multilateral trade negotiations is set to begin in the final quarter of December 1999. The commencement of these talks brings to mind several important areas where small and highly vulnerable states may be able to have an impact upon the negotiations, to ensure that their interests are in fact protected. The issues discussed relate only to the concerns of small vulnerable states, as they face particular difficulties simply by virtue of their size.

◆ ***Membership fees and WTO participation***

Perhaps no issue more than the question of the membership fees into the WTO so clearly depicts the gap in the perception and understanding of the depth of the problems and constraints of small and vulnerable states (see Annex 1). At present a new member, upon joining the WTO, must pay a minimum (based on a minimum of 0.03 per cent of WTO member trade) of CHF38,000 per annum in 1999 plus an equivalent amount, on a one-off basis, into the WTO capital fund. This appears a small amount to pay for the benefits of the multilateral trading system. However, for the smallest developing country acceding to the WTO, which is currently Seychelles with a population of 74,000, the fee per capita would be

CHF0.50. If this were the per capita fee paid by US citizens, it would obviate the necessity for collecting membership fees from any other WTO member, as the budget would be fully paid. In the case of Seychelles, which has a relatively high GNP/capita, this may not prove problematic, but in the Pacific, where three small island countries (Tonga, Samoa and Solomon Islands) are in the process of accession, the removal of the existing floor on membership fees (0.03 per cent of world trade) or its decrease to UN General Assembly equivalent levels (0.003 per cent of world trade)[1] would constitute a saving of approximately CHF165,000 for the five countries involved (Solomon Islands and Fiji are members of the WTO). This would be sufficient to pay the salary of a joint Pacific islands delegate to the WTO. For example, no Pacific island country has representation in Geneva. The existing WTO membership fee floor is not only regressive and a burden upon small states, it acts as a further barrier to their membership. It should also be kept in mind that the WTO until very recently prohibited members who were in arrears from receiving particular forms of technical assistance. Hence the floor constituted a double penalty for small states, which are frequently those in greatest need of such technical assistance.

It is worth comparing the fiscal burden of WTO membership fees on large and small developing countries. In 1999 India will pay approximately CHF923,000 to be a member of the WTO. This constitutes an impost of CHF0.001 per capita. Tonga, which, like India is also a developing country, is seeking membership. If its accession is complete in 1999 it will pay CHF38,000 to be a member, an impost of approximately CHF0.38, or 380 times more than India.

In the case of small and highly vulnerable countries such as those found in the Pacific, Caribbean and Indian Oceans, development of a mechanism by which *collective representation can be regularised is required.* This would facilitate SVS participation in the WTO. The problem is not entirely the making of the WTO; it is in part a result of the unwillingness of small states to co-operate at such a level. In theory, co-operation is possible. However, *regional organisations, such as the South Pacific Forum, are in effect prohibited by larger WTO members from having even observer status at the WTO's General Council.*

◆ ***Accession process***

Under the terms of WTO Article XII, 'negotiations' on the terms of accession by an applicant and existing WTO members are supposed to

[1]In the UN General Assembly, the floor on membership fees is based on 0.003 per cent of total UN member GDP.

occur. It is not widely understood by those who are not involved in accession that those countries seeking to accede to the WTO have no WTO rights and must negotiate the terms of their accession on a case-by-case basis. The members of the Working Party formed by the WTO to consider an applicant may demand in terms of trade concessions whatever the bargaining power of the parties permits. Given that an applicant has no rights and there are no rules, as WTO law does not extend to non-members, then what follows is a negotiation between what is often a very small state and existing WTO members. Thus on one side of the table will be the applicant, for example Seychelles, Vanuatu, Tonga, which is expected to bargain with the WTO members, which always include the *triad* – USA, EU and Japan – and whichever other WTO members have trading interests. It is difficult to define this unequal process between such small applicants and the world's most powerful trading nations as negotiations, a fact that has to be recognised by WTO members in order to accelerate the reform of accession.

Two factors greatly complicate the accession process. The first is that two very large and important trading countries, China and Russia, are now seeking accession to the WTO. As the process is highly legalistic and the only real guide is the precedent established by previous negotiations, the larger WTO members are quite explicit that they will not grant even SDT rights to LDCs because this may create a precedent for negotiations with China and Russia. This explicit recognition of precedent extends beyond the *triad* to Cairns Group members, which have stated in press releases that they will not allow accession of any country that uses export subsidies, especially in agricultural trade. The second factor that complicates the accession 'negotiations' is that as negotiations approach a new round, existing WTO members demand ever higher standards as heightened disciplines are expected from the new round.

The difficulty in dealing with accession is that countries and customs territories that are already members of the WTO, even developing and least developed members, are unwilling to expend political capital devising new rules to assist those who are not members and therefore cannot benefit their trade interests. At the 1997 WTO Ministerial Conference, the Solomon Island Minister of Commerce and Trade recommended a resolution to this problem that would see the accession process divided between the accession of LDCs and others. He recommended that *all SDT rights of LDC WTO members be extended automatically and without negotiation to all LDCs* in the process of accession. This would in effect differentiate the accession process of LDCs and others.

In terms of small states what is needed is recognition that no negotiation

between a small highly vulnerable economy and existing large WTO members is possible and that differentiation should not just be on the basis of LDC SDT provisions. Rather, when WTO membership is sought by a country that is an LDC or has a trade volume at the floor level recognised by the WTO Finance Committee (currently 0.03 per cent of WTO member trade), either a *committee of experts or the Accessions Division itself should, in consultation with the applicant, examine the trade regime of the applicant. If necessary, this body could recommend changes in that regime that are consistent with the applicant's development status and existing WTO rules.* Moreover, bilateral negotiations over tariff *bindings should be limited only to those commodities in which a demandeur has the right to initial negotiating rights by virtue of being a principal supplier* as defined by the WTO. Such a process would greatly accelerate the accession of LDCs and small vulnerable states.

