Chapter 5

Building Trade Capacity of Small States: Strategic Approaches to Aid for Trade

Mohammad A Razzaque

5.1 Introduction

Having emerged from the World Trade Organization (WTO)'s 2005 Hong Kong Ministerial Conference, the Aid for Trade (AfT) initiative is set to mark its tenth anniversary. It continues to attract huge attention in global trade policy discourse, particularly in the context of supporting trading capacity of developing countries. The financial and technical assistance provided under AfT aims to tackle developing countries' supply-side constraints so that they are able to effectively participate in global trade. It is this underlying but specific trade purpose that distinguishes AfT from the rest of traditional overseas development assistance (ODA). Although the term 'Aid for Trade' is relatively new in multilateral trade-policy discourse, aid flows serving similar intended purposes have long existed and have been regularly reported by donors. The trade dimensions as highlighted in AfT received renewed focus under the Doha Round of multilateral trade negotiations, as many developing countries realised that their lack of supply-side capacity prevented them from effectively participating in and benefiting from the expansion of global trade and investment activities.

This new emphasis has contributed to an increased allocation of ODA and other financial flows towards AfT, and all major donors have now attached a special priority to trade-related assistance, with a formal mechanism established for monitoring such flows and their impact on developing countries' capacity to trade. It is against this backdrop that, from the perspectives of the poorest and small states, one of the most important developments during the troubled Doha Round – which has now been running for 14 years – has been the inclusion of AfT in trade talks.

In general, the discussions on AfT have tended to treat beneficiaries as a fairly homogeneous group of developing countries. However, recipient countries differ on a variety of factors and needs, which are important to acknowledge in devising any AfT strategy. Small states, in particular, have certain unique and inherent characteristics that determine their external competitiveness and trade performance. These factors need to be given special attention when considering AfT support for building trade capacity.

This chapter puts AfT in the context of trade challenges and realities of small states. It provides a snapshot of AfT resources received by these countries, makes some observations on their effectiveness based on the studies available and highlights some strategic issues in making AfT more effective in small states.

5.2 External competitiveness of small states and their need for AfT

This chapter uses the Commonwealth Secretariat definition of small states.[2] The group of small states includes mostly African, Caribbean and Pacific small and island states. Owing to their small populations, the domestic market is limited in these countries. As a result, most of their firms are small and medium-sized enterprises with limited opportunities for reaping the benefits of economies of scale and investing in research and development.[3] Remoteness and isolation are typical features of small states that result in their high trading costs, due to both small consignment size and high shipping costs. Small domestic markets in combination with high trading costs contribute to the lack of competition and efficiency of product and factor markets. All this leads to a higher cost of doing business.[4] In addition, most small states suffer from general developmental challenges such as poor investment climate, weak institutions and inadequate human capital resources. The interactions of these challenges are manifested in higher unit production costs, making small states' exports uncompetitive in global markets.

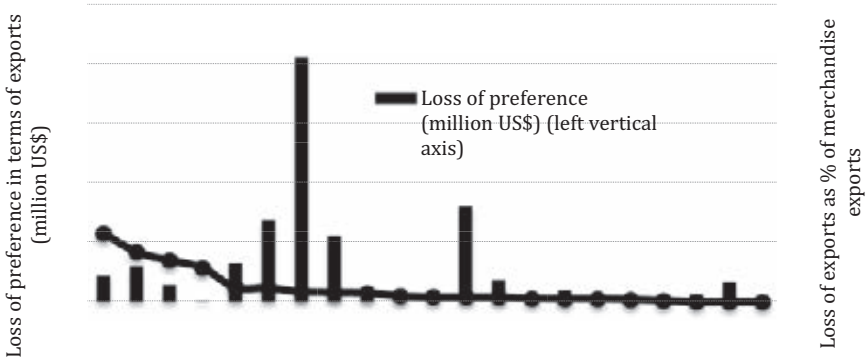
The comparative disadvantage of small states, arising largely from their inherent characteristics, is reflected in their declining relative significance in world trade (Razzaque 2011). In both merchandise and services exports, small states have seen their share of global trade dwindling. At the individual country level, nearly 70 per cent of these countries has suffered from declining share. Given that one of the principal purposes of AfT is to promote supply response from developing countries, the rationale for providing AfT support to these countries cannot be overemphasised.

The small size of the domestic market will imply that small states are likely to be more dependent on international trade for economic growth. Their weak trade capacity is thus already affecting their overall economic performance. Although small states have relatively high per capita income, mainly owing to their small populations, among other global regions since the 1990s they have experienced one of the lowest rates of per capita growth of gross domestic product (GDP). In recent times, their annual compound economic growth has been lower than that of the least-developed countries (LDCs) and of Sub-Saharan Africa (SSA).

Small states, like LDCs, also suffer from a lack of diversification in their production and export structures. On the whole, more than three-quarters of their exports are primary commodities and fuels. On an index of export diversification, which compares individual countries' export structures to the world average, ranging from a value of 0 (for highly diversified, reflecting the world average) to 1 (highly concentrated and thus very different from the world average), the average value of small states has been found to be 0.73, compared with 0.22 for the developing countries as a group (Razzaque 2011).[5] Given the above, the prospect of growth and economic diversification in small states is determined by their capacity and nature of export trade.

Another important rationale for AfT to small states arises from the need for trade-adjustment support. Studies find that these countries are most vulnerable to loss of trade preferences as a result of multilateral and regional trade liberalisation

