

# trade hot topics

## Aid for Trade in Small and Vulnerable Economies

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### Background

The discussions around Aid for Trade (Aft) have tended to treat beneficiaries as a fairly homogeneous group of developing countries. However, and quite obviously, groups of recipient countries differ according to a variety of factors and needs, which are important to acknowledge in devising any Aft strategy. This issue of Commonwealth Trade Hot Topics focuses on a specific group of developing countries – small and vulnerable economies (SVEs) – which has largely been neglected in the Aft debate, despite the special challenges these countries faced in their integration into the global economy. In this context, the objectives here are three-fold: highlighting the rationales for providing Aft to SVEs; examining the past flows of Aft to these countries; and evaluating the effectiveness of this type of assistance to SVEs comparing it to other developing countries. Some policy suggestions to maximise the benefits of Aft for SVEs are also provided.

### The rationales of Aft to SVEs

The group of SVEs includes mainly the African, Caribbean, and Pacific small and island states. Due to their small populations, the domestic market is limited in these countries. As a result, most of the firms are small and medium enterprises with limited opportunities for reaping the benefits of economies

of scale and investing in research and development. Also, most SVEs have a poor investment climate, weak institutions, are remote, and lack skilled labour or adequate human capital, which limits access to external capital and constrains industrial development.<sup>1</sup> All these factors contribute to high unit production costs for firms in these countries. The high production costs are compounded by high transportation costs due to the remoteness and insularity of many small states. This implies that SVEs need to charge higher prices to stay in business, accept lower returns on some part of their costs as compared to larger economies, or compensate cost advantages in some other way (for example, more flexible governance).

SVEs are particularly vulnerable to fluctuations in world prices due to their limited size and dependence on international markets. For most economies in the Pacific and Caribbean regions, the combined share of the two most important commodities/services is over 50 per cent in the total exports of goods and services. Importantly, the cost of doing business in small states seems to be generally higher than in other countries. In a Commonwealth Secretariat study, Winters and Martins (2005) find that business costs, particularly

<sup>1</sup>See Qureshi and te Velde (2008) for a more complete analysis of the challenges faced by small states.

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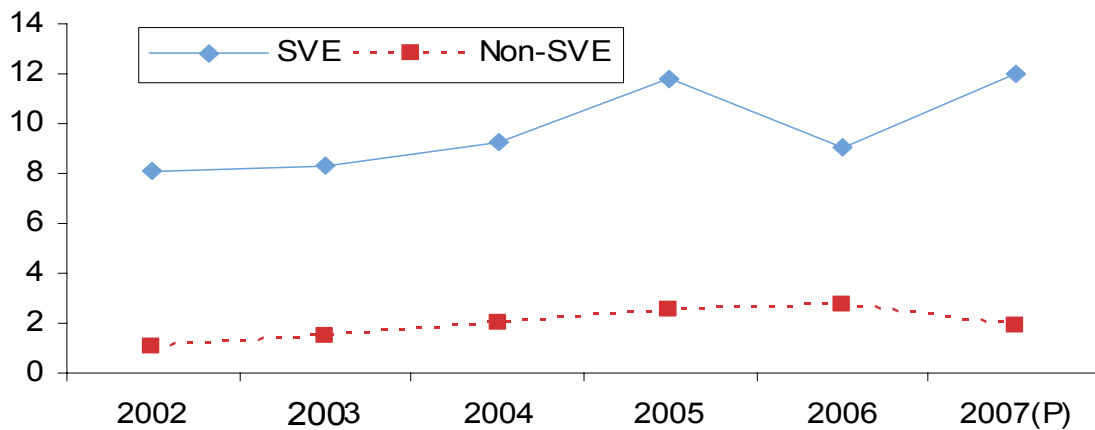
transport and labour, are significantly higher in small states. Small consignment size, poor infrastructure, lack of competition and weak institutions inflate the costs of trade, and create such strong economic disadvantages for these countries. In this context, well designed trade-related assistance may help SVEs

face the challenges posed by their characteristics. This is particularly the case during a time when the prospects for small states have deteriorated further due to (future) preference erosion and the emergence of new, large competitors (Briguglio et al, 2006).

### AfT flows to SVEs

The above discussion suggests that SVEs are a category of countries in special needs at least on the basis of two of the main rationales of AfT, that is, weak capacity to trade and high adjustment costs. Despite this, no donor has specific AfT programmes for this group of countries.<sup>2</sup> Notwithstanding the lack of specific programmes for SVEs, these countries have historically received higher levels of AfT per capita relative to other developing countries (Figure 1). This is consistent with the pattern for general aid and it is driven by the small population of these countries. 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.

