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The Financial Architecture of Aid for Trade

Executive Summary

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This paper is intended for general information purposes only, and should not be relied upon as legal advice, nor is it intended to replace legal advice. The paper is part of a broader project on Aid for Trade implemented by ILEAP. See first page for a list of other papers in this project. It was drafted under the coordination of ILEAP Executive Director Dominique Njinkeu by Massimiliano Calì, Sven Grimm, Sheila Page, Lauren Phillips and Dirk Willem te Velde at the Overseas Development Institute (ODI). Views expressed in this publication should not be attributed to ILEAP, its Board of Directors, its funders, or the institutions with which lead advisors are associated. Comments can be sent to the ILEAP Secretariat (dominique.njinkeu@ileap-jeicp.org).

Related ILEAP papers

ILEAP (2005). “Aid for Trade: Why and How?” Prepared by Dominique Njinkeu and Hugo Cameron, ILEAP. Presented at a forum organized in parallel to the WTO Hong Kong Ministerial Conference.

ILEAP (2006a). “Aid for Trade: How We Got Here, Where We Might Go”. Prepared by Michael J. Finger.

ILEAP (2006b). “An African Perspective on Aid for Trade”. African Union. Prepared by ILEAP.

ILEAP (2006c). “Aid for Trade Facility: Lessons for the Tanzanian Experience on Trade Related Assistance”. Prepared by Bede Lyimo and Edward Sungula.

ILEAP (2006d). “Operational Modalities for the Aid for Trade Initiative”. Prepared by Ademola Oyejide.

ILEAP and German Marshall Fund (2006). “Aid for Trade After the Hong Kong Ministerial – An Introductory Text”. Prepared by Claire Healey, Dominique Njinkeu and Hugo Cameron.

These papers can be accessed on the ILEAP website, www.ileap-jeicp.org.

Defining Aid for Trade

The explicit recognition in the December 2005 Hong Kong Ministerial Declaration of a World Trade Organization (WTO) interest in and responsibility for aid has raised high expectations, but involved parties such as the Africa Group must now define what they need, and how this can be efficiently and equitably implemented. Aid for Trade can be defined narrowly, in terms of directly WTO-related needs, but there are also broader needs to build countries' capacity to trade. The narrow needs include:

A. Implementation of existing commitments under the Doha Round, in particular the obligations related to Trade Facilitation. Such support is a recognized potential cost of a Doha settlement, so there is an obligation on developed countries to provide it or to accept that some developing countries will not be obliged to implement all aspects of a final Doha agreement. But while it may be of benefit to a developing country in the medium term, it is not necessarily an immediate priority for a cash-constrained government or for normal aid programmes.

B. Implementation of the explicit commitments to the Net Food Importing Developing Countries (NFIDCs) in the Uruguay Round which were left without an implementing mechanism. The commitment is clear, and a major external shock is a potentially valid use for aid to enable a country to adjust to a sustainable pattern of production.

C. The costs to developing countries of WTO reforms intended to benefit others – i.e. the costs of preference erosion. The July 2004 and Hong Kong Declarations recognized this as a legitimate concern, and dealing with it by maintaining preferences would have meant no liberalization, which is clearly contrary to normal WTO principles and unacceptable to those seeking liberalization.

D. Other implementation costs, for example those required to implement the WTO agreements on Trade-Related Intellectual Property Rights (TRIPS) and Sanitary and Phytosanitary Standards (SPS) and Technical Barriers to Trade (TBT).

E. The fiscal costs of liberalizing a country's own imports. This is not a cost to the country, but a transfer from the government to those who buy the imports, and it is not an exceptional cost from the introduction of either new rules (A and D) or major reforms to the system.

For A and D, we have estimated costs of about US$0.3 billion each, based on some country data and on what has been spent on aid relating to these in recent years. For each country, such costs are mainly one-off costs. The costs for B are estimated at $1 billion a year and for C at around US$1.1 billion a year: these are in principle continuing costs to the economy, but will fall as countries adjust. We have not included estimates for E because for LDCs the cost would be zero (they are not expected to reduce their tariffs in this Round) and for most developing countries, of the type expected to be included, the cost will also be zero (bound tariffs are sufficiently high that any reduction will merely remove some water in the tariffs, not reduce revenue).

The developmental case for aid to help countries use trade for development is clear and not at issue. Any funds identified as necessary under B or C could be expected to be spent on such activities. What is new and controversial is how far the WTO should have a role in this type of aid. This includes:

F. Support for conventionally recognized trade capacity building. This has been a very conspicuous part of trade-related aid, but in value has been around US$0.2 billion.

G. Support for infrastructure, investment, and other measures to build supply capacity. Aid to support this has increased sharply in recent years, from US$9.2 billion a year to US$14.8 billion by 2004, although almost the entire rise in expenditures has been driven by US spending to rebuild Iraqi and Afghani infrastructure.