Figure 5.1 Estimated loss of preference for small states



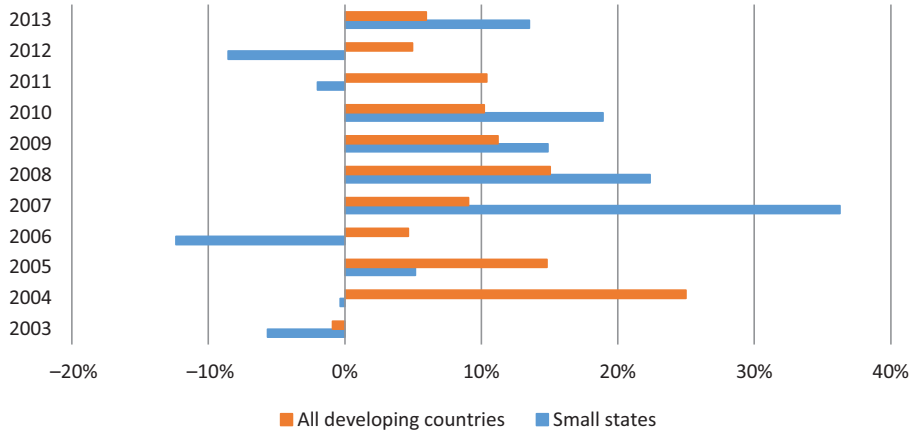
Source: Calì and Razzaque (2013)

programmes. As the exports of these countries are highly concentrated, most often around a few product lines for which preferences exist, any loss of favourable treatment can have disastrous consequences. A Commonwealth Secretariat-sponsored study showed that, by the measure of trade preference as a percentage of the trade-weighted average world market price of the countries' exports, the countries most exposed to preference loss were Mauritius, St Lucia, Belize, St Kitts and Nevis, Guyana, Fiji Islands, Dominica, Seychelles, Jamaica, St Vincent and the Grenadines, and Swaziland (Milner et al. 2011). When measured as a proportion of countries' total merchandise exports, potential export losses as a result of preference erosion are very large for St Vincent and the Grenadines (58 per cent), St Lucia (42 per cent), Dominica (35 per cent) and São Tomé and Príncipe (29 per cent), as shown in Figure 5.1. As summarised in Calì and Razzaque (2013), based on various estimates, about 15–29 per cent of the total estimated loss of all developing country exports as a result of preference erosion comes from small states. Considering that the proportion of the population in small vulnerable economies (SVEs) is just about 2 per cent of the total population of developing countries experiencing such losses, small states bear a much higher than proportionate share of the costs of preference erosion. Drawing on Caribbean regional experience, Nurse and Greene (2014) list significant drops in exports of rice, bananas and sugar as results of the erosion of trade preferences into the European Union (EU) market on account of WTO liberalisation. (Therefore, the peculiar country characteristics, together with the trade shocks facing them, make small states' integration into the world economy a daunting prospect.)

5.3 AfT flows to small states

AfT disbursed to all small states stood at US$583 million (in constant 2013 prices) in 2005 when WTO members, at their Hong Kong Ministerial Declaration, adopted the role of the WTO in monitoring AfT flows. Since then, AfT flows have almost doubled to US$1.2 billion in 2013, the most recent year for which information is currently available. During the same period, total global AfT flows have also seen an almost identical rise from US$20 billion to about US$40 billion. However, annual

Figure 5.2 Growth of AfT received by small states and all developing countries



flows have been much more volatile in small states (Figure 5.2). In 2013, the 49 small states in our sample accounted for 2.99 per cent of total global AfT endowment. This is considerably higher than the lowest share of 2.43 per cent in 2006 but much lower than the share of 4.18 per cent enjoyed by small states in 2002 (Figure 5.3).

AfT commitments by donors for small states have been significantly higher than the amounts actually disbursed (Figure 5.4).[6] Indeed, accumulated annual shortfalls between 2002 and 2012 are estimated to be close to US$3 billion in constant 2013 prices. This is more than three times the amount of AfT resources received by small states in 2013.

The relative significance of AfT in total ODA in small states and developing countries is comparable: 23 per cent in the case of the former compared with 26 per cent in the latter, with both figures corresponding to 2011. However, there are certain small states where AfT has much greater prominence, for example Cape Verde, Gabon, Grenada, Jamaica and Papua New Guinea. Table 5.1 shows country-specific AfT

Figure 5.3 Small states' share in all AfT disbursed (%)

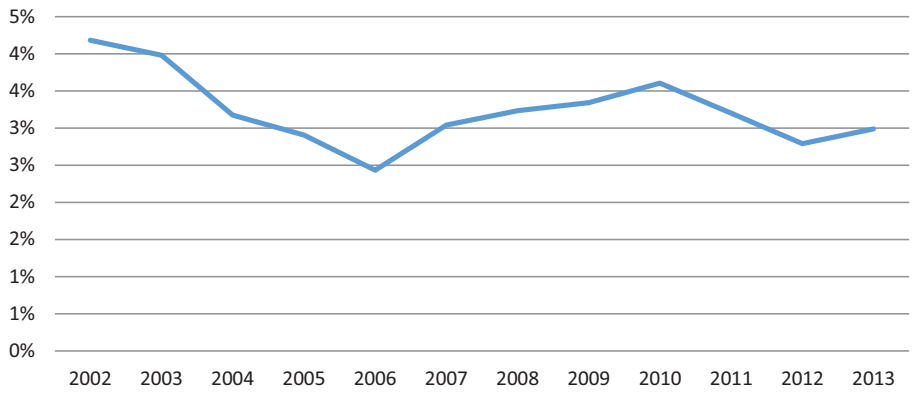
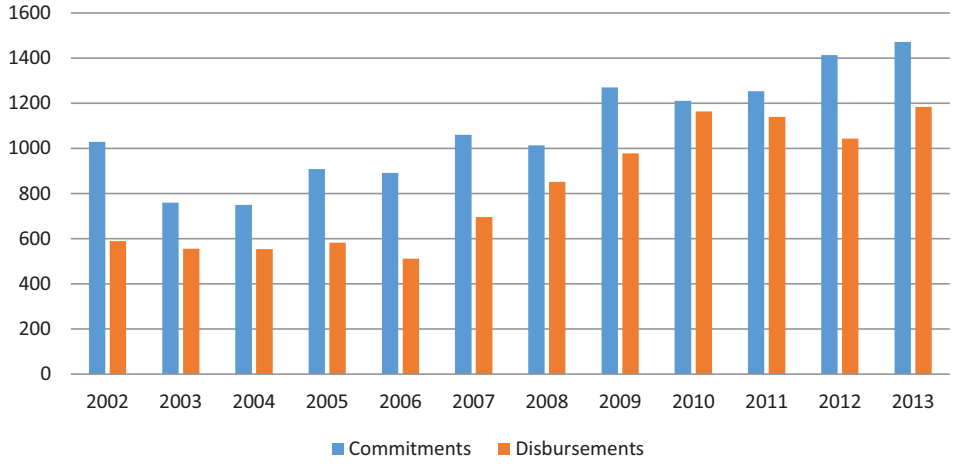


Figure 5.4 AfT flows in small states: commitments versus disbursements (in constant 2013 US$ millions)