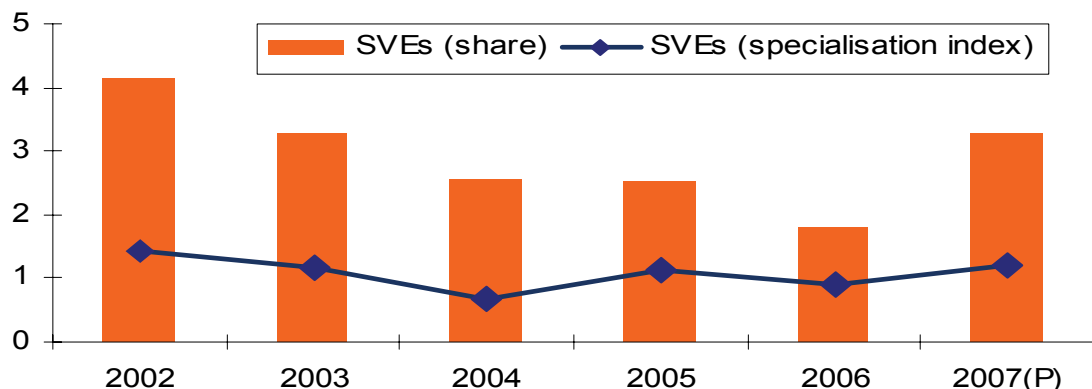
Figure 1: AfT to SVEs and other developing countries (US\$ per capita)



Note: Preliminary data available for 2007. Source: Authors' calculation on OECD/DAC Creditor Reporting System

Are SVEs receiving more or less aid as AfT relative to other countries? To answer this question, a specialisation index, defined as the ratio of the share of SVEs in total AfT and the share of the SVEs in total Official Development Assistance (ODA), is calculated. The value of the index greater than 1 indicates that aid to SVEs is more concentrated towards AfT than aid to other developing countries. The index shown in Figure 2 suggests that, despite some occasional fluctuations, SVEs appear to have AfT concentration (in total aid inflows) comparable to other developing countries.

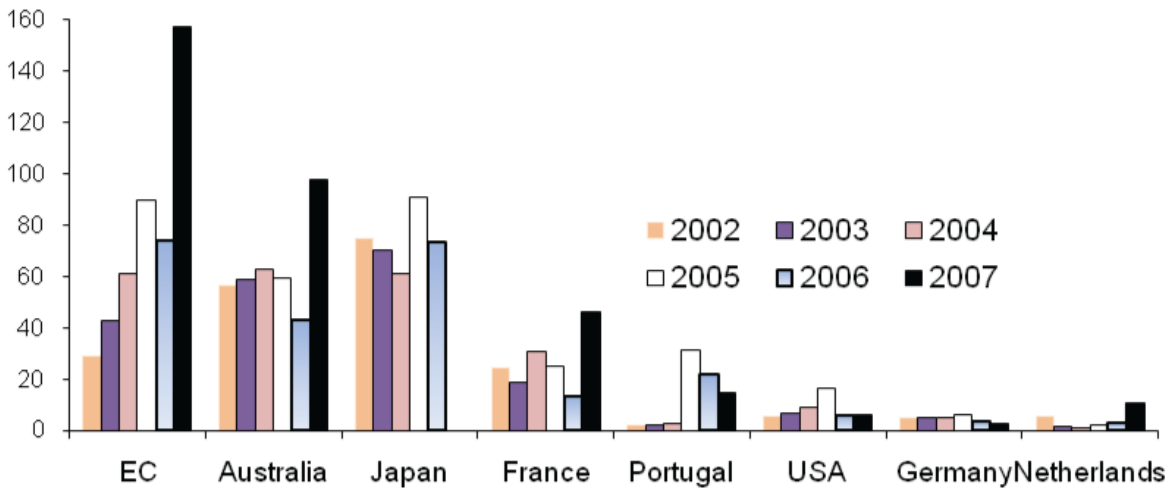
Figure 2: AfT to SVEs (share in total and specialisation index)



Note: Preliminary data available for 2007. Source: Authors' calculation on OECD/DAC Creditor Reporting System

What countries provide Aft to SVEs? Figure 3 shows that the European Commission (EC) has been consistently the largest donor during 2002-07, with more than US\$150 million disbursed in 2007, almost double the amount of 2006. Australia and Japan are the other main Aft donors to SVEs, with the former more than doubling its assistance in 2007. Other relatively large donors to SVEs include France, Portugal, the USA, Germany and the Netherlands.

