More on Trade & Transition[1]

ISSUES OF TRANSITION TO THE CHANGING GLOBAL TRADE REGIME

Erosion of trade preferences

1. Recent years have seen the progressive liberalization of world trade as a consequence of unilateral liberalization by countries; proliferation of regional trade arrangements; and agreements reached under the auspices of the WTO. As a result the trade preferences once afforded to small states have been eroded. Indeed, following the agreement on post-Lomé arrangements recently concluded between the European Union (EU) and the 71 African, Caribbean, and Pacific (ACP) countries, the latter will have to gradually give up the principle of non-reciprocal trade preferences. In addition, small non-LDC states will face increased competition from non-ACP LDCs as these countries will enjoy duty free access to EU markets on "essentially all products" as a result of a unilateral EU commitment to be implemented over the 2000-2005 period.

2. The European Union has entered into many new trade agreements, and the Maastricht Treaty has set the new framework for development cooperation, linking it (if only implicitly) to the EU's external policy. The Lomé IV Convention, which epitomized a unique relation between the EU and a substantial group of its development partners, lapsed at the end of February this year. While a number of the trade preferences of the Lomé Convention will be rolled over for a limited period (until end of 2007), there is little doubt that this unique EU-ACP relationship will undergo adjustment with the elaboration of alternate trade arrangements (after 2007) that are both compatible with WTO rules and take account of the capacity of small states to adapt their economies in response to liberalization. Similarly, while small states were treated at par with LDCs in many of the Convention provisions, this special treatment of small states has been called into question with the new provisions on access to additional funding in the event of shortfalls in export earnings (see Box 1). Fundamental to this shift in policy has been a change in trade patterns, with an increase in the importance of trade in manufactures and services (mostly with non-ACP countries) and a decrease in the importance of importing raw materials and exporting manufactured products (mostly from and to ACP countries). The development of the single European market with trade policy decisions made at the Union level is a further factor affecting many small states.

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[1] This text is extracted from ***Small States: Meeting Challenges in the Global Economy***, Report of the Commonwealth Secretariat/World Bank Joint Task Force on Small States, Washington DC and London, April 2000.

Box 1. Status of small states in EU-ACP relations

The provisions of the Lomé IV Convention between the European Union and 71 African, Caribbean, and Pacific (ACP) countries and the post-Lomé ACP-EU Partnership Agreement give special treatment to small states, often equivalent to that offered to LDCs.

First, recognizing the dependency on commodities of many ACP countries, the Lomé Convention provided compensation for shortfalls in commodity export earnings through its Stabex and Sysmin mechanisms, with LDCs, landlocked and island states eligible on conditions that were less restrictive than for other ACP countries. Under Lomé IV, small economies in the Caribbean have been among the substantial beneficiaries of the Stabex facility. These resources have helped countries to diversify and have promoted sectoral competitiveness.

Second, small economies also benefited from the various commodity protocols (banana, sugar, rum, beef, and veal), although many of these have been dismantled as a result of the recent negotiations on post Lomé arrangements.

In addition to these provisions, small vulnerable states receive higher financial aid per capita from the European Development Fund than other developing countries.

Changes to Lomé under the new "Partnership Agreement"

In addition to the effects of adapting Lomé commodity protocols to WTO rules, small states can be affected by the new framework of additional macroeconomic support established under the Partnership Agreement to replace the Stabex and Sysmin schemes so as to mitigate the adverse effects of instability in export earnings, particularly from the mining and agriculture sectors. In this new setting some small states may, however, find themselves ineligible for these additional resources, because the qualifying threshold has been set high; a lower threshold applies to LDCs. The new arrangements also provide support for market-based insurance schemes to address export earnings fluctuations.

There is a further distinction between LDCs and small states in the proposed new trading arrangements to replace Lomé preferences in line with the WTO rules. By 2005, LDCs will benefit from duty-free access to EU markets for "essentially all goods"—a preference that will not be extended to small states in general.

3. In just one example, the new trading environment has produced changes in the regulation of the market for bananas because the old regulation was considered incompatible with WTO rules. Though changing the regulation of the market for bananas will yield considerable benefits for European consumers, the short-term cost of the loss of banana preferences is high for a number of small states in the Caribbean, some with relatively undiversified economies (Table 1). The dispute over bananas has had wider implications. In its judgement on the EU banana regime, the WTO Dispute Settlement Panel brought into question the coverage of the waiver of the Lomé Convention from international trade rules implemented by the WTO.