Notes: Authors' estimates based on the Organisation for Economic Co-operation and Development Creditor Reporting System database. The combined total of ODA flows associated with sectors 200 and 300 are being considered as total AfT flows

Table 5.1 AfT disbursed (in 2013 constant US$ millions)

	2002	2005	2008	2010	2013
All developing countries	**14,096.9**	**20,049.0**	**26,327.4**	**32,271.0**	**39,618.0**
All small states	**589.3**	**582.6**	**851.3**	**1,163.1**	**1,183.3**
Antigua and Barbuda	9.5	5.7	0.4	5.8	0.3
Bahamas, The	0.0	0.0	0.0	0.0	0.0
Bahrain	0.0	0.0	0.0	0.0	0.0
Barbados	0.0	0.7	0.2	10.7	0.0
Belize	0.0	1.7	10.5	11.8	16.2
Bhutan	22.4	37.4	20.4	84.5	56.3
Botswana	1.9	19.4	10.6	23.6	10.6
Brunei	0.0	0.0	0.0	0.0	0.0
Cape Verde	25.3	46.3	99.1	161.4	59.7
Comoros	5.8	6.0	3.4	8.2	12.4
Cook Islands	0.3	0.3	1.6	3.1	5.1
Cyprus	0.0	0.0	0.0	0.0	0.0
Djibouti	16.3	4.1	16.6	28.2	17.8
Dominica	13.9	3.6	11.3	16.7	11.9
Equatorial Guinea	4.4	0.6	0.6	0.4	0.2
Fiji	0.7	12.8	7.8	9.0	12.0
Gabon	35.0	31.2	19.8	52.6	23.2
Gambia, The	22.3	18.9	16.6	32.0	34.4
Grenada	3.6	0.7	1.8	8.8	1.3
Guinea-Bissau	20.0	17.0	29.0	13.4	9.4
Guyana	9.7	6.7	36.2	62.8	57.1
Jamaica	22.6	35.4	74.2	55.0	47.0
Kiribati	9.6	13.9	6.6	3.6	32.7

Table 5.1 (continued)

	2002	2005	2008	2010	2013
Lesotho	38.2	9.0	21.2	23.4	20.0
Maldives	4.7	0.4	6.5	31.8	1.0
Malta	0.0	0.0	0.0	0.0	0.0
Marshall Islands	1.3	1.9	2.4	10.1	13.8
Mauritius	4.9	2.5	4.2	17.2	93.4
Micronesia	5.9	11.5	9.8	13.3	23.2
Montenegro	0.0	0.3	27.9	23.0	78.9
Namibia	36.5	32.9	36.6	56.7	57.9
Nauru	0.0	3.1	14.5	1.0	5.0
Niue	0.3	1.6	3.5	5.1	5.1
Palau	13.6	7.0	12.1	7.2	14.2
Papua New Guinea	144.2	103.5	139.1	131.8	198.5
Samoa	16.3	12.5	10.2	32.5	20.1
São Tomé and Príncipe	8.2	8.8	8.4	5.5	12.9
Seychelles	1.3	2.7	2.1	4.6	3.1
Solomon Islands	6.4	19.7	12.4	27.5	43.2
St Kitts and Nevis	6.9	0.7	0.4	2.7	0.2
St Lucia	14.5	9.2	12.5	23.0	9.7
St Vincent and the Grenadines	1.7	6.5	16.7	4.3	2.3
Suriname	5.5	6.8	38.8	25.4	17.3
Swaziland	4.0	26.4	11.4	9.3	35.7
Timor-Leste	34.2	38.8	36.4	44.2	66.3
Tonga	7.0	4.0	4.6	32.6	34.4
Trinidad and Tobago	0.5	2.6	0.4	1.4	0.0
Tuvalu	4.1	1.0	4.5	1.6	4.6
Vanuatu	5.6	6.9	47.8	36.2	14.8

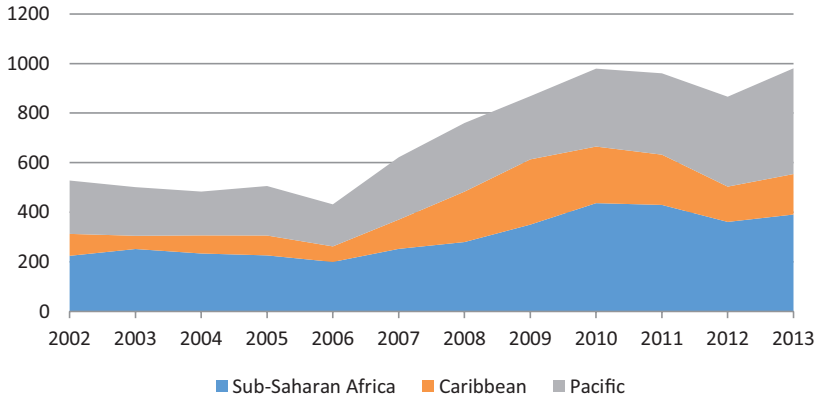
Source: Organisation for Economic Co-operation and Development Creditor Reporting System database

flows for different years. A close look at the table reveals that AfT flows are far from predictable, as there exists over time significant fluctuations.

In our sample of small states, 14 are from SSA and 14 are from the Pacific and 13 are from the Caribbean.[7] Of the resources available to small states in 2013, Pacific states received about 36 per cent, whereas African states received a share of 33 per cent. The Caribbean small states received only 14 per cent. Over time, the significance of Pacific countries as recipients of AfT has increased (Figure 5.5).

Although there has been no specific aid programme to deal with the problems arising from the inherent features associated with smallness and remoteness, when a comparison is made on the basis of per capita aid received, small states have historically shown higher levels of AfT.[8] This is mainly attributable to small populations of small states vis-à-vis indivisibilities in investment projects. For example, a trade-related infrastructure project such as a bridge or an airport funded by AfT would cost a similar amount across countries. However, the AfT per capita of that project would be considerably higher in a small than in a large receiving country.

Figure 5.5 AfT flows in small states by region (constant 2013 US$ millions)



In terms of major AfT donors to small states, the EU has consistently been the largest donor. Australia and Japan are the other major donors, with the former more than doubling its assistance in recent years. Other relatively large donors include France, Portugal, the USA, Germany and the Netherlands.