H. Support for institutions that improve capacity to trade. Aid for this has been about US$ 1.1 billion a year (WTO database), and, like F, has not shown an increase.

I. Support for the supply side in the sense of building up private sector enterprise in new export (or import replacing) areas. This category has moved up with infrastructure, from about US$0.5 billion in 2001 to US$0.9 billion in 2004.

Aid for Trade could cover a combination of narrow and broad Aid, i.e. any level of A, B, C, D and/or E plus any or all of F G, H and I. On our estimates, the new implementation costs (A and D) could be covered by roughly the existing level of resources being allocated to similar costs. The other 'narrow' costs could cost up to US$2 billion a year, which would be an addition to needed spending on 'broad' costs. This is currently about US$17 billion a year. There are advantages and disadvantages to treating these separately. Some donors do not view the needs identified under narrow as directly related to development (because they arise from a trade negotiation, not from a country-based assessment of priorities, as discussed below), so for some, additional aid under these might need to come under a separate budget line. For this purpose, separate calculations of the amounts are needed. Acceptance of a role for the WTO in ensuring that needs are met, both in terms of commitments this year and in implementation in the medium term, may be stronger for the narrow needs than the broad.

Eligibility for Aid for Trade

The question of which countries should be eligible for special treatment is sensitive in both aid and trade. While aid agencies can determine their own differentiations among recipients, and define groups, the WTO can only differentiate through the consensus of all members, and it is clear that there will be no new general categories adopted in this Round. The only classification in current use that is the same is Least Developed Countries. Beyond this, the WTO gives special status in a few agreements to developing countries, and specifies this as a condition for allowing preferences. What has become the practice is to list, either positively or negatively, countries other than LDCs that may be eligible for particular treatment (e.g. the agreement on agricultural subsidies in the Uruguay Round) or excluded from it (e.g. the agreement on importing pharmaceutical products of 2003). In legal terms, any eligibility for A4T specified by the WTO would have to follow this model.

For NFIDCs, there is a simple list, not an assessment of the exact losses of each member, although it was based on such analysis. This could be one model for the other narrow types of A4T – especially for preference erosion, which shares the characteristics that the effect can be large, by any calculation, but where the numbers are not knowable with any certainty.

For any cost-based scheme, it would be necessary to ask if it is the costs of a particular problem, total costs, or total net costs that make a country eligible. (A country might suffer a little preference erosion, have some food imports, but have sufficient gains on other products that its net result from a settlement was positive.) Total costs would be consistent with treating the problem as an exceptional shock, not just a disappointing negotiating outcome. An alternative approach would be for a country to ask for the application of a particular rule to be postponed (as has been done, for example, with the rules for customs valuation). The July 2004 agreement suggests a similar model for trade facilitation, by which countries present evidence to an appropriate Committee that they have not had the necessary aid to implement the agreement. This would be a more discretionary approach, and might therefore not meet the increased determination by developing countries to have clear and enforceable commitments for Special and Differential treatment.

Identifying countries that need aid to build their general trade capacity and ability to respond to new trade opportunities is likely to need a broader development measure, and could include all developing countries or perhaps all except those who chose to exclude themselves, as in the TRIPS agreement on imports. As some of this assistance is likely to be for international institutions, such as the Advisory Centre on WTO Law, or to meet regional needs, introducing strictly differentiated eligibility requirements could restrict its usefulness (i.e. most regions, whether legal or geographic, include countries at different levels of income).

Reconciling Aid for Trade with programmes and principles for Aid

The different purposes and the large scale of what donors are now calling A4T, as well as the unwillingness of both donors and recipients to rely on a single existing institution, suggest that the way in which A4T will work will be mainly through existing funds, multilateral and bilateral. There is therefore a need to find a way of reconciling multiple funds from multiple donors, with each covering some countries and/or some types of spending, in order to secure adequate funding for all relevant countries and purposes. It is possible that some of the needs identified here will be so far from what donors and their rules of operation recognize as official development assistance that new funds or new sections of funds will be needed.

Ensuring that secure mechanisms based on the legal structures of each fund are available for all A4T needs will be the first problem to overcome in 2006. The WTO will then need to monitor implementation over a medium term period. Reports on both overall results and individual countries could go from all the implementing agencies to the WTO, perhaps through both the Committee on Trade and Development (to monitor total implementation) and the Trade Policy Review mechanism (to cover individual countries).

There are also problems in reconciling efficient and effective aid administration with ensuring that trade criteria are applied (i.e. ensuring that trade is raised from its frequent position as a low priority for conventional aid). In aid, there is perceived to be a conflict between targeting specific areas for help and taking a broad view of a country's development process. Vertical funds, which apply to the former, may build up a level of expertise and specialization and benefit from economies of scale. They may be better at coordinating solutions at a global level. Against this are the possible lack of 'ownership' by the receiving country, the difficulties of aligning vertical funds with country programmes, and the risk of shocks because of changes in donor priorities.