Table 1. Potential costs of the loss of banana preferences in selected small states

Country	*Thousands of 1995 ECU*	*Thousands of 1995 U.S. dollars*	*Percentage of merchandise exports*	*Percentage of GDP*
Belize	3,084	4,034	2.45	0.69
Dominica	2,495	3,264	7.08	1.47
Grenada	342	447	1.73	0.16
St. Lucia	7,612	9,957	8.69	1.82
St. Vincent and the Grenadines	3,575	4,676	7.55	1.78
Suriname	2,099	2,746	0.66	0.53

Source: Based on Stevens, McQueen, and Kennan 1999, Table 2.

4. The creation of the WTO will also erode Lomé preferences by promoting further trade liberalization of the products of particular interest under the convention—clothing and temperate agricultural output. Although EU trade policy has been eroding preferences for ACP countries for several years, the trend is likely to accelerate markedly over the next 10 years, under the combined effect of the new trading arrangements that will come into effect between the EU and ACP countries and further multilateral liberalization. In particular, the phasing out, by 2004, of the Multifibre Arrangement (MFA) will remove an incentive to invest in ACP clothing exports capacity (as well as a key competitive advantage for such exports). Liberalization of temperate agricultural output risks eroding the advantages enjoyed by some ACP countries in global markets for sugar and beef.

5. Both time and resources will be needed to change the structure of small states economies in response to this new trading environment. And in most cases successful adjustment will require both policy change and external support: many small states are highly dependent on aid inflows which may continue to decline in real terms. Nevertheless, successful adjustment in time will enhance welfare, as measured by attainment of long-term development goals, poverty reduction, and an increase in the standard of living for the majority of their populations.

Domestic policies and economic management

6. There are a number of issues that small states will need to address in order to adapt, indeed transform, their economies in response to the changed trading environment and thus ensure sustained economic development. In this as in other endeavors sound domestic economic policies—macroeconomic, structural and social policies—will be key. They include not only policy reforms to increase private sector investment and employment but also complementary public policy action and investment. Growth based on attracting private investment, both national and foreign, requires public policies and investment to provide better infrastructure, education, and institutions. A stable macroeconomy, low average tariffs and tariff dispersion, well-established property rights, effective governance and the rule of law, high investment in education and health care, are also essential It will be also be important to address the structural problems specific to small states, such as income volatility, difficulties in attracting the attention of investors and weak domestic capacity, both in the public sector and in commercial

activities. And complementary action will be needed to create safety nets to ease the hardships some will face in the process of adaptation and to avoid an increase in poverty.

7. To facilitate transition and attract private investment, a number of specific domestic policy areas merit attention:

- First, as small states adjust to the changing external environment, they must send clear signals on the direction of their own trade policies and regulation. The costs of transitional changes are closely related to the time needed to adapt to new market conditions (the longer the time, the greater the total cost that needs to be borne by the economy) and to the flexibility that economies have in reallocating resources. Transition takes time; but governments need to give a clear message that changes will occur and will not be postponed indefinitely. When there is uncertainty about whether new market conditions are permanent, investments in an economy are often postponed—and earning and employment opportunities are lost.

- Second, a drop in import tariff revenues, which may result from tariff reduction as part of import liberalization, can pose a problem for small states where prudent fiscal policies are more than ever essential to ensure the macroeconomic stability that is needed for investment and growth: tax reform and its implementation will require time and resources, especially in those small states where capacity is weak. A range of options are available to raise tax revenue through other means than import tariffs.[2] Some small states (including Barbados, Estonia, Fiji, Gabon, Malta, Mauritius, and Samoa) have successfully implemented a value added tax (VAT), for example. The VAT has many advantages for economies undergoing structural transformation, especially a shift toward greater reliance on services, but it does require good administrative capacity. Other ways to proceed in the smallest economies could be to implement a retail sales tax or a low flat-rate tax on imports, the latter supplemented by taxes (such as excises) targeted at domestically produced goods and services such as tourism.