The distribution of spending of AfT in small states across the main categories of AfT is broadly in line with that for other developing countries. The largest share accrues in economic infrastructures, followed by aid to productive sectors. AfT policy and regulations are relatively small, while – despite its critical relevance to small states – the aid for supporting trade-related adjustments has so far been almost non-existent.

5.4 Effectiveness of AfT small states

5.4.1 Approaches to study AfT effectiveness

There are several ways of studying the effectiveness of AfT. A popular approach has been to study individual AfT projects (e.g. case studies) and to qualitatively, in most cases, infer information about their general effectiveness. A related approach also relies on qualitative methodologies; however, rather than studying specific projects, it aims to capture general trends emerging from donor-, sector- and country-specific projects. Perhaps the most rigorous and challenging approach is to employ well-specified quantitative/empirical methodologies, mostly using econometric techniques, to find out the net overall impact (e.g. quantitative macro assessment). All the approaches have their inherent advantages and disadvantages. Case studies offer very useful insights, providing details of issues specific to individual projects that are most likely to be overlooked in a broad assessment. The generalised qualitative approaches can help obtain a broader perspective beyond individual projects. However, when the objective is to ascertain the overall AfT effectiveness, individual project evaluations cannot indicate very much. As the evidence arising from the evaluation of specific trade-related aid programmes on trade performance is likely to be mixed, a macro study aiming to understand the overall effectiveness is appealing to policy-makers and analysts. This examination is, however, challenging, because of the difficulties associated with isolating the impact of AfT programmes

on the recipient's economy and also owing to data limitations and unavailability of appropriate quantifiable indicators.

The Third Global Review of Aid for Trade, held in 2011, is a prominent example of evaluation of AfT projects based on case studies. Based on a call for such studies from the WTO and the Organisation for Economic Co-operation and Development (OECD), the Global Review received 269 case studies on individual projects. They provided very rich and insightful perspectives, narrating various elements of the implementation and results achieved. Despite the usefulness of such an approach, the review could not provide a broad assessment, for example, of whether or not a country/donor had been generally successful in an AfT initiative. Arguably, this is a more realistic approach, given the heterogeneity of the projects and the qualitative information that it generated on various issues. Nevertheless, the quest for generalising the findings based on an empirical methodology, which is commonplace in the most economics fields, could not be met. Furthermore, the case study approach is subject to a serious selection bias: project managers are likely to be less inclined to report on projects that have not been successful. Therefore, one important question was: if the individual projects were so successful and if the submitted studies were a good sample, why was it not reflected in the overall economic performance of the countries? One obvious reason is that, given the needs of the countries, supply-side capacity interventions remain extremely limited.

Using qualitative approaches, Basnett and Engel (2013) evaluated country and donor experiences and their potential to provide insights into effectiveness. They considered various barriers and examined circumstances that affected outcomes at four phases of the AfT cycle: (1) determining priorities including the identification of binding trade-related constraints on growth; (2) structuring AfT delivery, examining particularly what is known about different delivery instruments; (3) the design and implementation of projects and programmes, focusing on delivery of national and regional AfT programmes; and (4) monitoring and evaluation, including different methodologies used and how this informs ongoing and future programmes at the global, regional, national and project levels.

The authors suggest that, despite the overall positive impact, many individual projects are failing to deliver results. Improving the effectiveness of AfT requires not only the identification of the most binding constraints to trade, but also tackling of the bottlenecks within donor and recipient institutions that impede successful implementation of projects at various stages throughout the project cycles. This, according to Basnett and Engel (2013), requires an understanding of the nature and causes of co-ordination failures and information asymmetries specific to the institutional structure and political economy of recipient countries and regions, as well as donor agencies.

Another qualitative approach is that used by Ancharaz et al. (2013), where the authors use the Paris principles of aid effectiveness to offer insights into the dynamics of AfT on the ground. The methodology uses a combination of quantitative indicators and information gathered from interviewing key stakeholders. The findings suggest that AfT works best when flows are additional and predictable, projects are owned by the

recipients' countries, donor objectives are aligned with host governments and local absorptive capacity exists, among other requirements.

Massa (2013) provides a comprehensive survey of the quantitative studies on AfT that have emerged over recent years. She finds that empirical evidence on the impact of AfT is scarce, but a number of studies have been attempted. The review shows that several econometric techniques with different degrees of sophistication have been used to assess the impact of AfT on trade and other economic performance factors in recipient countries, especially at the macro level. The methodologies include gravity model specifications, difference-in-difference estimations, panel data estimations and various econometric regression techniques, with each technique having its own advantages and disadvantages. The review suggests that AfT impacts vary considerably depending on the type of AfT intervention, the income level and geographical region of the recipient country, and the sector to which AfT flows are directed. Major issues identified in Massa (2013) include the fact that (1) the evidence on the impact of specific AfT interventions is still limited; (2) differences in AfT effectiveness by productive sector have been considered only to a limited extent; (3) the evidence on the actual effects of AfT at the micro level is scarce; and (4) databases on AfT need to be improved.

Finally, Cadot et al. (2014) conducted a survey of studies to highlight that a multiplicity of approaches is needed to learn what works and what does not. The authors found some evidence for an emphasis on reducing trade costs through investments in hard infrastructure (ports and roads) and soft infrastructure (such as customs). Support to exporters is found to lead to diversification across products and destinations, but the review could not confirm that the benefits were durable.

5.4.2 Empirical evidence relevant to small states

Most of the empirical studies available in the literature aim to ascertain if support measures can help reduce trade costs. They focus mainly on the whole group of developing countries. The unique challenges of small states are rarely considered. Our literature search seems to suggest that there exists only one study, Calì et al. (2011), that has examined small states' situation in particular using robust econometric techniques.

By using a large cross-country dataset of developing countries over a considerable period of time, this Commonwealth Secretariat-supported study (Calì et al. 2011) has made an attempt to offer more systematic evidence on the overall effectiveness of AfT in small states. As mentioned earlier, although the specific term 'Aid for Trade' is relatively new in multilateral trade-policy discourse, the concept is not. The OECD has long been reporting data on such flows to individual developing countries that are comparable to the six categories of trade-related assistance identified by the WTO (namely trade policy and regulations; trade development; trade-related infrastructure; building productive capacity, including private-sector development; trade-related adjustment, including support for adjustment associated with changes to international trade regimes; and other trade-related needs). This allowed Calì et al. to study the overall impact of AfT, and the various AfT types, using a panel dataset.