◆ ***The Dispute Settlement Mechanism***

The single most important development of the Uruguay Round was the creation of the strengthened DSM. This, possibly even more than the liberalisation process itself, has reshaped the thinking of all WTO members. In many ways the experience of the DSM has demonstrated that smaller WTO members, such as Guatemala, have been able to mount successful challenges against the very largest WTO members such as the USA and the EU. This in itself is viewed as clear proof of the success of the DSM, a convincing demonstration that the rule of law can be exercised between small and large nations equally. The Guatemalan experience is in a sense unique and the DSM remains very much an instrument of trade policy of those larger WTO members better able to afford and make use of it. The fact remains that no least developed country[1] has ever in the history of the GATT or the WTO brought a dispute to the DSM. There would appear to be at least three reasons for this:

- LDC and small and highly vulnerable country trade is such a small proportion of global trade that it is statistically less probable that a dispute with other WTO members would occur. The fact that no current LDC has been involved in a dispute as either litigant or defendant suggests that this is an important consideration;
- The legal costs of a dispute are substantial: the figures frequently used at the WTO vary from US$1.5–6 million for legal costs, plus the costs of travel and time of government officials. For small states the DSM would clearly be financially inaccessible. The WTO does provide technical assistance to LDCs but it is in the form of advice from one

[1]By LDC is meant any country that is on the current ECOSOC list of LDCs.

of the WTO experts. While these experts are very valuable, the assistance provided does not extend to paying the costs of legal advice. The establishment of a legal aid trust fund at the discretion of the Director General of the WTO for use in assisting LDCs and small highly vulnerable states in the event of a dispute would increase the capacity of those states to use the DSM to advance their trade interests;

- WTO disputes rarely result in retaliation, which only occurs in the event that one party refuses to bring its trade regime into conformity with its WTO obligations. However, such an outcome in the event of a dispute between a complainant small state and a large developed WTO member renders the DSM ineffective for the purposes of resolving disputes between the smallest and larger WTO members. Retaliation, irrespective of the circumstances, is widely recognised as bad economics, as those who suffer by it are the citizens of the retaliating WTO member. It is clear that the international community is unwilling to abandon retaliation and move completely to the rule of law under a system of binding arbitration based on financial compensation. One solution to the dilemma faced by SVS would be to move away from the concept of retaliation in the event of a dispute between an LDC or small highly vulnerable state and a developed country WTO member. In such a case the transgressor would agree to binding arbitration to determine financial compensation and the complainant would waive the right of retaliation.

The WTO and the political economy of SDT

Assuming that the global community accepts the proposition that the small vulnerable states require some form of special treatment to assist them in their participation in the global trading system, the normal modality employed in the past has been the concept of SDT. The WTO only formally accepts the group of least developed countries in terms of offering special treatment. The WTO accepts the UN list of LDCs as defined by ECOSOC for the purpose of application of SDT provisions. Diminished SDT provisions for developing countries are also in existence. However, that category exists by self-election in the WTO. For example, until very recently countries such as Singapore, Israel and even South Korea, which has recently joined the OECD, have chosen to define themselves as developing countries. This failure of the WTO to define developing countries in an unambiguous manner has further served to erode confidence in the principle of SDT.

Most small and highly vulnerable states that are members of the WTO already enjoy SDT by virtue of their developing country or least devel-

oped country status. However, most small and highly vulnerable economies are not defined as LDCs by ECOSOC even though their size, vulnerability and economic adjustment problems suggest that they confront problems greater than other countries of a similar development status. *In terms of SDT provisions of the WTO agreements, the optimal negotiating outcome for small vulnerable states is recognition that their smallness and vulnerability make them special, putting them in a category similar to LDCs. However, even if the SVS seek formal recognition only for the purposes of membership fees, accession or modified DSM rules, rather than SDT-equivalence to LDCs, then there will still be a need for a clear and unambiguous definition of small vulnerable states.*

There are a number of alternative strategies for increasing the special and differential treatment of small vulnerable economies. There is also the possibility of accepting existing WTO definitions as a basis for small states differentiation. These include:

- ***Introducing the concept of 'small, highly vulnerable states'***
  There are essentially two ways of trying to introduce this category into the WTO as a basis for SDT privileges:
  - *Via ECOSOC*. It may be politically feasible to have the definition of LDC so amended by the use of the vulnerability index and other measures that many, if not all, small vulnerable states will be defined as LDCs. This would present the WTO with a *fait accompli* as it has always accepted the ECOSOC definition of LDC. The question arises whether small states are willing and able to employ at the UN the political capital necessary to achieve this objective. Countries can reasonably expect political resistance at the UN from both larger developed countries and those at the margin that might be excluded. However, resistance at the UN may be less than at the WTO.
  - *Via WTO directly*. There are two ways of achieving this goal directly – either by creating a separate category of small vulnerable states or by seeking treatment on a par with LDCs.
  - The first of these would mean *establishing a separate category of 'small and highly vulnerable states'* and then establishing a separate, i.e. third, type of SDT treatment. This tactic has only the remotest chance of success and should not be pursued as it will not be supported by other larger, developing countries in the WTO.
  - The second, slightly more politically feasible, option is to seek to have *all 'small highly vulnerable states' treated the same as LDCs*. While this is more feasible than developing a third category, it must be recalled that the WTO system is based on consensus. It is a polit-

ically difficult forum for what would be a divisive issue. Given that larger developing countries such as Brazil have traditionally been hostile to the introduction of new graduation concepts they, along with other large developing countries, are likely to oppose such an expedient.