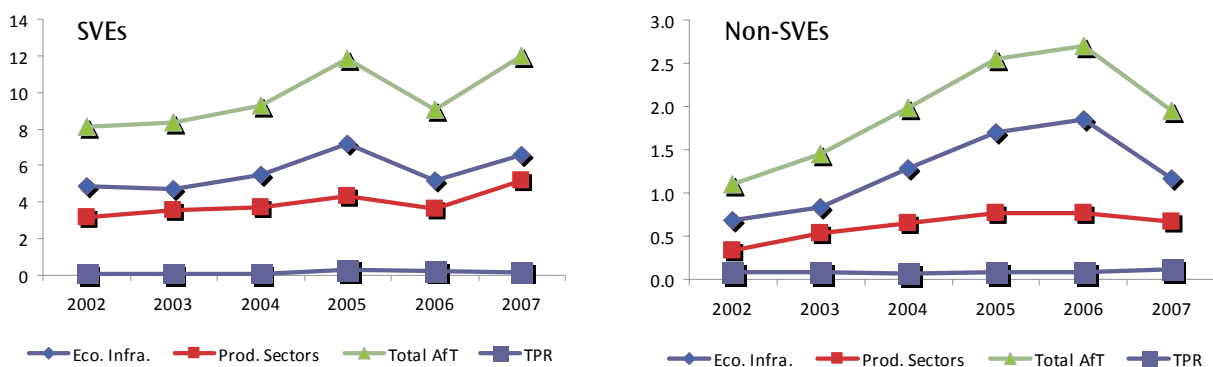
Figure 3: Aft disbursement to SVEs, by donor and year (current US\$ million)



Note: Preliminary data available for 2007. Source: Authors' calculation on OECD/DAC Creditor Reporting System

The distribution of spending of Aft in SVEs across main categories is broadly in line with that for other developing countries, as shown in Figure 4. The largest share accrues to economic infrastructures, followed by aid to productive sectors and aid to trade policy and regulations. The major difference relates to the smaller importance of aid to infrastructure in SVEs relative to non-SVEs, for which this type of Aft was three times larger than aid to productive sectors in 2006. On the other hand the ratio between these two types of Aft was just above one for SVEs.

Figure 4: Aft disbursement to SVEs and non-SVEs by category (US\$ per capita)



Note: Preliminary data available for 2007. Source: Authors' calculation on OECD/DAC Creditor Reporting System

<sup>2</sup>(Page2) There are a number of programmes that may be particularly relevant for SVEs as they address some of the trade-related shocks likely to be faced by these countries, such as the European Union's Special Framework of Assistance (SFA) for bananas, the Special Fund for Rum and the Trade integration mechanism. However, there is no programme we are aware of that addresses specific trade constraints of SVEs such as remoteness and smallness.

## AfT effectiveness and SVEs

The existing evidence based on independent evaluations of specific trade related aid programmes on trade performance is mixed. This examination is challenging owing to the difficulty in isolating the impact of AfT programmes on the recipients' economy. This attribution problem has often resulted in a lack of clear and measurable objectives and indicators in programming documents. However, some problems in the programming and delivery of AfT seem apparent. For example, administrative constraints faced by African, Caribbean and Pacific (ACP) countries in dealing with European Union procedures usually lead to very slow rates of aid disbursement, which may undermine the value of the assistance extended in support of time

need to be interpreted with caution as they are valid on average but may not be applicable to specific countries. In fact, the effectiveness of AfT in boosting trade related performance is likely to depend crucially on a large number of country-specific factors, which are not captured by the cross-country data analysis. Nevertheless, such analysis may provide some general indication of what types of AfT seem to be more or less effective.

The results suggest that a particular category of AfT, that is, aid for trade facilitation, is likely to have a significant cost-reducing effect on the costs of handling exports. SVEs seem to enjoy particularly high returns on aid for trade facilitation, which is consistent with these countries' having on average higher unit transaction costs on exports (as these are

Table 1: SFA allocation and payments (as of December 2004)

Country 9th EDF National Indicative Programme	1990-2005 SFA Allocation	Total disbursements	Disbursement as % total allocation
St Vincent and the Grenadines	40,589,801	3,119,992	7.70%
St Lucia	58,234,810	16,043,206	27.50%
Dominica	43,513,625	4,531,201	10.40%
Grenada	4,000,000	399,974	10%
TOTAL	146,338,236	24,094,373	16.50%

Source: compiled by the author from text of the various agreements

sensitive adjustment processes. Table 1 illustrates the extent of this problem as far as the EC Special Framework of Assistance (SFA) for bananas and rum are concerned for a number of SVEs. Moreover, our review suggests the importance of ownership, alignment and harmonisation as critical factors of success of AfT, much in line with the traditional aid effectiveness literature. The implications mainly refer to the need to involve stakeholders, and trade and other officials in beneficiary countries from the very beginning – to help design programmes, devise specific objectives and implementation strategies, keeping country-specific conditions in mind.