The underlying empirical work was carried out by constructing a theoretically consistent analytical framework to understand the routes through which AfT contributed to trade performance. This framework was then utilised in building empirical specifications, linking trade-related indicators to AfT and its various components while controlling for a host of other factors that can also affect countries' performance. Three types of impact were analysed: (1) the impact of AfT facilitation on the cost of trading (as measured by the time and costs of importing and exporting); (2) the impact of aid to economic infrastructure and of aid to productive capacity on total exports; and (3) the impact of aid to economic infrastructure and of aid to productive capacity on sectoral exports. Although the AfT data by recipient countries came from the OECD Creditor Reporting System (CRS) database on aid disbursements, the information on the cost and time of trading, aggregate and sector-specific exports, and other investment climate-related variables were compiled from different World Bank sources.

The key results emerging from the above mentioned empirical research suggest that a particular category of AfT, namely *aid for trade facilitation*, is likely to have had a significant cost-reducing effect on handling export and import trade in developing countries. The doubling of this type of aid is associated with a decrease in the cost of importing of 5 per cent. Small states are found to register particularly high returns on AfT facilitation, which is consistent with these countries' having, on average, higher unit transaction costs on exports (as these are spread over smaller volumes of exports).

The results further suggest that *aid to economic infrastructure* increases overall exports for developing countries, and more so for small states, whereas *aid to productive capacity* has no significant effect on exports. The weak effect of *aid to productive capacity* may be partly explained by a poor identification strategy, as this type of aid is mostly sectoral and thus should be measured against sectoral exports. When sectoral aid is used to explain the variation in sector-specific exports, a positive impact of AfT is found on tourism and mineral exports. This is an important result, considering the relevance of tourism in the export basket of small states. However, other sectors such as food and manufacturing exports, for which empirical analyses could be undertaken, do not appear to benefit from increased AfT flows.

One priority issue for small states is to achieve export diversification and structural transformation of their economies. Overwhelming dependence on primary commodities made the export sector critically reliant on tariff preferences that have been subject to erosion as preference-donor countries have undertaken either unilateral or regional trade liberalisation measures. Increased trading capacity for these countries will naturally lead to the need to generate supply response from non-traditional sectors. It is in this sense that export capacity-building should be linked to AfT support. There is no credible empirical work on small states that links structural transformation and AfT flows. However, one recent study (Cirera and Winters 2015) has addressed the same issue in the context of SSA. Given that export structures of SSA and small states are comparable (Razzaque 2011), some important insights may be obtained from this study.

The study by Cirera and Winters (2015) used econometric techniques to find out if AfT programmes have assisted the process of structural transformation in African

countries. They first assessed the impact on trade flows and trade costs, which are the main channels of transmission from AfT flows to structural change, and then examined the direct impact on structural change. Using a rich dataset on trade and aid flows for SSA countries from 1995 to 2010, the study showed that AfT flows appear not to have had any statistically significant impact, and the only positive impact that can be identified is a reduction in the time of exporting and importing. Overall, the results suggest that factors other than AfT flows explain different experiences in relation to structural change in SSA.

5.5 Strategic approaches to AfT to make it effective

One important issue to consider for building trade capacity is that AfT strategy needs to be in line with countries' broad development objectives. Despite the general recognition of the significance of achieving structural transformation, adopted policy options may be lacking in triggering the required changes. Generating supply response from non-traditional sectors can require going beyond across-the-board improvements in policy and enabling environments. Selective support mechanisms may be required without introducing any substantial policy reversals. The oversimplification of action programmes should be avoided to highlight the importance of specific tasks. One encouraging development has been that development partners and donor communities are increasingly supporting these specific interventions to promote export supplies.

Another factor is that the realities of small states can be quite different. Therefore, action programmes that are successful elsewhere may not be effective for many small states. At the outset, it is worth noting that, in the global AfT architecture, the peculiarities of small states are not well recognised; as a result, donor support programmes tend to be quite generalised. However, various regional and national initiatives seem to suggest that, within these standardised interventions, there now exists flexibilities for innovation.

The Global Reviews of Aid for Trade have helped secure development partners' greater response and engagement with the elated stakeholders to make trade components of their programmes more prominent. The policy discourse on AfT is vibrant and dynamic. Policy-makers, trade negotiators and other stakeholders regularly pay attention to the design of AfT projects, the trends in AfT flows and various AfT components, results and outcomes, and topical issues as programmes are implemented, as well as other aspects, and they often share experiences and best practice. There has been noticeable sharing of information and discussion of all relevant issues.

Against this background, small states can now be effectively strategic in demanding and utilising AfT resources that would help them to build trade capacity aligned to their developmental objectives. There is a huge and rapidly growing literature base, in which trade projects are being implemented and lessons derived thereof. Many factors highlighted in the literature are likely to be relevant for a large majority of recipient countries. As part of this chapter, a few strategic issues for small states are highlighted below.

5.5.1 Adequacy and predictability of AfT support

Although AfT resources have increased, it is important to recognise that their availability is still extremely low in comparison with the need of small states. Comparison of per capita aid disbursed will be misleading because of the small population sizes of small states. Infrastructure and public sector projects suffer from lack of economies of scale in countries with small populations.

Another factor associated with AfT flows is their predictability. Despite the expansion of trade support measures, their volatility is an important concern. This volatility can result in a loss of momentum in trade capacity-building projects, hamper implementation of associated economic policies and reform measures, and discourage private sector investment. However, it is worth mentioning that volatility has been a general problem affecting not only small states but also other countries, particularly in Africa (UNECA 2014).

Again, in spite of generally increasing trends, the resources disbursed fall short of commitments on a regular basis. The reasons for this phenomenon need to be better understood. This phenomenon could be an indication of a problem of absorptive capacities of recipient countries. However, as pointed out in UNECA (2014), such a tendency adds to unpredictability concerns and should be linked to the 'mutual accountability' pillar of the Paris Declaration of Aid Effectiveness. The regular gap between commitments and disbursements suggests that lessons are not being learnt in designing and implementing projects.

The lack of adequacy, unpredictability and volatility of flows should be put into perspective. If these problems persist, recipient countries should consider reviewing project implementation. Under these circumstances, rather than spreading resources over many different projects, the option of fewer successful projects should be looked into. Without sustained and deepened support, building trade capacities will be extremely challenging.