- ***Acceptance of current status, i.e. LDCs and developing countries*** Given the high political costs of developing new groups of disadvantaged WTO members, small vulnerable states may wish to avoid trying to introduce a new category or even a sub-category of 'small vulnerable states' at the WTO. SVS that are members of the WTO may wish to work together with developing and least developed partners and use the Millennium Round to try to improve the SDT rights for all developing and least developed countries.

  The cost of taking this position is that there would then be no recognition of the particular problems of small vulnerable states.

- ***The WTO trade floor of 0.03 per cent of WTO member trade used by the Finance Committee of the WTO*** constitutes an already accepted, if only implicit, definition of 'small' and this could be used as a basis for defining small for other purposes in the WTO. As this is already a politically accepted definition it will be explored below.

It remains a matter of political calculus whether the SVS consider that the expenditure of political capital on obtaining acceptance of the category is justified. If this is seen as politically worthwhile, the least cost strategy for enhancing SDT treatment for small highly vulnerable states may be in altering the ECOSOC definition of LDCs by the use of the vulnerability index. However, during a new round of multilateral negotiations, the direct route through the WTO may also be feasible. Given the system of consensus that has emerged at WTO it would be difficult, though not necessarily impossible, to introduce SDT treatment for small vulnerable WTO members directly.

'Border' issues and the definition of 'small vulnerable states'

If small vulnerable states chose a path involving an acceptance of the existing WTO development status taxonomy for SDT purposes, i.e. LDC, developing and developed, then they will have to develop an appropriate and politically acceptable definition if they wish to have any acceptance of their status. *It is perhaps worth beginning by saying that there exists no unambiguous or politically simple choice of definition – each will involve difficult decisions and choices.* The fact that the WTO system is now based upon consensus makes it difficult to see how any definition will be

acceptable to all members of the WTO. The more inclusive the definition of relatively high-income small vulnerable states, the more opposition there will be from large but relatively low-income developing WTO members. The more it excludes these high-income border cases or outliers, the more they will object to the definition. *The question of definition is the rock upon which the whole issue of SDT provisions or even the recognition of small vulnerable states may founder.*

Demographic definitions

Since the 1960s the most common definition of 'small' employed by the international community has been based upon population. The modal definition has been based upon the threshold of a population of one million. This, however, was increased by the Comsec (Commonwealth Secretariat, 1997) to 1.5 million, largely because of population increase in those small countries. The Comsec definition also includes countries such as Jamaica and Papua New Guinea, which have populations well in excess of this threshold but have other characteristics similar to small countries. Some definitions based purely upon demographic considerations, such as those employed by academics, argue that the definition of small should be 3 million, without further justification than is presented by those employing 1.5 million. Such definitions are of little use for the purpose of achieving SDT for small states at the WTO, because such purely demographic definitions will throw up anomalies of high-income countries that would be completely unacceptable to most WTO members.

A definition of 'small' based purely upon demographic measures is likely to be subject to the fatal flaw of not relating smallness to any economic variable. The key to *a politically acceptable definition* of smallness at the WTO must lie in *simplicity* while simultaneously assuring that it does not result in *anomalies* like those that allow WTO members such as Lichtenstein, Luxembourg or Singapore to be in a position to receive SDT equivalent to LDCs. Since such an outcome would, quite understandably, not be acceptable to most WTO members, demographic solutions to the definitional issues should not be sought by small vulnerable states in the WTO context. This is not to suggest that demographic solutions are not useful in other contexts but certainly not in the context of the WTO. An *economic definition, not a demographic one, is needed* because the problem of adjustment of small vulnerable states to a liberalised economic environment is essentially an economic problem.

The vulnerability index

One possible economic foundation for dealing with the question of smallness is through the vulnerability index. In the final analysis what type of

vulnerability index is used will also be a political issue. An enormous amount of research has been undertaken on the vulnerability index by academics (Briguglio, 1995, 1997; Chander, 1996), the Commonwealth Secretariat (Commonwealth Secretariat, 1997, 1998a; Wells, 1997) and UNCTAD (Atkins and Mazzi, 1998; Weston, 1994). While the vulnerability index is extremely useful as a tool, it is predicated upon macroeconomic aggregates and hence very often fails to come to terms with the existing microeconomic problems of enterprises operating within the context of small vulnerable states. The use of the vulnerability index by ECOSOC as a tool to define 'least developed' in a rigorous manner may help in the recognition that some small states do in fact suffer from economic constraints not evident through more conventional but less sophisticated macroeconomic aggregates such as GDP per capita. However, within the context of the WTO, the vulnerability index also creates anomalies that would be unacceptable to WTO members, such as the fact that Singapore is the tenth most vulnerable country in the composite vulnerability index.

The justifiable reply of economists who work with this index is that the vulnerability index measures, as the name implies, vulnerability to external shocks and changes. It is not meant to be a proxy for either poverty or disadvantage per se. Nevertheless, it is precisely the case of countries such as Singapore that WTO members would point to as the sort of anomaly that would make the vulnerability index unacceptable as a sole basis for a definition. This is not to suggest that the vulnerability index is flawed. The problem is, rather, that it will not act as a proxy for the phenomenon that WTO members would look for, i.e. a list of countries that are not least developed but are nonetheless handicapped in terms of their ability to adapt to a liberalised global environment.

Share of world trade

The WTO already implicitly recognises small states. Several definitions and applications of SDT imply recognition of small producers. This is true in the *de minimis* provisions of Article 5.8 of the Agreement on the Implementation of Article VI (Anti-dumping Code). In other agreements, such as the Agreement on Textiles and Clothing, there are provisions for SDT, not only for LDCs but also for small suppliers (Article 6.b), which do not differentiate between the SDT treatment that is to be afforded to an LDC and that afforded a small supplier. In short, the concept of small producers and suppliers is by no means without precedent at the GATT and the WTO.