There is additionally a significant level of distrust, and occasionally even contempt, between aid and trade agencies and practitioners, with fears by aid agencies that the ability of countries to exert pressure in the WTO could lead to them receiving more than an 'objectively determined' share, and by trade people that aid programmes are too focused on immediate poverty reduction, and not enough on long-term production and trade.

Precedents in other funds

A survey of 25 funds, some general, others vertical, both trade and non-trade, suggests that there are quite a few funds that address diagnostics of what trade measures are required. These include the Integrated Framework for Trade-Related Technical Assistance to LDCs (IF), part of the European Commission's trade related assistance (TRA) programme, the Joint Integrated Technical Assistance Programme (JITAP), and the EU-ACP Project Management Unit (PMU). However, far fewer programmes address supply side constraints or implementation costs of trade agreements directly.[1] Thus there are significant gaps that the debate on A4T can address.

Some funds have emerged out of international conventions or agreements**,** e.g. the Montreal Protocol Fund and the Global Environmental Fund; others have reflected special concerns that were thought to need additional attention, e.g. the health and research funds. Some of the trade-related funds have been specifically to address potential adjustment needs from trade reform: the ACP PMU by the EC to examine the effects of possible EPAs, and the Sugar, Banana, and Rum funds. Others are more general, e.g. the US Millennium Challenge Account (MCA) focuses on growth and poverty reduction. This corresponds well to the discussion on A4T, for both narrow and broad interpretations.

The funds have very different ways of operating. Some take time to come to fruition while others can do so more quickly. There might be some rigidity and potential distortion of vertical funds, but where an issue has been neglected by donors, imposing rigidity and reversing past distortions may be required. Some issues require global co-ordination and involvement of a pool of expertise.

Any conclusions on the merits of different aid architectures must be seen in the context that the most important lesson from work on aid is that good plans and participation by recipient governments are the most important determinants of what works. One important consequence of this is that any donors' assistance should imply a compromise between donor's priorities and local ownership.

It may be that a compromise between special funds and general assistance is to ensure that the special funds have broad aims (e.g. the World Bank's Highly Indebted Poor Countries Initiative - HIPC) and align their rules with the government and with other programmes (e.g. common rules for government procurement). There are high risks and high benefits from budget support.

One example of such a compromise is the Sector Wide Approach (SWAp), which is a process where donors give significant funding to a government's comprehensive sector policy and expenditure programme. It might be a means to ensure increased aid to a sector and improve coordination in-country by setting clear sectoral programmes, but it should not lead to additional administrative requirements.

The SWAp may involve sector budget support when implementation and accountability concerns are being met, but where weaknesses exist, financing may be more mixed in the form of funds earmarked for specific purposes or project support. In practice, sector programmes (and thus SWAps) have centred around lead implementation ministries; it has been more difficult to fund activities that involve other ministries, or NGOs and the private sector. This has implications for

[1] The US Millennium Challenge Corporation (MCC) could be a useful mechanism to address supply side issues, and current WTO assistance might fit with addressing implementation costs. The data on trade related aid also suggests that implementation is being funded from normal aid programmes.

the debate on Aid for Trade, where the narrow interpretation might be more suited to a SWAp (e.g. a trade-related SWAp), while the broad interpretation would need several SWAps.

Scale of funds available and required

The value of current trade assistance excluding the equivalent of implementation costs was about US$17 billion in 2004, and had risen by US$6 billion in the three years from 2001, although a substantial part (about US$ 3 billion) of this increase comes from US infrastructure spending in the rebuilding of Iraq and Afghanistan. Most aid for both Trade Policy and Regulation and Trade Development categories has been channelled through grants. For infrastructure aid, most has come in the form of loans rather than grants. The grant component dominates aid in the narrow categories, while the loan part is slightly more important for the broad categories. Such prevalence of grants over loans in the narrow categories may be viewed as a sign of donors' willingness to interpret this part of aid as covering pure costs, from which recipient countries do not gain in net terms.

All major donors have either maintained or increased over time their spending on trade related assistance. To assess the extent to which countries are specialized in this type of assistance, we use an index of specialization in aid for trade for the major donors. On this measure, only the EC and Japan have had a relative specialization in aid for trade over the period 2001-04, although it has been declining for both countries. The value for the EC is mainly driven by expenditure on trade policy and regulation and trade development, while Japan's value is the result of the focus on infrastructure in its development assistance strategy. The US has an index greater than 1 only in 2004, because of spending on infrastructure in Iraq and Afghanistan. All other donors are spending relatively little on trade related assistance, with UK, Canada, France and Italy at the bottom of the list.

