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Implementation and Adjustment Costs: Special and Differential Treatment and Assistance for Developing Countries

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1. Introduction

There is a clear recognition that some institutions in developing countries are inadequately resourced to deal with the implementation of trade agreements. There is also clear evidence of large adjustment costs associated with structural changes forced on economies by trade liberalisation. Both of these costs impact disproportionately on developing countries whose institutions are least capable and whose populations are most vulnerable. Together these costs represent the largest political barriers to multilateral trade liberalisation.

Special and differential treatment is both a cause of and a solution to these costs. To the extent that SDT minimises the impact of structural adjustment, it is likely to improve welfare and facilitate progress. However if SDT creates additional trade distortions through short-run preferential treatment, its benefits may be outweighed in the long-run by adjustment costs to the beneficiaries and negative effects on non-beneficiaries.

There are three problems with the way SDT is being implemented in the Doha Round. First the commitments of developed countries regarding preferential treatment are problematic because they are non-binding and not designed to maximise developing country welfare. Rather, the focus has been on concessions that are of the least cost to the special interests that have been central to trade policy in the developed countries. Second, there is a paternalistic (but nonetheless sincere) fear that less liberal trade policies embodied in some SDT provisions may not be optimal for developing countries. Third, to the extent that some SDT instruments lead to trade distortion in the short run, they may be increasing the adjustment costs incurred by all countries.

Discussions over the Development Round have highlighted a fourth problem, one that emerged in the aftermath of the Uruguay Round. Special trade agreements of those in geographical proximity have increasingly become accepted (regional trade agreements), though in many quarters, there has been concern that such arrangements undermine the multilateral system.[1] But in the modern world of rapid communication and low cost transportation, there is no reason that such trade agreements should, if they are acceptable, be limited to those in immediate proximity. De facto, the U.S. agreements with Chile, Singapore, Jordon, and Israel exemplify this. But even more important are the far deeper connections among countries that are based on long historical ties. Such is the case, for instance, with the countries of the

[1] See, e.g. Bhagwati [ ] or the World Bank [Winters book]

Commonwealth, or those in the Francophone zone. Any new international agreement should be mindful of the benefits of these connections, and of the costs of weakening them. Trade links are an important part of these connections, and historically preferential treatment has strengthened them. The gains from trade *within* a trading bloc with diversity are arguably far greater than the gains from trade within a trading bloc lacking such diversity. Again, even if our ideal world were one in which there were no trade barriers (and no subsidies), and in such a world, there would be no room for such preferential agreements, we are now far from that world. The management of moving towards that ideal world has to be done with care. The elimination of certain preferences, which large subsidies and distortions and other forms of trade barriers remain in place, may impose undue, and unnecessary hardship.

SDT provisions need to be designed as part of a broad development package sensitive to the institutional weaknesses of different countries and linked to assistance packages.

2. Adjustment Costs

Adjustment costs play a central role in the political economy of trade liberalisation. If labor and capital could move between industries without cost and domestic populations could be completely compensated for price changes, there would be significantly less resistance to multilateral trade liberalisation. Indeed, with adequate compensation, there would be a demand for unilateral elimination of trade barriers; it would be exporters that would be dragging their feet, insisting that the reduction in import duties be used as leverage to get more market access.

In reality trade liberalisation impacts differently on various subpopulations, creating 'winners' and 'losers' from structural changes.

Structural changes caused by trade liberalisation can involve several sources of adjustment costs. First, trade liberalisation affects the prices of goods and services that the poor consume and produce. Inflows of foreign goods can harm the domestic producers of competing products. Reduced demand for some domestic goods increases unemployment and reduces wages in affected industries.

Second, trade liberalisation can affect wages and other factor prices more generally. The experience of reform led to increased inequality in several Latin American countries. Brazil, Chile and Colombia all experienced increases in the premiums paid to skilled workers. The decline in the relative wage of unskilled workers was provoked by the entry of several large unskilled-labor abundant countries into the international market. [2]

Third, trade liberalisation can cause short-term transition costs such as unemployment, and increase the volatility of economic growth. Among these transition costs are induced unemployment. In economies facing a problem of insufficiency of aggregate demand, there may be multiplier effects.

Fourth, it can reduce government revenue and with it the resources available for anti-poverty programs. This was particularly problematic in transition economies where trade liberalisation led to the dismantling of the system of implicit trade taxes.

Fifth, liberalisation may make an economy more vulnerable to external shocks. The Asian crisis emphasised the increased volatility of open economies and the danger of premature financial sector liberalisation. The crisis dramatically increased poverty in affected countries.

The effects of adjustment costs are most severe in developing countries. Developed countries are able to mitigate the effects of adjustment costs on their populations through government intervention. Social safety net programs including social insurance, price subsidies, public works, or development programs can compensate the losers and minimise the effects of trade liberalisation on income distribution.

2. Instruments of SDT

Special and differential treatment is one means of reducing the effect of adjustment costs on poor economies. SDT provisions in the WTO fall into two categories: (a) positive actions by developed countries to provide preferential access to less developed countries and additional rights in the agreements and (b) exceptions to the existing agreements including time limited derogations, favourable treatment regarding tariff and subsidy reduction commitments, and thresholds in the application of countervailing measures.