5.5.2 Trade costs and global value chains

Two issues that have added much dynamism to AfT policy discourse are trade costs and participation in global value chains (GVCs). The Fourth Global Review of Aid for Trade in 2013 was on the theme of 'connecting to global value chains', while the theme of the Fifth Review in 2015 was 'reducing trade costs for inclusive, sustainable growth'. Many AfT projects are focused on helping countries reduce trade costs, thereby enhancing recipient countries' external competitiveness. The support provided, particularly to trade facilitation measures, has generally been found to have a positive impact, cutting time-to-trade and costs of handling goods at borders. However, as GVC-led trade has become more prominent, there has been increased emphasis on improved trade facilitation measures, among others, as a means for being more competitive and plugging in to international production networks. Although there are many factors that determine countries' participation in GVCs, tackling excessive trade costs has been singled out as requiring the most policy attention.

Tackling trade costs of small states effectively requires a recognition of the need for actions that would go far beyond improved trade facilitation measures. There are inherent structural characteristics related to the trade costs of small states that can result in the systemic exclusion in GVCs, given the adverse effects of economic geography on external competitiveness. As well as suffering from the small size of their domestic markets, the situation of many small states is further exacerbated by their unfavourable geographical location, as reflected in the very long distances between them and the global centres of commercial activities. This inflicts serious disadvantages in terms of excessive trade costs.

In a Commonwealth Secretariat study, Razzaque and Keane (2015) analysed data from a pioneering World Bank–UNESCAP (United Nations Economic and Social Commission for Asia and the Pacific) project (Arvis et al. 2013) that provide trade costs between bilateral trading partners of up to 178 partners. Measured in *ad valorem* equivalent terms, the analysis finds that the average trade cost for the group of small states is at least 50 percentage points higher than that of the overall developing country group. When compared with the developed-country average, such cost disadvantages are three times higher. While developed countries have experienced significant falls in trade costs and developing countries show a generally declining trend, this is not true for the group of small states.

While the geographical distance between the bilateral partners exerts the largest impact on trade costs, other factors such as liner shipping connectivity has also been shown to have important bearings (Arvis et al. 2013). Indeed, the liner shipping connectivity index (with a high index value showing better connectivity) and trade costs are strongly and inversely correlated. Inherent structural characteristics of small states severely inhibit their prospects of improved shipping connectivity. Being far away from end markets will also result in longer export times to destinations from many small states, particularly those in the Pacific.

These excessive costs have serious implications for trade in general and for participation in GVCs in particular. A 10-percentage point increase in transport costs has been found to reduce trade volumes by about 20 per cent (Limao and Venables 2001). In addition, for a small price-taking country, *ad valorem* transport costs of 20 per cent on both final output and intermediate goods have been found to reduce the domestic value added (and thus GDP), including wages and profits, by 60 per cent when intermediate goods account for 50 per cent of costs. The implication of this is that, because of geographical location alone, foreign firms might be reluctant to move or relocate their production to these countries, even when wages are low (Redding and Venables 2004).

Although this issue of structural characteristics affecting participation in trade and GVCs is illustrated with the case of small states, many low-income developing countries, particularly in SSA, also suffer from similar disadvantages. The typical policy prescriptions of liberalised environment and good domestic policies automatically attracting foreign direct investment (FDI)- and value chain-led trade are likely to be less relevant to these circumstances.

Given the above, the typical policy prescription of trade openness and good domestic policies automatically attracting FDI- and value chain-led trade is likely

to be ineffective. It has been argued that distance matters more in supply chains and, even with today's information and communication technology revolution, global production networks are likely to remain concentrated in low-wage nations that are near, or even contiguous with, high-technology nations (Baldwin 2011).

This cost disadvantage of small states must be considered within the context of available value-added shares being low at the entry-level stages of the global production network. Based on the review of literature by Razzaque and Keane (2015), it is argued that GVCs are characterised by highly asymmetric distribution of valued added, in which high value-added activities are retained by lead firms, whereas low value-added activities are disbursed to developing countries.[9] Excessive trading costs vis-à-vis low value-added share in GVCs results in participation in GVCs being a daunting prospect for many small states.

The above has important policy implications for small states' AfT strategy. Of course, improved trade facilitation measures are important for these countries to improve their competitiveness. However, it will be extremely difficult to tackle the inherent structural factors (e.g. distance from major markets and weak shipping connectivity) with the help of AfT. Therefore, relying on trade facilitation alone to generate automatic supply response to enable countries to participate in GVCs needs to be assessed holistically. Where exports currently exist, improvement in trade logistics will help expand sales. Otherwise, generating supply response will require more sector-specific interventions.

The structural factors acting as constraints to trade generally means there is natural protection accorded to certain domestic activities, the growth of which is limited because of market size. However, the development of certain sectors can have special characteristics resulting in export success (e.g. brand products, exports with strong geographical indication). Services sectors may have a good potential for development, as many countries are already dependent on sectors such as tourism. Trade policy options and support measures available should be combined to develop these sectors, rather than considering investment in trade facilitation alone.

5.5.3 Building export capacity through targeted projects

As is suggested from the above, for small states, building productive capacity, particularly in sectors with export potential, should be considered a priority and this is an area where a strategic approach to AfT can be most useful. Supporting specific sectors is often considered not an ideal approach, but within a relatively open trade regime such a policy option is worth considering, especially when there are inherent structural disadvantages and supply responses are generally weak. A major criticism of AfT programmes has been that donors and relevant implementing agencies rely heavily on the broad architecture of trade support programmes and do not give sufficient consideration to enterprise development (Cirera 2009).

It is rather encouraging to find that some of the sectoral initiatives in small states are currently already under way. The Caribbean Rum Sector Programme is one example. The purpose of this scheme was to assist the sector with enhancing competitiveness

and move towards higher value products. According to OECD (2014), the interventions were extremely successful, as they resulted in the introduction of new brands in the EU market. A 20 per cent rise in female employment in the sector has also been reported. The programme was implemented with direct involvement of the private sector in each of the Caribbean Community and Common Market (CARICOM) countries. Another similar example is the Caribbean Trade and Private Sector Development Programme (CTPSD), under which about 200 companies and business support organisations were awarded grants.