Lack of proper data and benchmarks (for example, in terms of outcome variables to evaluate the project against) has often constrained the possibility of properly assessing the effectiveness of AfT over a large number of projects. By using a large panel dataset of developing countries, in a study for the Commonwealth Secretariat, we provide new more systematic evidence on AfT effectiveness. We examine the overall impact of different types of trade-related assistance on specific trade-performance indicators. The results obtained

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 SVEs, while aid to productive capacity has no significant effect on exports for either SVEs or non-SVEs. The weak effect of aid to productive capacity may be partly explained with a poor identification strategy, as this type of aid is mostly sectoral and thus should be measured against sectoral exports. When we do this (using sectoral exports and sectoral aid for four broad sectors), we find heterogeneous effects of AfT across sectors. In particular, sectoral aid seems to have a positive impact on tourism and mineral exports, which is larger in SVEs than in non-SVEs. On the other hand, food and manufacturing exports by SVEs do not appear to benefit from higher AfT.

## Conclusions and policy suggestions

On the basis of the above discussions, some general AfT related suggestions for donors as well as for SVE policy-makers that can be put forward are the following:

- First, donors could consider introducing AfT

programmes (or projects) addressing specific trade-related constraints faced by SVEs, including remoteness and isolation as these seem to be binding especially in a world of increased trade integration. These could include among others the strengthening of trade-related infrastructure, both communications and transport, as well as the development of appropriate professional skills especially for the services market, where the disadvantages of remoteness and smallness are less severe.

- Second, donors should improve the disbursement rules of AfT. Slow disbursement tends to undermine the value of the assistance extended in support of time sensitive adjustment processes, such as the trade-related ones experienced by SVEs.
- Third, it would be desirable that donors programmed their trade-related activities for longer time spans and with a more active participation of the recipients. This would increase the predictability and ownership of AfT flows. These recommendations are in line with those for general aid, but given the high variability of trade-related aid in particular towards SVEs, they may be of particular importance in this context.
- Fourth, donors could consider scaling up the level of aid for trade facilitation as this appears to be a particularly cost-effective investment. This is particularly the case for SVEs.
- Fifth, as the impact of aid to economic infrastructure on exports seems to be especially high in SVEs, it would be worth considering the opportunity of increasing its allocation.
- Sixth, donors should work with recipients to identify those contexts in which there is more need for aid to productive sectors, considering that this form of aid seems to work better in certain sectors in SVEs, such as tourism and minerals.

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# International Trade & Regional Co-operation Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth - an association of 53 independent states, comprising large and small, developed and developing, landlocked and island economies - facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITRC is entrusted with the responsibilities of undertaking policy-oriented research and analysis on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITRC approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on two highly vulnerable Commonwealth constituencies - least developed countries (LDCs) and small states.

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- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development-friendly outcomes, notably their economic growth through expanded trade.
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- It contributes to the processes involving the multilateral and bilateral trade regimes that advance the more beneficial participation of Commonwealth developing country members, particularly small states and LDCs.

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- 8-10 October 2008: African Workshop on Economic Partnership Agreements - Reaping the Benefits on the EPAs, held in Addis Ababa, Ethiopia
- 9-10 September 2008: Meeting on Private Enterprises and EPAs, held in Addis Ababa, Ethiopia
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- 28-30 August 2008: 1st South Asian Economic Summit, held in Colombo, Sri Lanka
- 28-29 August 2008: Regional Dialogue on ACP-EU Fisheries Relations, held in Windhoek, Namibia
- 12-13 August 2008: Global Partnership for Development, held in New Delhi, India
- 4-5 August 2008: Business Implications of EPA Negotiations for the East African Community (EAC), held in Kigali, Rwanda
- 25 July 2008: Seminar on Commonwealth Trade Policy Activities, held in London, UK
- 8 July 2008: Meeting of Geneva Group of Commonwealth Ambassadors, held in Geneva, Switzerland
- 7-8 April 2008: Workshop on Economic Partnership Agreements, held in Cape Town, South Africa

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