The WTO has an implicit and accepted definition of a small member used by the Finance Committee, which sets the budgetary contributions

of members. All members pay according to their share of world trade,[1] but those small states whose share of world trade is less than the threshold of 0.03 *per cent of world trade* pay a floor contribution. Thus small least developed countries will pay a disproportionately high share of the budget in comparison to large developed countries.

The positive side of this definition is that virtually all the Commonwealth states defined as small are included except Papua New Guinea in the Pacific, Jamaica in the Caribbean, Mauritius in the Indian Ocean and Botswana in Africa. High-income countries such as Brunei, Cyprus and Malta would also be excluded. The 0.03 per cent threshold has only one anomaly and that is Liechtenstein. In order to eliminate such anomalies there must be *double criteria* and only small vulnerable *developing countries* should be included.

This second criterion, i.e. developing country, would only be of use in excluding the one anomaly that exists in the current implicit definition of small, which is set at 0.03 per cent of WTO trade. As we shall see, an attempt by the SVS to modify this definition by raising the threshold to include the 'border cases' of Papua New Guinea, Mauritius and Jamaica would create anomalies. Such anomalies would include countries that, using the self-election principle to define themselves as developing, for example Brunei, will then have access to the SDT rights of LDCs. This would probably be unacceptable to WTO members.

What would be the net economic impact of extending the LDC SDT privileges using the 0.03 per cent of world trade threshold? The 45 WTO members that are implicitly defined as 'small' are responsible for only 0.481 per cent of world trade. Twenty-six of these WTO members are LDCs and are together responsible for 0.25 per cent of world trade. Thus the net increase in world trade that would be subject to LDC SDT provisions if this proposal were accepted by the WTO would be 0.23 per cent of world trade. At present, agriculture and textiles, which still remain outside strict WTO disciplines and benefit large developed countries, constitute 12 per cent and 7 per cent of world trade respectively. Some large developing countries would raise the counter-argument that although this is a small proportion of world trade in those sensitive sectors where there are tariff peaks, for example clothing and footwear, the impact of the extension of LDC SDT rights would still be significant and would erode their relative market position.

As an illustration of the type of problem that would be created by raising

[1]The definition of trade used by the WTO is the total of imports and exports of goods and services as provided by the IMF.

the threshold, it is worth considering the case for raising the threshold to, say, 0.05 per cent of world trade. In this situation all the Commonwealth small states would be included but the number of 'anomalies' would also increase. High-income countries such as Brunei, Iceland and Malta would be eligible for LDC status. As Malta is seeking EU membership, clearly a definition granting them LDC status would not be appropriate. In fact this reflects the dilemma of any such definition. The more restrictive the definition the fewer the anomalies that are created but the less inclusive it is of 'deserving cases'. It is precisely these border cases that pose the principal problem for finding a simple definition for small vulnerable economies. If a restrictive definition is employed, countries like Jamaica, Mauritius and Papua New Guinea would be excluded. They are therefore unlikely to support such a definition.

In the event that a trade-based criterion for defining small states at the WTO is accepted, then some consideration of the conditions of graduation is necessary. If a country's exports rise above the threshold for a five-year period, then graduation should occur. Such a period is necessary to avoid the possibility that commodity price fluctuations cause a short-term rise in the share of world trade.

Self-election

A further option worthy of consideration is that of allowing members to define themselves as 'small vulnerable states'. However, if the definition is to be associated with enhanced SDT provisions, equivalent to LDC status, then this would be acceptable neither to the LDCs nor to the large developed WTO members as it would clearly undermine the multilateral trading system and the technical assistance that LDCs currently obtain. If it were to be associated with SDT provisions of developing countries it would be of no economic benefit as all SVS receive LDC or developing country SDT provisions under the WTO agreements. Moreover self-election, which is the basis for defining developing countries, is arguably one of the significant weaknesses of the system of SDT as it creates anomalies such as have been discussed above. Such an approach seems of limited value.

In the final analysis the choice of definition of small vulnerable states is a political matter. Simple economic definitions that exclude high-income anomalies are the ones most likely to meet with success. However, it should be recalled that even if an inclusive but simple definition were to be found for small vulnerable states, there will be border cases and there will almost certainly be political resistance from those larger developing and least developed countries that will consider themselves disadvantaged by such arrangements.

Millennium Round issues

By the final quarter of 1999 a new round of multilateral trade negotiations may be launched. The agenda for the Denver Ministerial Conference of the WTO, which is likely to start the round, is unknown at the time of writing and there is as yet no agreement among WTO members on the subject matter of the negotiations. Built-in agenda issues are discussed below as there is no consensus on the so-called 'new issues' and WTO members will almost certainly start negotiations on the built-in agenda although there is every chance that they may leave the contentious 'new issues' for subsequent negotiations.

Technique of negotiations

- At the 1996 Geneva Ministerial Conference President Clinton suggested a new type of shortened negotiations, which has been called the 'round-up' (Schott Proposal), where areas of agreement are found and smaller quicker rounds are negotiated.
- *The 'round-up' proposal runs the risk of marginalising the developing countries even further.* In the Uruguay Round, the ability to extract concessions from developed countries in key areas such as textiles ultimately rested upon the ability to halt progress in the negotiations until such time as there was complete agreement on the entire agenda.
- It is possible that given the highly contentious trade issues that may appear on the agenda, for example trade, environment and labour standards, there will develop a series of plurilateral rather than multilateral agreements. In the Tokyo Round several plurilateral agreements were signed, such as the Agreement on Customs Valuation and the Tokyo Round Subsidies Code. These became multilateral agreements during the Uruguay Round. *Plurilateral agreements should be avoided* by developing and small highly vulnerable states as they will also diminish their bargaining power and undermine the multilateral trading system.
- The series of service sector agreements on information technology, stand-still on e-commerce and telecommunications have been plurilateral in nature. However, if, in the rush to see quick results, this plurilateral approach should be extended to trade in goods with the introduction of the APEC EVSL issues at the WTO negotiations, the ability of small vulnerable states to negotiate would be even further weakened.