One significant finding that came out of the empirical study by Calì and Razzaque (2013), also referred to earlier, is the lack of relationship between AfT provided to production sectors and sector-specific export response. It is essential to obtain further insights into the nature of support provided to the production sectors. Because of the structural factors described above, export success from all sectors will be difficult. Therefore, the selection of enterprises for support will be a delicate task.

One related issue is the adequacy of support. As mentioned above, AfT resources remain very small for small states. Capacity development at the enterprise level requires sustained efforts in terms of both resource and policy efforts. One component of AfT, known as the support for trade-related adjustments, has not been utilised much. There can be various adjustment requirements, ranging from tackling export shortfalls to capacity development for dealing with new trade measures and provisions. Nevertheless, adjustment support remains negligible. It has been argued that one of the main reasons for low utilisation of such assistance could be the problem of defining 'adjustment' (Silva 2013). Another potential reason could be the AfT reporting system's bias away from emphasising trade-related adjustment needs. The top recipients of AfT are mostly large, non-LDC and non-small state developing countries; for many of the top recipients, AfT priorities are dominated by non-trade-related adjustment categories, such as the need to improve infrastructure or to address gaps in trade facilitation. However, another reason that has been suggested is donors' reluctance to fund programmes with an explicit focus on adjustment. Whatever the reason for this may be, any potential adjustment support can also be utilised to develop specific sectors.

5.5.4 Regional integration

The small size of markets provides a strong rationale for regional integration. The traditional regional trading arrangement models that relied on exchange of tariff preferences to promote intra-regional trade are being replaced with schemes that consider deeper integration with the objectives of expanding markets, leveraging investible resources and harnessing region-wide trade and growth opportunities. Therefore, there has been a lot of emphasis on AfT targeted at regional initiatives helping to promote regional linkages between firms and producers, with the objective of facilitating development of the regional production network.

Small states under consideration here have broadly seen two types of regional integration initiatives. One is the Economic Partnership Agreements (EPAs)-led North–South integration, whereas the other is South–South integration involving

countries within their geographical neighbourhood. EPAs are largely preference based, in which the earlier non-reciprocal system that are favourable to African, Caribbean and Pacific group of states (ACP) countries have been/are being transformed into reciprocity-based arrangements. On the other hand, South–South integration within ACP regions is far more elaborate and aims to develop a regional trade network through the so-called 'corridor approach', as well as co-ordinated investments border customs related to hard and soft infrastructure.

Promoting regional integration has become prominent within AfT programmes, with significant investment being made in developing various corridors in Africa with the objective of facilitating uninterrupted and smooth flow of goods. Although some African small states are expected to benefit from these initiatives, improving regional connectivity in the Pacific and Caribbean remains a challenge. This also makes establishing a regional production network a difficult task. Although, for African small states, corridor approaches can help to reduce transport times and costs, thus addressing a major constraint to regional and international trade, it has been argued that recent examples have yet to prove their broader impact at the local or regional level (Byiers and Lui 2013).

5.5.5 Role of emerging economies

The emergence of developing countries as a major driving force of global trade flows has important implications for small states. Trade with fast-growing developing countries offers opportunities for specialisation, efficiency gains, export market diversification and investment flows. In response to the rise of the BRICS nations, there has been a recent resurgence in interest on South–South trade and co-operation as a vehicle for promoting trade-led development in the weaker Southern economies. Large developing countries are now also providing improved market access to others. Some of them, particularly China, have also become important providers of aid resources.

However, the nature of small states' participation in South–South trade is a cause for a number of concerns. Small states' exports to the South are predominantly primary commodities (Razzaque and Gosset 2015). This tendency towards international specialisation in trade greatly limits the participation of many.

One particular issue is that aid flows from emerging economies are not well documented and, currently, it is not clear how they link to AfT projects supported by other donors. Small states can consider undertaking co-ordinated mechanisms so that available aid resources from all sources are utilised in a coherent manner. In developing export sectors, as pointed out above, resources from emerging economies can be particularly useful. In addition, in certain cases, FDI can be attracted from emerging economies to develop export sectors to take advantage of trade preferences that are available elsewhere.

5.6 Conclusion

Small states face some unique challenges that have important consequences for their participation in global trade. Given this, the importance of AfT cannot

be overemphasised in building export capacities. These countries have become marginalised in global trade and the economic landscape, and, given their critical dependence on international trade, only robust export performance would help boost growth performance.

Although AfT flows have been on the rise, there exists significant scope for addressing the needs of small states much more effectively. Given challenges such as remoteness and isolation, excessive transportation costs and the need for hard and soft infrastructure development, the current level of support provided is greatly inadequate. In particular, assistance provided under one component of AfT, known as the support for trade-related adjustment costs, has been negligible. The empirical evidence that is available for small states seems to suggest that, although the support for trade facilitation has generally resulted in favourable outcomes, AfT provided to enhance productive capacity has not had any discernible positive impact on export performance.

As AfT continues to attract a lot of attention among all major donors, small states can be strategic in demanding and utilising AfT resources that would help them to build trade capacities to support their developmental objectives. First and foremost, the level of AfT flows to small states is greatly inadequate and volatile, with yearly disbursements falling short of commitments. Small states need to be proactive in working with donors to address these issues.

Owing to inherent characteristics, trade costs for small states are excessive, which makes participation in GVCs very difficult. Although trade facilitation measures can generally help improve competitiveness, cost disadvantages are so huge that generating export responses from non-traditional sectors will require a significant effort. One strategic approach will be to consider sector-specific export-promotion initiatives. There are already some such donor-supported projects; however, scaled-up and sustained efforts from both a policy and a resource perspective will be required. Regional integration initiatives for small states need to be better understood, as the popular approaches to promote cross-border regional co-operation may not be equally appropriate for island states. Finally, trade supporting resources from emerging economies should be mobilised and co-ordinated in line with the national priorities.

Small states can also benefit further from engaging more effectively with the ongoing relevant policy discourse. The current AfT architecture has a general focus on trade-related impediments and does not consider their special challenges, resulting in very generalised support measures. Small states should play a proactive part so that their special circumstances are well articulated and attract wider attention. This can also make the AfT regime more innovative and effective.

Notes

1 The author is Adviser & Head of International Trade Policy, Commonwealth Secretariat, London, UK. The views expressed in this chapter are those of the author and do not necessarily represent those of the Commonwealth Secretariat.

