Chapter 2

From 'Trade Not Aid' to 'Aid for Trade'

The institutions of the modern multilateral trading system were established at a time of relative, albeit far from uniform, consensus about the relationship between trade liberalisation and development. Tariff reduction was widely understood to have a clear and positive effect on trade flows. Trade flows were deemed to be positively associated with economic growth. And trade-induced growth was believed to enhance general welfare. Armed with these supposed certainties, developed and developing countries were emboldened to embrace the liberalisation of global trade. The Uruguay Round was struck and the World Trade Organization was born.

The Uruguay Round was by far the most ambitious trade liberalisation in history. After effectively sitting out the first four decades of multilateral trade negotiations, developing countries' participation in the Uruguay Round led them to accept substantial liberalisation of their trade regimes. It covered tariff and non-tariff barriers in industrial and agricultural goods and extended multilateral rules to new areas, including services and intellectual property. International organisations including the World Bank and the Organisation for Economic Co-operation and Development (OECD) strongly supported the round. They published estimates of large projected welfare gains in the order of US$200–US$500 billion per year. A large share of these gains, it was argued, would accrue to the poorest countries and, on that basis, the international financial institutions (IFIs) urged developing countries to sign up.[1]

Almost as soon as the ink dried on the Uruguay deal, it became clear that the agreement was unbalanced. The final terms reflected, in large part, the priorities of the advanced countries. Market access gains were concentrated in areas of interest to developed countries including services, intellectual property and advanced manufacturing. Far less progress was made in areas of interest to the poor countries such as agriculture (including subsidies to agriculture) and textiles. The effect was to concentrate tariff reductions on products exported by the rich countries. Laird (2002) estimated that after the implementation of the Uruguay Round Commitments, the average OECD tariff

on imports from developing countries was four times higher than on imports originating in the OECD.[2] Developed countries had also maintained non-tariff barriers and other protectionism including agricultural subsidies and phytosanitary conditions, which effectively limited the competitiveness of farmers and some other producers in poor countries.[3]

Even where the exchange of market access had been *de jure* reciprocal, it was *de facto* unbalanced. Exporters in rich countries were able to quickly take advantage of greater market access, but the poor countries found their ability to export to rich countries was limited by a range of constraints including non-tariff barriers, weak infrastructure and supply constraints.

To make the 'Uruguay hangover' worse for developing countries, they rapidly realised that as well as receiving only a small share of the gains from the Uruguay Round,[4] they were now subject to a remarkable range of additional obligations and responsibilities. Finger and Schuler (2000) estimated the implementation costs of just three areas (customs valuation, Trade Related Aspects of Intellectual Property Rights [TRIPS] and sanitary/phytosanitary measures) would cost each developing country around US$150 million – a huge sum for many least-developed countries. Overall the agreement was not only unbalanced, it was unjust. Some estimates suggested the 48 least-developed countries had actually lost a total of US$600 million a year as a result of the Uruguay Round (around 5 per cent of their gross domestic product [GDP]).

There was increasing concern too about the high developmental and health costs of some of the obligations undertaken under the Uruguay Round and the Financial Services Agreement. For instance, access to lifesaving generic medicines was restricted; countries' health budgets were hit badly and/or access to life-saving medicines was diminished; and newly flourishing generic drug companies in developing countries saw their prospects wane. Local financial firms found it difficult to compete with large multinationals, and local small businesses often seemed unable to gain access to credit from these multinationals. A growing body of literature suggested that financial market liberalisation (as pushed by the Financial Services Agreement) did not promote growth, but did enhance instability (Detragiache et al. 2008).