- Third, flexibility in domestic factor markets should be encouraged to facilitate transformation of the productive structure of small economies. Distorted factor markets can impede long-term, growth-seeking investment; for instance where land markets are locked in a social-legal regime that favors subsistence rather than transfer, security, collateral, investment, and growth. Labor markets can be distorted by the wages and performance expectations prevalent in a dominant public sector. Labor market flexibility can be enhanced by re-training programs and by reducing obstacles to dismissal of workers by firms so as to increase labor demand in the medium and long-term and foster faster employment growth. Similarly, small states stand to gain from putting in place regulatory environments—including a transparent and predictable tax regime, effective financial sector regulation and supervision—that invite new investment as well as inflows of foreign capital in general.

- Fourth, in some states the unfinished structural reform agenda is still large and should be tackled as a priority. Small states—like many large states—have a mixed policy

[2] Liam Ebrill, Janet Stotsky, and Reint Gropp, *Revenue Implications of Trade Liberalization*, Occasional Paper 190, IMF, 1990.

record.[3] After independence some small states nationalized banks, public utilities, and vast parts of agriculture and manufacturing. Governments often interfered in the allocation of economic resources, imposed ineffective and counterproductive price regulations, and severely restricted foreign investment. Such policies discouraged investment in physical capital, encouraged the emigration of skilled workers, and ultimately caused economic stagnation or contraction. By contrast, small states that avoided or moved away from nationalization and heavy state intervention fared far better (Box 2).

8. Part of the problem in designing transition policies is that it is unknown which activities will succeed—for example, when adjusting the central role of agriculture in countries where agricultural export preferences have been eroded. Here, two lessons of experience are relevant. First, the costs of mistakes—poor governance and inappropriate policies—in a small state are disproportionate, given the difficulty in recovering from the consequences of inappropriate policies and practices sustained over a long period. Second, governments in many small states realize that despite genuine efforts towards diversification, they have a poor track record in "picking winners"—what to produce, how to organize production, how to market, how to diversify.

9. Rather than trying to predict winners, small states should therefore focus on improving infrastructure and public services, on cutting red tape and bureaucracy affecting enterprises, on improving the information available to investors and entrepreneurs, on facilitating business linkages on a regional basis, and on lowering the costs of reallocating resources—especially labor—across activities. This process involves new investments in human resource development, in physical capital, and in retraining workers with the necessary skills. Many types of training and public infrastructure are relevant across a range of manufacturing and service sectors. For instance, a strong information and communications capability at reasonable cost to businesses will help improve the competitiveness of perishable produce as well as of financial services. More efficient, information-technology based, port operations will help exporters in all sectors—as well as domestic consumers of imported goods. Such capability is required for a resilient, export-oriented economy. Information and communications capabilities are expensive both in terms of money and people, but costs are going down in areas such as software and more simplified hardware. Small states have a strong interest in ensuring that their institutions are abreast of these developments and acquire as soon as possible the capability to take advantage of them. These issues are discussed further below in sections dealing with private sector capacity building and positioning small states better to benefit from the opportunities of globalization.

[3] Indeed, during the 1990s, there was no statistically significant difference in the quality of macroeconomic and structural policies in small states and other developing countries (Collier and Dollar, February 1999).

Box 2. Small island states adjusting to changing external conditions: Cyprus and Mauritius

Cyprus (in the eastern Mediterranean) and Mauritius (in the Indian Ocean) have small territories and populations. Cyprus has a surface of 9,300 square kilometers and is home to 753,000 people while Mauritius has 2,000 square kilometers and 1.2 million people. Despite their small sizes and limited natural resources, Cyprus and Mauritius have achieved remarkable economic growth and excellent social indicators. These outcomes were achieved by ensuring macroeconomic stability, being oriented to exports and open to foreign investment, exploiting international market niches, and providing social services to the entire population—especially the poor.

The success stories

The numbers tell the story. Over the past 25 years real annual GDP growth in both countries has averaged 6 percent, resulting in a 1999 per capita income of $13,000 in Cyprus and $3,800 in Mauritius. Social indicators have also improved remarkably. Unemployment is about 4 percent in Cyprus and 6 percent in Mauritius. Absolute poverty is almost nonexistent in Cyprus and has fallen to less than 5 percent in Mauritius. And life expectancy has increased to 78 years in Cyprus and 71 years in Mauritius.