2 According to this definition, independent states with populations of fewer than 1.5 million people are considered small states. There are, however, a few exceptions, where countries have slightly larger populations but are thought to have similar characteristics as small states.

3 See, among others, Qureshi and te Velde (2008) for a more complete analysis of the challenges faced by small states.
4 There are few studies that have investigated the relationship between a country and the costs of doing business. Various competitiveness and trade logistics indicators do reveal that many small states have weaker performances. Using cross-country primary data from about 100 countries, Winters and Martins (2005), in a Commonwealth Secretariat study, provided robust evidence that business costs, particularly those associated with transportation and labour, are significantly higher in small states.
5 This is based on the widely used United Nations Conference on Trade and Development (UNCTAD) export diversification index.
6 The phenomenon of disbursements being smaller than commitments is not found only in relation to small states. Globally, the shortfalls between disbursements and commitments have been quite significant.
7 There are also five small states from Asia and three from Europe.
8 For example, it is estimated that the per capita AfT flows in SVEs in 2009 were about five times higher than the developing-country average.
9 Based on their review of the literature, Razzaque and Keane (2015) reported that coffee and cocoa producers received just 10–15 per cent of the final retail price. In the case of apparels, the corresponding figure is higher, at 30 per cent, but this margin included two-way shipping costs (imports of raw materials and exports of final products).

References

Ancharaz, V, P Ghisu and C Bellmann (2013), 'Chapter 7: Assessing the Effectiveness of Aid for Trade: Lessons from the Ground', in Razzaque, M A and D W te Velde (Eds), *Assessing Aid for Trade: Effectiveness, Current Issues and Future Directions*, Commonwealth Secretariat and ODI, London.

Arvis, J F, Y Duval, B Shepherd and C Utokhtam (2013), 'Trade Costs in the Developing World 1995–2010', World Bank, Washington, DC, available at: http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-6309 (accessed 23 March 2015).

Baldwin, R (2011), 'Trade and Industrialisation after Globalisations 2nd Unbundling: How Building and Joining a Supply Chain are Different and Why It Matters', NBER Working Paper No. 17716, National Bureau of Economic Research, Cambridge, UK.

Basnett, Y and J Engel (2013), 'Chapter 6: Aid for Trade in Practice: Addressing Political Economy Barriers to Improve Development Outcomes', in Razzaque, M A and D W te Velde (Eds), *Assessing Aid for Trade: Effectiveness, Current Issues and Future Directions*, Commonwealth Secretariat and ODI, London.

Byiers, B and D Lui (2013), 'Regional Aid for Trade Effectiveness and Corridors', ODI and ECDPM Report.

Cadot, O, A Fernandes, J Gourdon, A Matto and J De Melo (2014), 'Evaluating Aid for Trade: A Survey of Recent Studies', Policy Research Working Paper 6742, World Bank, Washington, DC.

Calì, M, M Razzaque and D W te Velde (2011), 'Effectiveness of Aid for Trade in Small and Vulnerable Economies', Economic Paper 91, Commonwealth Secretariat, London.

Calì, M and M Razzaque (2013), 'Chapter 5: Aid for Trade: Impact on Sub-Saharan Africa', in Razzaque, MA and DW te Velde (Eds), *Assessing Aid for Trade: Effectiveness, Current Issues and Future Directions*, Commonwealth Secretariat and ODI, London.

Cirera, X (2009), 'Changing the Aid for Debate towards Content', Institute of Development Studies, IDS In Focus Policy Briefing 6, Brighton, UK.

Cirera, X and L A Winters (2015), 'Aid for Trade and Structural Transformation in Sub-Saharan Africa', Commonwealth Trade Policy Discussion Papers, issue 2015/01 Commonwealth Secretariat, London.

Limao, N and A Venables (2001), 'Infrastructure, Geographical Disadvantage and Transport Costs', World Bank Policy Research Working Paper No. 2257, World Bank, Washington, DC.

Massa, I (2013), 'Chapter 2: Impact of Aid for Trade: A Survey of Empirical Evidence', in Razzaque, M A and D W te Velde (Eds), *Assessing Aid for Trade: Effectiveness, Current Issues and Future Directions*, Commonwealth Secretariat and ODI, London.

Milner, C, O Morrissey and E Zgovu (2011), *Policy Responses to Trade Preference Erosion: Options for Developing Countries*, Commonwealth Secretariat, London.

Nurse, K and G Greene (2014), 'Aid for Trade and Export Diversification: The Case of Barbados', World Trade Organisation, Geneva.

OECD (2014), *Regional Perspectives on Aid for Trade*, Organisation for Economic Co-operation and Development, Paris.

Qureshi, M and DW te Velde (2008), *Working Smart and Small: The Role of Knowledge-Based and Service Industries in Growth Strategies for Small States*, Stylus Publishing, London.

Razzaque, M A (2011), 'The Poorest, Smallest and Most Vulnerable Economies in Global Trade: A Role for the G20', paper prepared for Commonwealth-Le Francophonie Annual Dialogue with the G-20, held in Cape Town, South Africa.

Razzaque, M A and L Gosset (2014), 'Trading with the Rising South: Opportunities and Challenges for Sub-Saharan Africa', *Commonwealth Trade Hot Topics*, Issue 113.

Razzaque, M A and L Gosset (2015), 'Small states in South-South Trade: Trends and Issues', *Commonwealth Trade Hot Topics*, Issue 120.

Razzaque, M A and J Keane (2015), 'Delivering Inclusive Value Chains', paper prepared for Commonwealth-Le Francophonie Annual Dialogue with the G-20, held in Washington, DC.

Redding, S and A Venables (2004), 'Economic Geography and International Inequality', *Journal of International Economics*, Vol. 62, pp. 53–82.

Silva, S (2013), 'Chapter 13: Aid for Trade Adjustment: Implications for Small and Vulnerable Economies and Least Developed Countries', in Razzaque, M A and D W te Velde (Eds), *Assessing Aid for Trade: Effectiveness, Current Issues and Future Directions*, Commonwealth Secretariat and ODI, London.

UNECA (2014), *Building Trade Capacities for Africa's Transformation: A Critical Review of Aid for Trade*, United Nations Economic Commission for Africa.

Winters, A and P M G Martins (2005), *Beautiful but Costly: Business Costs in Small Remote Economies*, Commonwealth Secretariat, London.