Even after the results of the Uruguay Round were clear, the international financial institutions continued to advise the developing countries that liberalisation was in their best interests. Developing countries were encouraged to address their concerns

through a fresh round of liberalisation. The acting European Trade Commissioner, Sir Leon Brittan, said 'the only way to address the issue is through a new round of negotiations. Indeed, I would ask all WTO members, including developing countries, whether they are entirely happy with the present trading system. If the answer is no, it is clear that the only way of improving upon that system is in a new round' (see Stiglitz and Charlton 2005: 39, and the references cited there). The answer to the problems of liberalisation was more liberalisation. But developing countries' experiences had made them wary of a repeat of the unfairness of Uruguay. Fresh from what they felt was a betrayal,[5] developing countries were cautious about signing up to another round. The first attempt to establish a new round of trade talks in 1999 in Seattle was a debacle. Sceptical developing countries torpedoed the meeting. Outside on the streets some 40,000 people protested the injustices of the global trading system.[6]

To restart trade talks, in 2001 at Doha the advanced countries made a string of promises to put the poor at the centre of the new round – even naming the talks the Doha Development Agenda. The Ministerial Declaration acknowledged the unfairness of the past and promised to 'place (the developing countries') needs and interests at the heart of the work program' for the new round. These assurances soothed the concerns of many developing countries. Ever hopeful, they signed up to a new round.

The goodwill lasted less than two years.[7] When developing countries walked out of the 2003 meeting in Cancun, the Doha Round stumbled into a deadlock from which it never recovered. By July 2005, the negotiations had reached an impasse. Recognising the crisis, WTO Director-General, Pascal Lamy, made a decision to suspend negotiations. The stalling of the Doha Round and the implacable sense that the world trading system was manifestly unfair to developing countries led the WTO, its members and civil society to search for alternative avenues to promote trade, bring development closer to the centre of the WTO's work programme and mollify the concerns of developing countries. In this context, aid for trade – an obvious carrot for the developing countries – was an idea whose time had come.

2.1 Questioning the benefits of liberalisation

At the same time that developing countries began to fear that the trading system was unbalanced, they also began to more critically question the benefits of trade liberalisation. This provided a second impetus for aid for trade.

The welfare impacts of free trade were formalised in modern economics by Paul Samuelson (1938).[8] However, the underlying assumptions that yield this conclusion are highly restrictive and often fail to reflect many of the relevant characteristics of developing economies.[9] Moreover, neither Samuelson nor subsequent analyses provided a strong analytic basis for the notion that trade liberalisation would lead either to stronger development or faster growth. Nonetheless during the 1980s, neoliberal policy prescriptions based on the positive welfare impacts of trade liberalisation gained support among the international financial institutions.

Import substitution policies and managed trading regimes fell out of favour and developing countries were encouraged to rely more on market mechanisms.[10] Developing countries were told they must reduce their own tariffs if they were to reap the benefits of engagement in the global economy. Influenced by advice from the international financial institutions and cajoled by aid conditionality, whereby aid was extended on the condition of trade liberalisation, many developing countries shifted their strategy to participate more actively with the WTO.

In the last decade, there has been a significant reappraisal of the Washington consensus, and especially the relationship between trade liberalisation and economic development (Chang 2002). Although some research in the 1990s appeared to confirm that trade liberalisation promoted economic growth, several subsequent studies cast doubt on these results on the basis that the key ‘openness’ variables employed in earlier empirical studies poorly reflected trade liberalisation (Rodriguez and Rodrik 2000). Recently, successive studies have emphasised the heterogeneity in developing countries’ experience with liberalisation and economic growth. For instance, Wacziarg and Welch (2008) found that roughly half of the countries in their survey experienced zero or even negative changes in growth post-liberalisation. Other studies have questioned the direction of causation – it may be possible that rather than being caused by liberalisation, successful development leads to integration into the global economy.[11] Estevadeordal and Taylor (2008) agree that most of the prior literature is weak, but find some support for positive effects on growth of liberalising intermediate goods and imported capital tariffs.

While there remains controversy about the relationship between trade liberalisation and growth, what is clear is that the simple and clear link asserted by liberalisation advocates has not been verified by the data. It may be that under certain circumstances

(for instance, when the economy is fully employed and when financial markets work well – circumstances applicable in few least developing countries) trade liberalisation, at least of intermediate goods, could enhance growth. Trade liberalisation might lead to growth when accompanied by certain other policies. However, trade liberalisation, as practiced, has often had adverse effects on growth, for reasons that are explained shortly below.