Built-in agenda

- An increasingly common position of developing countries is that the negotiating mandate for the new round should be based upon the so-

called 'Uruguay Round' built-in agenda and should not extend to the 'new issues'. Some larger developing countries argue that until they actually see the putative benefits of Uruguay Round liberalisation in agriculture and textiles, there should be no new disciplines negotiated.

- The main issue small vulnerable states will have to confront is that of further *agricultural sector liberalisation*. However, small states are divided between:

  - those that benefit from the EU's Common Agricultural Policy (CAP) by virtue of their assured access to key markets through the tariff quotas provided under the commodity protocols of the Lomé Convention; and

  - those that are beneficiaries of neither tariff quotas with CAP prices nor US preferential sugar quotas. For these countries the phasing out of agricultural subsidies is seen as beneficial as it will raise world prices. For example in the Pacific Fiji, which exports sugar to the EU and the USA under preferential agreements, benefits from the high internal prices but the rest of the Pacific islands, which export copra and coconut oil, suffer from low world prices because of subsidies by large WTO members.

  Small vulnerable states would be wise to recognise that the numerous pressures for further agricultural liberalisation are of such an order of magnitude that they would appear to be inevitable. The best negotiating option is to seek financial assistance. This assistance for transition away from dependence upon these products could be provided multilaterally through the IMF/World Bank or through the EU in the post-Lomé arrangements. Such a negotiating position is more realistic than expending scarce political capital on attempting to support an agricultural system that, irrespective of its present benefits to some SVS, is unlikely to survive the next decade.

- *Service sector negotiations* are also mandated for the new round. In previous rounds the OECD countries have pushed for the liberalisation of trade rules on the trade in goods, services, disciplines in intellectual property and now in investment. The only sector where the OECD countries have consistently pushed for market tightening is in the 'grey' and 'black' market movement of natural persons. Only the movement of skilled managers and experts through corporations is slated for further liberalisation. Given *that many small vulnerable states are substantial net exporters of unskilled and semi-skilled labour* by virtue of their own exogenous economic handicaps, expanded disciplines and liberalised market access in this area of movement of natural

persons is in the interests of small states. One way of achieving this is through seeking developed country service *sector quota bindings on rights of temporary sojourn of unattached service providers*. This could be achieved by a guarantee from WTO members of market access for a fixed number of semi-skilled and skilled workers, who would have fixed-term work permits, i.e. it would be a scheme for guest workers. However, the political constraints to such liberalisation are well understood.

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Annex 1. Share of world trade and financial contribution of WTO members

Table 1. Comparison of WTO Members Assessed at Minimum (0.03 per cent) in 1998 with their Real Share in Trade of all WTO Members and Equivalent Hypothetical Contribution (*LDC members are shown in italics*)

WTO member	Minimum 0.03%		Real share		Difference	
	%	CHF	%	CHF	%	CHF
Antigua and Barbuda	0.03	34,320	0.008	9,152	(0.022)	(25,168)
Barbados	0.03	34,320	0.018	20,592	(0.012)	(13,728)
Belize	0.03	34,320	0.006	8,864	(0.024)	(27,456)
Benin	0.03	34,320	0.010	11,440	(0.020)	(22,880)
Bolivia	0.03	34,320	0.025	28,600	(0.005)	(5,720)
Burkina Faso	*0.03*	*34,320*	*0.008*	*9,152*	*(0.022)*	*(25,168)*
Burundi	*0.03*	*34,320*	*0.003*	*3,432*	*(0.027)*	*(30,888)*
Central African Rep.	*0.03*	*34,320*	*0.004*	*4,576*	*(0.026)*	*(29,744)*
Chad	*0.03*	*34,320*	*0.006*	*6,864*	*(0.024)*	*(27,456)*
Congo	*0.03*	*34,320*	*0.029*	*33,176*	*(0.001)*	*(1,144)*
Djibouti	*0.03*	*34,320*	*0.004*	*4,576*	*(0.026)*	*(29,744)*
Dominica	0.03	34,320	0.002	2,288	(0.028)	(32,032)
Fiji	0.03	34,320	0.022	25,168	(0.008)	(9,152)
Gambia	*0.03*	*34,320*	*0.004*	*4,576*	*(0.026)*	*(29,744)*
Grenada	0.03	34,320	0.003	3,432	(0.027)	(30,888)
Guinea	*0.03*	*34,320*	*0.014*	*16,016*	*(0.016)*	*(18,304)*
Guinea-Bissau	*0.03*	*34,320*	*0.001*	*1,144*	*(0.029)*	*(33,176)*
Guyana	0.03	34,320	0.012	13,728	(0.018)	(20,592)
Haiti	*0.03*	*34,320*	*0.005*	*5,720*	*(0.025)*	*(28,600)*
Honduras	0.03	34,320	0.029	33,176	(0.001)	(1,144)
Lesotho	*0.03*	*34,320*	*0.010*	*11,440*	*(0.020)*	*(22,880)*
Liechtenstein	0.03	34,320	0.009	10,296	(0.021)	(24,024)
Madagascar	*0.03*	*34,320*	*0.014*	*16,016*	*(0.016)*	*(18,304)*
Malawi	*0.03*	*34,320*	*0.011*	*12,584*	*(0.019)*	*(21,736)*
Maldives	*0.03*	*34,320*	*0.004*	*4,576*	*(0.026)*	*(29,744)*
Mali	*0.03*	*34,320*	*0.011*	*12,584*	*(0.019)*	*(21,736)*
Mauritania	*0.03*	*34,320*	*0.009*	*10,296*	*(0.021)*	*(24,024)*
Mongolia	0.03	34,320	0.009	10,296	(0.021)	(24,024)
Mozambique	*0.03*	*34,320*	*0.013*	*14,872*	*(0.017)*	*(19,448)*
Myanmar, Union of	*0.03*	*34,320*	*0.009*	*10,296*	*(0.021)*	*(24,024)*
Nicaragua	0.03	34,320	0.013	14,872	(0.017)	(19,448)
Niger	*0.03*	*34,320*	*0.007*	*8,008*	*(0.023)*	*(26,312)*
Rwanda	*0.03*	*34,320*	*0.004*	*4,576*	*(0.026)*	*(29,744)*