(i) Preferential access

The benefits of preferential market access agreements for developing countries have been eroded by large reductions in developed countries'

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[2] World Bank (2001) World Development Report 2001.

MFN tariff rates under the Uruguay Round. For instance in Japan, the US, and the EU, the preference margin between MFN tariff rates and the rate applying to imports from Sub Saharan Africa fell from 4.25 to 2.47 per cent as a result of the Uruguay Round.

Also if developing countries only sell part of their production in preferential markets, then they are selling the rest of their output at lower than normal prices because of the depressing effect of OECD protection on prices in the rest of the international market. Developing countries might, accordingly, benefit more from an across the board cut in the tariff than from a preferential tariff reduction.

Another major problem with preferential access provisions is that they are non-binding on developed countries. As a consequence developing countries are at the mercy of the goodwill of developed countries. This has become of increasing concern as the United States has imposed political conditionality. When developed country governments are selective in their provision of preferential treatment, then there will be trade diversion, and the use political conditionality reinforces the view of trade as a political instrument, impairing confidence in the motives of broader gauged reforms.

Preferential agreements harm those countries that are not in the agreement, including many who are very poor. Borrell (1999) discusses this point in the context of the banana dispute of the 1990s in which one study showed that for every dollar of benefit to producers of bananas in ACP countries, the regime harmed non-ACP developing country producers by a similar amount and reduced the welfare of EU consumers by 13 dollars. This type of scheme does not seem to be a very efficient means of assisting banana producers in ACP countries, who could be directly compensated by gains from removing the preference.

In addition, preferential agreements are by their nature trade diverting. They thus have negative effects on developing countries outside the preferences and, to the extent that the preferences are short-term, they will create further adjustment costs.

Finally, preferential agreements often do not cover products in which beneficiary countries have comparative advantage. In these industries increased market access would have the most impact and thus the domestic opposition in developed countries is often strongest. This means the most promising sectors are often those that benefit the least.

As a result of all of these problems, many observers believe that deals involving preferential access offered by developed countries have tended to be at best ineffective and at worst harmful to developing countries as a whole.

(ii) Special treatment within WTO agreements

On the other hand, allowing developing countries longer periods of adjustment (especially when those countries face a high unemployment rate), may lower the adjustment costs (including the induced unemployment rate.) For example the agreement on Subsidies and Countervailing Measures allows for a transition period of 8 years, while the agreement on Trade-Related Intellectual Property allows for a transition period of 5 years.

In addition, making the adjustment period conditional on macro-economic conditions, like unemployment, may provide the international community with an incentive to provide assistance and advice that will enable the developing countries to remain at full employment.

However transition periods seem to be determined almost arbitrarily. There is little analysis of the time and resources to build institutional capacity where it was inadequate or totally lacking. Transition periods are determined independently of national circumstances and commitments of technical assistance. Without additional resources to direct towards the implementation and administration of WTO agreements, longer transition periods are of little use.

Greater flexibility in timing is only one way of providing SDT within the WTO. For instance, it also makes sense to provide developing countries with greater latitude to provide technological assistance (under the infant industry argument) may facilitate their ability to catch up to more developed countries. International agreements limiting the length of time for which such assistance can be provided may remove one of the persistent objections to such infant industry subsidies: the infants often never grow up.

(iii) Technical Assistance

The main objective of technical assistance to developing countries is the strengthening of their institutional capacity for the purpose of implementing WTO agreements.

There is a need to address the scope of technical assistance and the capacity of the WTO to adequately provide it within existing structures. Helping low income countries strengthen their institutional capacity to permit them to meet WTO agreements will require not only technical assistance but also significant financial assistance. The costs of implementation of WTO commitments are very substantial. [3]

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[3] Finger and Schuler (1999) "The implementation of Uruguay Round Commitments: The development challenge", Policy Research Working Paper no. 2000, World Bank, Washington D.C.

While a limited assistance program may assist developing countries to implement reform, technical assistance is not sufficient to deal with the economy-wide adjustment costs associated with structural change. These costs, which generate domestic opposition to trade liberalisation, are no less important barriers to progress than the lack of institutional capacity.

In addition, lack of institutional capacity has the effect of limiting the access of developing countries to justice within the dispute system. Developing countries are disadvantaged in complex and expensive legal proceedings. An expansion of existing legal assistance schemes will be an important prerequisite for institutional fairness.

The bulk of technical assistance has fallen on international organisations. Both the World Bank and the WTO have increased their technical co-operation activities. However as much as 90 per cent of financing for these activities is provided by trust funds provided by two or three bilateral donors, while the WTO itself has typically allocated for technical co-operation activities less than one per cent of its total annual budget – less than half a million US dollars, Michalopoulos (2000). [4]

[4] Michalopoulos, C. (2000) 'The role of special and differential treatment for developing countries in GATT and the World Trade Organisation' World Bank mimeo.