If there are strong doubts about the relationship between trade liberalisation and growth,[12] there is even less consensus on the causal link between liberalisation and poverty. The evidence is at best weak (see: Bannister and Thugge 2001; Winters et al. 2004) with many studies finding that trade liberalisation, even when it is associated with economic growth, also leads to an increase in inequality (World Bank 2005; Topalova 2010).

Earlier theoretical literature had explained why results suggesting that trade liberalisation might not lead to an increase in well-being should not have come as a surprise. Dasgupta and Stiglitz (1977) and Newbery and Stiglitz (1984) had noted that trade liberalisation increased risk, so much so that everyone could be worse off. These concerns were especially relevant in developing countries, where risk markets were imperfect. Second, the process of adjustment to liberalisation was costly. Neoclassical theory (upon which most of the pro-liberalisation analyses were based) simply presumed that workers would move from inefficient protected sectors to efficient unprotected sectors, without cost. What often happened in reality was that they moved from inefficient protected sectors into unemployment. Output decreased rather than increased. It should have been obvious that the neoclassical model did not describe economies in which there were, even before liberalisation, high levels of unemployment. In these cases, trade liberalisation simply added to the ranks of the unemployed. Again, this was a concern especially in developing countries, where financial markets often didn't work well and where there was a scarcity of entrepreneurship. It was harder to create new jobs than to destroy old jobs. Moreover, trade liberalisation took away one of the most important sources of government revenue. Most countries found it difficult to replace tariffs, say with a value-added tax (VAT) (Aizenman and Jinjarak 2009). The constraints in government revenues forced cutbacks in investments in education and infrastructure, thereby impairing development.

At first, the impacts on inequality came as a surprise, since the conventional model (the Samuelson-Stolper theorem)[13] predicted an increase in unskilled wages in developing countries.

However, three factors contributed to the increase in inequality typically associated with liberalisation:

i As we have already noted, it often was done in a way that resulted in increased unemployment. This had adverse effects directly on poverty and inequality (in particular, since it is typically those at the bottom who suffer the most from unemployment [Furman and Stiglitz 1998]). But it also has an indirect effect: higher unemployment puts downward pressure on wages.

ii. Liberalisation was often asymmetric, with capital and goods liberalisation outpacing labour market liberalisation.[14] This adversely affected workers' bargaining position, and put pressure on governments to cut taxes on capital and, correspondingly, programmes for those who were less mobile – unskilled workers. Thus before taxes and transfers, income became more unequal, and after taxes and transfers it was even worse.

iii. The unskilled didn't benefit from the creation of new export jobs, and they were often in agriculture, which could be hurt by subsidised agriculture exports from developed countries.[15]

The reappraisal of the main tenets of the Washington consensus in economic literature was an inevitable consequence of the mixed experience among the developing countries that had embraced trade liberalisation. Many countries that had, according to the neoliberal prescription, done the 'right things' (that is, not only had liberalised, but followed other policy dictates of the Washington-based international institutions) subsequently stagnated. And many countries that had not followed the Washington consensus had achieved considerable success. Rodrik (2001) argued that the three primary models of successful development in the twentieth century all relied on managed trade regimes: import substitution, as practised by a number of countries in the 1960s; outward-orientated industrialisation, as practiced in East Asia in the 1980s; and the state-directed capitalism of China in the 1990s. Chang (2002) showed that almost all of today's rich countries used tariff protection and subsidies to develop their industries, and 'Britain and the USA, the two countries that are supposed to have reached the summit of the world economy through their free-market, free-trade policy, are actually the ones that had most aggressively used protection and subsidies'.[16]

The ultimate refutation of the trade-not-aid mentality came with the introduction of highly favourable market access preferences for least-developed countries, including the EU's Everything but Arms initiative (EBA) and the United States' African Growth and Opportunity Act (AGOA). These initiatives, though a positive and important step, have had limited impact on beneficiary countries' exports. Sub-Saharan Africa's share of world exports decreased dramatically between 1980 and 2006, falling from 3.9 per cent to 1.9 per cent. African least-developed countries (LDCs) did even worse, seeing their average share fall from 0.06 per cent to 0.02 per cent over the same period. Multilateral tariffs, it turned out, were not the binding constraint on the ability of these countries to trade. Their capacity to export was hindered by a range of non-tariff trade costs and barriers, as well as supply constraints.