Table 1 (continued)

WTO member	Minimum 0.03%		Real share		Difference	
	%	CHF	%	CHF	%	CHF
St. Kitts and Nevis	0.03	34,320	0.002	2,288	(0.028)	(32,032)
St. Lucia	0.03	34,320	0.007	8,008	(0.023)	(26,312)
St. Vincent and the Grenadines	0.03	34,320	0.003	3,432	(0.027)	(30,888)
Senegal	0.03	34,320	0.025	28,600	(0.005)	(5,720)
Sierra Leone	*0.03*	*34,320*	*0.004*	*4,576*	*(0.026)*	*(29,744)*
SolomonIslands	*0.03*	*34,320*	*0.002*	*2,288*	*(0.028)*	*(32,032)*
Suriname	0.03	34,320	0.007	8,008	(0.023)	(26,312)
Swaziland	0.03	34,320	0.017	19,448	(0.013)	(14,872)
Tanzania	*0.03*	*34,320*	*0.028*	*32,032*	*(0.002)*	*(2,288)*
Togo	*0.03*	*34,320*	*0.009*	*10,296*	*(0.021)*	*(24,024)*
Uganda	*0.03*	*34,320*	*0.015*	*17,160*	*(0.015)*	*(17,160)*
Zambia	*0.03*	*34,320*	*0.026*	*29,744*	*(0.004)*	*(4,576)*
Total	1.35	1,544,400	0.481	550,264	(0.869)	(994,136)

Table 2. Draft Scale of Contributions for 1999
(Minimum contribution of 0.03 per cent)

Members	1998 contribution CHF	1999 contribution %	1999 contribution CHF	Interest earned[1] CHF	1999 Net contribution CHF
Angola	80,080	0.06	75,876		75,876
Antigua and Barbuda	34,320	0.03	37,938		37,938
Argentina	537,680	0.48	607,008	(1,810)	605,198
Australia	1,567,280	1.35	1,707,210	(11,640)	1,695,570
Austria	1,990,560	1.57	1,985,422	(13,613)	1,971,809
Bahrain	102,960	0.08	101,168	(750)	100,418
Bangladesh	102,960	0.09	113,814		113,814
Barbados	34,320	0.03	37,938	(182)	37,756
Belgium	3,695,120	2.92	3,692,632	(21,598)	3,671,034
Belize	34,320	0.03	37,938	(1)	37,937
Benin	34,320	0.03	37,938	(127)	37,811
Bolivia	34,320	0.03	37,938		37,938
Botswana	45,760	0.04	50,584	(212)	50,372
Brazil	1,052,480	0.83	1,049,618	(2,548)	1,047,070
Brunei Darussalam	45,760	0.04	50,584	(66)	50,518
Bulgaria	125,840	0.11	139,106	(8)	139,098
Burkina Faso	34,320	0.03	37,938		37,938
Burundi	34,320	0.03	37,938		37,938
Cameroon	45,760	0.03	37,938		37,938
Canada	4,404,400	3.91	4,944,586	(33,861)	4,910,725
Central African Rep.	34,320	0.03	37,938		37,938
Chad	34,320	0.03	37,938		37,938
Chile	331,760	0.34	429,964	(645)	429,319
Colombia	286,000	0.25	316,150	(1,002)	315,148
Congo	34,320	0.03	37,938		37,938
Costa Rica	80,080	0.06	75,876		75,876
Côte d'Ivoire	80,080	0.07	88,522	(98)	88,424
Cuba	45,760	0.05	63,230	(229)	63,001
Cyprus	80,080	0.06	75,876	(548)	75,328
Czech Republic	583,440	0.48	607,008	(3,218)	603,790
Congo, Dem. Rep. of	45,760	0.04	50,584		50,584
Denmark	1,258,400	1.00	1,264,600	(9,674)	1,254,926
Djibouti	34,320	0.03	37,938		37,938
Dominica	34,320	0.03	37,938	(132)	37,806
Dominican Republic	114,400	0.10	126,460		126,460

[1]Interest earned in 1997 under the Early Payment Encouragement Scheme (l/6384) and to be deducted from the 1999 contribution.