In addition, both economies have increased the share of non-primary exports in total exports. The share of non-primary exports—primarily financial services, transportation, and tourism—from Cyprus skyrocketed from 13 percent in 1965 to 96 percent in 1996. In Mauritius non-primary exports—primarily textiles—jumped from 14 percent in 1975 to 76 percent in 1997. Another indicator of the transition to service-based economies is both islands' development of tourism, with 1997 tourist arrivals for Cyprus exceeding 2 million and for Mauritius reaching 500,000.

How did they do it?

Both countries lack natural resources, cannot exploit economies of scale, face high transportation costs for imports and exports (especially Mauritius), experience natural disasters (earthquakes in Cyprus and cyclones in Mauritius), and depend on international trade. So how did they manage to do so well? By adopting prudent fiscal and monetary policies and flexible exchange rate policies, aggressively pursuing foreign direct investment (Mauritius), participating in the EU Sugar Protocol (Mauritius), exploiting textile preferences for EU and U.S. markets, emphasizing education (Cyprus), building physical infrastructure, promoting the rule of law and inspiring confidence in the judiciary, fostering democratic institutions, promoting public-private partnerships, and encouraging entrepreneurship.

The new challenges

Both countries now face difficult challenges: Cyprus is preparing for future membership in the EU while Mauritius' international competitiveness is at risk (reflecting its success and the resulting higher wages and the emergence of new, cheaper competitors). In Mauritius these challenges are complicated by the possible erosion of certain trade preferences, saturation in tourism areas and ecological constraints to tourism expansion, and costly welfare systems.

But these challenges can be overcome. Education reform—with a stronger emphasis on science and technology—can raise skills. Policies can be further reformed to reduce distortions. Welfare programs can be adjusted. And efforts to attract the next generation of foreign direct investment can increase technological sophistication.

Source: Matsis 1999; Treebhoohun 1999.

External support and global economic environment

10. While domestic policy choices in these areas by the affected countries will be critical to the success of transition, international development, trade and finance institutions must recognize also that external financial and policy support is needed if small states are to succeed in bringing about transition without excessive social costs that would set back their development. There are five types of external support that would be particularly helpful. First, agreement on transition periods of sufficient length; second, the provision of financial assistance in the process; third, action wherever possible to reduce or remove barriers to small states' exports, including agricultural exports[4]; fourth, recognition of the difficulties small states face because of their vulnerability and limited public and private sector capacity; and fifth, active support for their participation in the WTO and international trade discussions.

11. Where will external financial support be most effective? Changes in global trade have made unprofitable some sectors that once accounted for a large portion of some small states' economies; reallocating resources to new sectors will take both time and new investments in physical and human capital. Improving small states' human capital is the most important vehicle for a rapid transition and more equal income distribution. A better-educated, healthier workforce is likely to be more entrepreneurial in raising its incomes and welfare, efficiently using the resources at its disposal. This should be complemented by efforts to build a knowledge base for productive activity and economic development. So support for human capital development is certainly one way to assist. Another will be support to mitigate the adverse social impact of transition. There will be others, linked to specific country circumstances—support must be sensitive to country needs and constraints. But in general, for aid to be effective during the transition, it must be channeled to modernizing the economy rather than to delaying adjustment. This would send signals to the private sector as to the direction of economic policy and accelerate economic restructuring, rather than hold it back.

12. Turning to participation in the WTO, the experience of Vanuatu illustrates well the case for lowering the small states' cost of accession to and use of international trade conventions (Box 3). It is hard to believe that the process and costs of accession to the WTO for small states could not be streamlined and accelerated. Small states would find it easier to become WTO members if they were given financial and technical assistance in the process of accession, and if membership costs were lower. In the Interim Report of the Task Force, it was proposed that the costs of WTO membership—the lower end of which was based on a threshold of 0.03 percent of world trade of the membership—could be reduced for small states given that these states account for just 0.25 percent of world trade and that the per capita contribution required of them far exceeded that of some larger members. Efforts in the WTO on this have already borne success; for the budget year 2000, that threshold has been reduced to 0.015 per cent. Nevertheless, small states need additional support in participating in trade negotiations, and accessing the WTO

[4] The critical importance of access to markets is highlighted in World Bank (SecM2000-97), *Trade Policy for Development and Poverty Reduction*, Draft, March 2000.

Dispute Settlement Mechanism, where the recent creation of an Advisory Center on WTO law is welcome. It would also help small states use their limited capacity better if they were permitted to be represented collectively—for example by regional grouping—where they wish to be so.