These three factors – the historical unfairness of previous trade agreements; the high adjustment costs and disappointing results from trade liberalisation; and the broader reappraisal of the relationship between trade, trade liberalisation and development – changed developing countries' approach to multilateral trade liberalisation and their engagement with the WTO. If the gains from trade were not automatic, as the Washington consensus had implied, and the relationships were complex and contingent and the outcomes were heterogeneous, developing countries would (and should) be significantly less sanguine about further trade liberalisation.

At the 2003 WTO meeting in Cancun, UNCTAD Secretary-General, Rubens Ricupero, spoke for many when he acknowledged the shifting mood: 'Trade liberalization is no panacea for developing countries. For many of them, it involves considerable adjustment and social costs. There is a need for synergy and proper sequencing – between the capacities of the developing countries, the level of obligations they are to take on, the cost of implementation, and the adequacy of financial and technical resources available to them' (Ricupero 2003: 3).

2.2 Birth of aid for trade

Aid for trade was born in this context. Once the developing countries began to lose faith in the prospects for multilateral liberalisation, the rich countries had to put something else on the table. Aid for trade was a salvo. Some saw it as a recognition that previous agreements had been unfair, others said it was recognition that developing countries faced adjustment costs

associated with trade liberalisation, others still saw it as a means to increase the benefits of market access. It was all of these things, but the fundamental driver of the aid for trade initiative was that the trading system was in crisis. If the developing countries walked away from the round, the WTO's agenda for expanding trade would grind to a halt.

In early 2005 at the International Monetary Fund (IMF)–World Bank spring meeting, the Development Committee put aid for trade firmly on its agenda and resolved 'to work with others to develop proposals to help developing countries adjust to and take advantage of the round, for consideration by our next meeting' (International Monetary Fund and World Bank 2005: 2). A few weeks later at the Gleneagles G8 meeting in May, Heads of Government committed 'to increase our help to developing countries to build the physical, human and institutional capacity to trade, including trade facilitation measures',[17] and called 'on the IFIs to submit proposals to the annual meetings for additional assistance to countries to develop their capacity to trade and ease adjustment in their economies'.[18]

By late 2005 the WTO had rallied behind the proposal. At the WTO Ministerial Conference in Hong Kong in December 2005, the 'Aid for Trade Initiative' was officially launched. The Hong Kong Ministerial Declaration reflected the interests and objectives of both the WTO and donors: 'Aid for Trade should aim to help developing countries, particularly LDCs, to build the supply-side capacity and trade-related infrastructure that they need to assist them to implement and benefit from WTO Agreements and more broadly to expand their trade'.[19] Shortly thereafter, aid for trade moved toward the centre of the WTO's work programme. Director-General, Pascal Lamy, said in 2006: 'We cannot ignore the costs of adjustment, particularly for the developing countries, and the problems that can arise with the opening up of markets. These adjustments must not be relegated to the future: they must be an integral part of the opening-up agenda. We must create a new "Geneva consensus": a new basis for the opening up of trade that takes into account the resultant cost of adjustment' (Lamy 2006).

It is noteworthy that Lamy emphasised only the adjustment costs. The term 'adjustment costs' suggested that the costs were a short-term problem: they didn't recognise that trade liberalisation might actually impede longer-term development. Advocates of trade liberalisation never fully understood that even in equilibrium, trade liberalisation might have adverse effects, and especially so if it was pursued in an asymmetric way.