Table 2 (continued)

Members	1998 contribution CHF	1999 contribution %	1999 contribution CHF	Interest earned[1] CHF	1999 Net contribution CHF
Ecuador	102,960	0.09	113,814	(374)	113,440
Egypt	297,440	0.26	328,796	(1,372)	327,424
El Salvador	45,760	0.04	50,584	(94)	50,490
European Com.			0		
Fiji	34,320	0.03	37,938	(246)	37,692
Finland	869,440	0.74	935,804	(5,267)	930,537
France	7,321,600	6.02	7,612,892	(48,581)	7,564,311
Gabon	45,760	0.04	50,584		50,584
Gambia	34,320	0.03	37,938		37,938
Germany	11,211,200	10.16	12,848,336	(70,085)	12,778,251
Ghana	34,320	0.03	37,938		37,938
Greece	388,960	0.33	417,318	(1,259)	416,059
Grenada	34,320	0.03	37,938	(18)	37,920
Guatemala	57,200	0.05	63,230	(266)	62,964
Guinea	34,320	0.03	37,938		37,938
Guinea-Bissau	34,320	0.03	37,938		37,938
Guyana	34,320	0.03	37,938	(179)	37,759
Haiti	34,320	0.03	37,938	(99)	37,839
Honduras	34,320	0.03	37,938	(71)	37,867
Hong Kong, China	4,049,760	3.82	4,830,772	(29,705)	4,801,067
Hungary	366,080	0.29	366,734	(2,242)	364,492
Iceland	45,760	0.04	50,584	(349)	50,235
India	652,080	0.73	923,158	(1,292)	921,866
Indonesia	995,280	1.01	1,277,246	(4,184)	1,273,062
Ireland	800,800	0.76	961,096	(5,806)	955,290
Israel	674,960	0.53	670,238	(4,540)	665,698
Italy	5,193,760	4.94	6,247,124	(39,425)	6,207,699
Jamaica	68,640	0.05	63,230	(137)	63,093
Japan	9,586,720	7.58	9,585,668	(35,406)	9,550,262
Kenya	57,200	0.05	63,230	(210)	63,020
Korea, Republic of	2,654,080	2.48	3,136,208	(13,355)	3,122,853
Kuwait	274,560	0.24	303,504		303,504
Lesotho	34,320	0.03	37,938	(51)	37,887
Liechtenstein	34,320	0.03	37,938	(264)	37,674
Luxembourg	251,680	0.22	278,212	(1,522)	276,690

[1]Interest earned in 1997 under the Early Payment Encouragement Scheme (1/6384) and to be deducted from the 1999 contribution.

Table 2 (continued)

Members	1998 contribution CHF	1999 contribution %	1999 contribution CHF	Interest earned[1] CHF	1999 Net contribution CHF
Macau	80,080	0.06	75,876	(520)	75,356
Madagascar	34,320	0.03	37,938	(20)	37,918
Malawi	34,320	0.03	37,938	(5)	37,933
Malaysia	1,498,640	1.18	1,492,228	(4,202)	1,488,026
Maldives	34,320	0.03	37,938	(50)	37,888
Mali	34,320	0.03	37,938		37,938
Malta	57,200	0.05	63,230	(355)	62,875
Mauritania	34,320	0.03	37,938		37,938
Mauritius	45,760	0.04	50,584	(334)	50,250
Mexico	1,727,440	1.56	1,972, 776	(6,405)	1,966,371
Mongolia	34,320	0.03	37,938		37,938
Morocco	183,040	0.16	202,336	(131)	202,205
Mozambique	34,320	0.03	37,938		37,938
Myanmar, Union of	34,320	0.03	37,938	(217)	37,721
Namibia	34,320	0.03	37,938	(229)	37,709
Netherlands	4,038,320	3.61	4,565,206	(28,930)	4,536,276
New Zealand	331,760	0.30	379,380	(2,817)	376,563
Nicaragua	34,320	0.03	37,938		37,938
Niger	34,320	0.03	37,938		37,938
Nigeria	228,800	0.19	240,274	(4)	240,270
Norway	960,960	0.95	1,201,370	(4,956)	1,196,414
Pakistan	217,360	0.18	227,628	(247)	227,381
Panama	160,160	0.13	164,398		164,398
Papua New Guinea	57,200	0.04	50,584	(131)	50,453
Paraguay	57,200	0.05	63,230	(334)	62,896
Peru	137,280	0.13	164,398		164,398
Philippines	526,240	0.41	518,486	(1,764)	516,722
Poland	549,120	0.57	720,822	(3,576)	717,246
Portugal	663,520	0.64	809,344	(3,769)	805,575
Qatar	68,640	0.06	75,876	(275)	75,601
Romania	171,600	0.17	214,982	(870)	214,112
Rwanda	34,320	0.03	37,938		37,938
St. Kitts and Nevis	34,320	0.03	37,938	(206)	37,732
St. Lucia	34,320	0.03	37,938	(231)	37,707
St. Vincent	34,320	0.03	37,938	(28)	37,910

[1]Interest earned in 1997 under the Early Payment Encouragement Scheme (I/6384) and to be deducted from the 1999 contribution.

Table 2 (continued)

Members	1998 contribution CHF	%	1999 contribution CHF	Interest earned[1] CHF	1999 Net contribution CHF
Senegal	34,320	0.03	37,938		37,938
Sierra leone	34,320	0.03	37,938		37,938
Singapore	2,574,000	2.35	2,971,810	(11,733)	2,960,077
Slovak Republic	194,480	0.20	252,920	(1,676)	251,244
Slovenia	217,360	0.18	227,628		227,628
Solomon Islands	34,320	0.03	37,938		37,938
South Africa	629,200	0.54	682,884	(5,196)	677,688
Spain	2,802,800	2.45	3,098,270	(14,251)	3,084,019
Sri Lanka	102,960	0.09	113,814	(594)	113,220
Suriname	34,320	0.03	37,938	(266)	37,672
Swaziland	34,320	0.03	37,938	(228)	37,710
Sweden	1,830,400	1.45	1,833,670	(10,223)	1,823,447
Switzerland	1,979,120	1.68	2,124,528	(14,752)	2,109,776
Tanzania	34,320	0.03	37,938	(230)	37,708
Thailand	1,361,360	1.31	1,656,626	(8,568)	1,648,058
Togo	34,320	0.03	37,938		37,938
Trinidad and Tobago	45,760	0.03	37,938	(279)	37,659
Tunisia	160,160	0.14	177,044	(762)	176,282
Turkey	686,400	0.79	999,034	(3,651)	995,383
Uganda	34,320	0.03	37,938		37,938
United Arab Emirates	594,880	0.52	657,592	(1,954)	655,638
United Kingdom	6,783,920	5.95	7,524,370	(39,091)	7,485,279
USA	17,869,280	15.55	19,664,530		19,664,530
Uruguay	68,640	0.06	75,876		75,876
Venezuela	366,080	0.35	442,610	(123)	442,487
Zambia	34,320	0.03	37,938		37,938
Zimbabwe	45,760	0.04	50,584	(284)	50,300
Total	114,400,000	100.0	126,460,000	(542,828)	125,917,172