Box 3. Costs of accession to the WTO–the experience of Vanuatu

Vanuatu has been trying to accede to the WTO for five years. So far, it has spent nearly $400,000—about $2 per capita—on its effort. It has reached the point where it has completed almost all protocol negotiations as well as negotiations with all its major trading partners (the European Union, Australia, Canada, and New Zealand). The only outstanding problems are in the bilateral negotiations with the US, a country with which Vanuatu has very limited trade.

Vanuatu (population of 182,000 and GNP per capita of $1,270) has no income tax, so the government relies on import duties for revenue; a VAT has recently been introduced. Vanuatu has agreed to limit its tariff to an average of 45% and has also agreed to liberalize imports of services and information technology. But this has not been sufficient to conclude negotiations with the US. The main outstanding issues are a further reduction of tariffs as well as opening of the telecommunications sector where France Telecom has a monopoly till 2012. Vanuatu believes, however, that agreement to open up its telecommunications sector would lower the incentives for France Telecom to invest in necessary service improvements. Telecommunications infrastructure is vital for this remote country that is highly dependent on services and tourism.

Based on Dr. Roman Grynberg, *The Pacific Island States and the WTO: Towards a Post-Seattle Agenda for the Small Vulnerable States,* February 2000.

13. Finally, there is the question of special treatment in the WTO. At the February 2000 global conference in London on the Development Agenda for Small States, it was recognized that a blanket approach, as given to LDCs in Special and Differential Treatment, would not be suitable for small states given their varying stages of development. Nevertheless, the special characteristics and vulnerability of many small states should be recognized as justifying special consideration by the international system to deal with those issues that are crucial to the transformation of their economies, such as length of transition periods.[5] In particular, it would seem practical that specific characteristics of certain small states—such as low institutional capacity and vulnerability—should be among the criteria used to determine any specific treatment. It is clear that many small states will need help to ensure that emerging global trade rules and procedures fully reflect their special circumstances and advance, rather than hinder, their development prospects. For example, monitoring of compliance with the new rules applicable to small states should not disproportionately burden their limited capacity and resources. It is also clear that without help, the small states cannot begin to match the negotiating power of larger WTO members.

[5]This argument was included in the WTO Ministerial declaration of 1998 – WT/MIN(98)/DEC/1 –which noted that ministers were “deeply concerned over the marginalization of LDCs and certain small economies and recognised the urgent need to address this issue”.

Box 4. Key actions to facilitate transition

- Small states must adapt, indeed transform, their economies to secure the benefits of globalization and the increasingly open global trading environment—trade policy for small states, as for other developing countries, needs to be seen as part of sound overall economic development strategy. Clear signals about the direction of trade and regulatory policies and the length of transition periods will be needed to guide the process and to attract new investment.
- The work of the task force has shown that many small states will face special difficulties in making this transition and will need time to adjust to changes in the external trade regime, and sequence changes in their economies. The particular vulnerabilities of those small states that are not LDCs should be recognized as justifying special consideration to deal with the issues that are crucial to transformation of their economies, including length of transition periods, as the global process of trade liberalization, and removal of special protective regimes, continues. It would be useful to review the current process of WTO accession as it affects small states to see if the problems and costs these countries face in the process can be reduced.
- Another issue related to WTO participation is the lack of adequate resources to participate fully in international trade negotiations. The Commonwealth, through its permanent trade advisers in Geneva and Fiji, already provides assistance of this type to its member countries. It will continue to do so and has expressed a willingness to take a lead in expanding such facilities. The EU is financing an ACP countries' bureau in Geneva to facilitate relations and negotiations with WTO and UNCTAD. Additional support from the World Bank and others would be welcome, as is the recent creation of an "Advisory Centre on WTO Law". The WTO should examine other ways to help, for example by allowing groups of small states to be represented collectively at discussions where they wish to do so.
- Trade liberalization can have major fiscal consequences for small states. The IMF should continue to take a pragmatic approach to the advice it gives to small states that risk losing a major source of fiscal revenue as tariffs fall, recognizing that for some open, small economies low, flat-rate tariffs may be a component of an efficient tax system. However, as small states move to more service based economies, they will need to adopt broader-based consumption taxes. They will also need technical assistance from the IMF and others in tax administration.