Yet even if liberalisation did not have these adverse effects, and even if the multilateral trade agreements (the Uruguay Round in particular) had been 'fairer', there would be a need for aid for trade. Symmetric agreements can have asymmetric effects, as we have already noted, because of the asymmetries of different countries. (That was part of the rationale for special and differential treatment.) Market failures are especially pervasive in developing countries and there is, accordingly, need for government interventions. Trade requires resources – infrastructure and finance – that developing countries often cannot provide on their own. Aid for trade can be seen in part as filling in these lacunae.[20]

2.3 Questioning the effectiveness of aid

Aid for trade was born at least in part as a result of a crisis in the global trading system. But it would not have got off the ground with the support of the trade community alone. Aid for trade received additional impetus from the aid and development communities, which were faced with a parallel series of challenges to significantly scale-up disbursements and to demonstrate the effectiveness of development programmes. At the United Nations Millennium Summit in 2000, world leaders came together around eight goals for the poorest countries, which came to be referred to as the Millennium Development Goals. Two years later at the financing for development conference at Monterrey in Mexico, leaders recognised 'dramatic shortfalls in resources required' to achieve these goals.[21] In subsequent years, major advanced economies made significant commitments to increase their aid budgets. Several major countries committed to a collective foreign aid target of 0.7 per cent of Gross National Product (GNP) by 2015, these targets have not for the most part been reached.[22]

At the same time the aid community faced a challenge to its legitimacy from those who questioned the benefits of aid. In the last two decades, researchers have scrutinised the conditions under which aid is effective. William Easterly argued that the US$568 billion spent on aid to Africa over the last 40 years has not lifted average African incomes.[23] Other recent cross-country analyses also conclude that the relationship between aid and development is weak and often ambiguous (Rajan and Subramanian 2008; Easterly et al. 2003; Hubbard and Duggan 2009). Clemens et al. (2012: 590) do find that it is 'plausible […] that aid causes some degree of growth in recipient countries, although the magnitude of this relationship is modest, varies

greatly across recipients and diminishes at high levels of aid'. In a recent meta-analysis of the literature, Doucouliagos and Paldam (2011) conclude that the overall finding on 'aid ineffectiveness' has not been overturned, though there are some results suggesting certain components of aid *may* be effective.

It is perhaps not surprising that the links between aid and development are often difficult to discern. Aid has frequently been provided for with non-economic objectives, such as emergency assistance following disaster relief, or for political or geostrategic reasons. During the Cold War, billions of dollars of aid supported corrupt and tyrannical dictators such as Joseph Mobutu of Zaire (now the Democratic Republic of the Congo) and Jean-Bédel Bokassa of the Central African Republic. Many well-intentioned aid projects were rendered ineffective through poor conception and execution, or fettered by tenuous and sometimes counterproductive conditionality. In other cases, aid may have had a negative effect on growth through 'Dutch Disease' effects – where inflows of capital reduce the competitiveness of the export sector through the appreciation of exchange rates.

Moreover, because the effects of aid (such as education) often take years to be realised, it is hard to assess with contemporaneous data the effects of aid. More generally, the cross-section 'aid and growth' literature is bedevilled by all the econometric problems associated with the 'trade and growth' literature, to which we referred earlier. The effectiveness of aid clearly depended on circumstances.[24]

Critiques of the impact of aid have become more vociferous as the global campaigns to increase aid have gained momentum. Policy-makers and researchers have responded, both in a commitment to make aid more effective and in analyses to enhance understanding of what is required to do so. At Monterrey donors wanted to know that aid would be used as effectively as possible before they agreed to increase their ODA budgets.

In 2003 aid officials and representatives met in Rome for the High-Level Forum on Harmonization, where donor agencies committed to work with developing countries to better co-ordinate their activities. Two years later, the Paris Declaration on Aid Effectiveness was endorsed – a comprehensive attempt to establish principles to improve the effectiveness of aid.

Aid for trade has been a beneficiary of these trends. It has been presented as an effective channel through which significantly increased aid can be disbursed. At the same time linking aid to trade has enabled the development community to point to

longer-term impacts of assistance programmes on growth and economic development.[25] This became especially relevant as many in the development community shifted attention away from just poverty to growth, in the belief that it was only or mainly through growth that there would be long-term, sustainable reductions in poverty.

Moreover, if aid for trade did enhance trade, then a stronger case could be made that it was in the self-interest of the developed countries to provide such assistance. Exporters in developed countries knew that their exports could only increase with the enhanced trading capacity of developing countries.[26]