[1]Interest earned in 1997 under the Early Payment Encouragement Scheme (1/6384) and to be deducted from the 1999 contribution.

Annex 2. Issues relating to 'investment preference'

This annex deals with some of the questions relating to an investment preference facility. It also considers some of the possible objections that could be raised to this type of alternative to the existing trade preference regime.

◆ *How would an investment preference facility work?*

The operation of an investment preference would depend upon the scale of the project proposed to the facility. The scheme would operate at three separate levels:

1. Through the IFC directly, for large investments;
2. Through private sector banks, for smaller loans;
3. Through NGOs, for a micro-project component.

The provision of concessional assistance would occur at the beginning of the project through either the provision of low-interest loans or, in the event of a high-risk project, an equity position being taken by a risk capital fund. An investor would receive access to these funds if the country is defined as a small vulnerable state or a least developed country. In the event that the country is graduated by ECOSOC from LDC status or in the event that an SVS surpasses a threshold level of world trade for a period of five years, then access to the fund would be withdrawn. However, firms that have already received loans or equity injections would remain unaffected. Appropriate exit conditions for the disposal of equity held by the investment preference facility would have to be developed so that equity could be withdrawn from the project.

◆ *This would be a subsidy to inefficient operations*

Currently, subsidies provided under arrangements for disadvantaged regions are exempted from many of the WTO disciplines. As the world economy globalises, investment will move away from high-cost regions, which may experience high operating costs for reasons beyond the control of the state. A World Bank/IFC investment preference facility should be seen as the global equivalent of an investment fund for the world's highly disadvantaged regions.

The funds, if provided directly to the private sector, would be a subsidy, but it would be a subsidy to the cost of establishment, unlike trade preference, which subsidises inefficient operations through a continual stream of revenues. Such revenues are subsidised indirectly through a

duty remission offered by the trade preference donor.

In order to assure that such a facility is not a subsidy to structural and macroeconomic inefficiency, it could also be operated as part of a structural adjustment programme provided once a country has undertaken basic economic reforms. For those economies that operate in such a manner as to create high production costs, the facility would not achieve the objective of stimulating investment, because even with such subventions, investment would not be forthcoming.

While investment preference is not a first best outcome, it does constitute a possible transitional arrangement for highly disadvantaged countries that have been highly dependent upon trade preference arrangements.

◆ ***It would distort the local capital and money market***

Distortions to local capital and money markets could be minimised by ring-fencing the portfolio of the facility to investments and loans in new export sectors that would otherwise not be supported by domestic financial institutions. Ring-fencing the investments to the export sector would then have the same sectoral impact as trade preferences have had in the past.

The facility should not be involved in investments that are the normal domain of domestic financial institutions. The advantage of such a facility is that it would not be at the discretion of trade preference donors, which, by lowering duties, can completely alter the structure and level of incentives available to investors in least developed countries and small vulnerable states. The calculus of the investor would be based only upon landed prices for the export and would hence be based on less market-distorting factors than is currently the case with trade preferences. Trade preferences offer an administrative subvention to exporters based largely upon domestic trade policy considerations of the trade preference donor. Investment preferences, however, could, at least in principle, be tailored to the needs of least developed and small vulnerable states.

◆ ***This has been tried before and failed***

In general most of the facilities that provide low interest loans, such as the European Investment Bank facilities through the Lomé Convention, do so through governments, as they have normally required government guarantee. In the past, regional and multilateral development banks have offered investment funds that have been passed on to national development finance institutions through the government. In order to cover the foreign exchange risk, governments have marked up the loans and hence

the private sector has received very little or no direct financial benefit from the facility. In order to assure that investment preference works the benefits of low interest loans have to be passed on to the private sector borrower.

◆ ***Such a facility involves numerous types of moral hazard***

There are a number of possible moral hazards but these can be managed. Such hazards include the following:

1. If the facility is managed by commercial banks, the moral hazard is associated with the possibility of a domestic commercial bank abusing the facility in the full knowledge that it would be reimbursed by the facility if a borrower defaulted on a loan. This can be avoided only by requiring any associated commercial bank to provide a portion of its own funds for any investment.

2. A further moral hazard exists when a state-owned financial intermediary becomes involved, as has been the case in many small states. In this case loans have become highly politicised. For this reason, the facility should be limited to commercial banks, with a subsidy to the commercial bank to cover the cost of administration, thus ensuring that the full benefit is passed on to the private sector borrower/investor. Without assistance to cover the cost of loan administration it is doubtful many commercial banks would be interested in being involved. This is the only way one could ensure that the benefits of low interest, long gestation loans are actually passed on to the investor rather than being held by the financial intermediary.

◆ ***The facility subsidises capital costs and therefore skews the nature of the investment towards more capital intensive projects***

There can be no doubt that this is a serious distortionary consequence of this type of facility because of the probability that investors with capital intensive projects or more capital intensive techniques of implementing a given project will be attracted by such a subsidy to capital.