An analysis by recipient shows that the funds are fairly equally spread across regions. For countries, the largest recipients over 2001-04 are all Asian countries: Vietnam, India, Indonesia and China. The first sub-Saharan country, Ethiopia, is in the 12th position, confirming a different (less trade related) model of development assistance for Sub-Saharan Africa compared to Asia. This finding is confirmed by regional indices of relative specialization in aid for trade. Europe and the Far East are the regions with the highest level of trade related aid relative to the total aid they receive, while sub-Saharan Africa, the Middle East and South America have the lowest values of the index. Low–Middle Income countries (LMIs) and non-LDC low income countries (OLICs) have received the highest share of trade related funds over 2001-04. This result is in line with the analysis of the spending relative to total ODA, which shows that LDCs (and Upper-Middle Income countries) receive a lower level of spending in trade-related assistance relative to total aid than LMIs and OLICs. Such a figure may be a cause for concern to the extent that LDCs face the highest costs in the trade integration process.

In the second half of 2005, including at Hong Kong, increases in trade-related aid were announced by several donors. If these announcements refer to funding that is additional to the 2004 levels of spending, they would cover the costs of the Round (B and C) plus a continuing increase in broad aid for trade. They would not, however, represent an acceleration of recent spending on trade aid.

Implications for an Architecture for Aid for Trade

The examination of existing programmes and the discussion of how trade-related aid has increased in recent years demonstrate that there is no need to design Aid for Trade from scratch.

Existing mechanisms have been able to sustain an increase of US$6 billion in trade-related aid (broadly defined). But the analysis suggests that some types of need are not being well met. While there is reasonable capacity to determine new types of need, the means for translating these assessments into new financing are less satisfactory. It also suggests that there are very different types of need, and, on the basis of both analysis of institutions and the precedents in aid, these are likely to require different types of organizations and programmes to meet them. Some needs are small and easily defined (for example: assessments of new circumstances or institutional reform to meet particular implementation needs, often to a deadline). These require an organization able to offer quick disbursement, probably with a minimum of conditionality or planning. Others require longer term and more considered programmes, to ensure that building the supply capacity to trade is well integrated into a country's (and perhaps a region's) development programme. This contrast is not an inconsistency, and there are examples of successful programmes of both types. SWAps are a potential means through which different types of projects, programmes and sector support can be aligned with a government's comprehensive sector policy and expenditure programme on trade-related assistance and other areas of Aid for Trade while making aid less fungible, though lessons need to be learned from existing SWAPs. In particular, it has not been straightforward to fund SWAps outside the social sectors or those that involve various types of actors (beyond government, which is possible in the case of private sector development) and more than one ministry (which is also possible, particularly in the agriculture and services sectors).

There is a potential conflict between the country programme and the vertical approach to aid. The vertical funds for environment, health, and other needs show that trade is not the only area where those outside the aid process have identified a need for more aid, and show both the advantages and the disadvantages of solving the problem by providing finance 'tied' to a particular subject. The fact that trade-related aid has increased in recent years suggests that normal, horizontal, donors agree that there is a need to spend more on trade, but the commitment in the WTO declaration and the identification of increased costs that countries will face because of new WTO commitments suggest that some formal way of guaranteeing a continued priority for trade needs to be found.

There are two elements in the needs for Aid for Trade identified here that could require some form of guarantee, or legal commitment, plus continuing monitoring, additional to the informal donor-by-donor commitments already recorded. The first is that some countries will face exceptionally high costs. The experience since the Uruguay Round shows that while small costs, particularly those easily tied to a need for specific spending (customs rules, for example) did attract additional aid, those which require a macroeconomic approach both to calculate them and to find a way of meeting them (adjustment needs following on the terms of trade change in agriculture) were left to one side. The second is the growth in 'broad' aid for trade: how to ensure that the increase which has occurred in the last 5 years will in fact be repeated, as the pledges made in 2005 promised?

The first problem suggests that there may be a need for new funds, with new criteria, either as designated parts of individual donors' programmes (the EU Action Plan for Sugar, for example) or in a new multilateral form (HIPC, the vertical funds in health). In addition, or possibly as an alternative, there may be a need for a new assessment process (like the IF for trade in PRSPs, the IMF's Trade Integration Mechanism (TIM) for balance of payments costs or the EU-ACP assessment of the costs of EPAs) to provide an agreed definition and calculation of macroeconomic adjustment needs. The IF precedent suggests that an assessment process divorced from any commitment to provide finance can be inadequate and disappointing.

There is an additional reason for believing that a special fund or special terms within normal funds may be needed. Although any financing for the adjustment costs of trade liberalization could be used for purposes and in countries that might normally expect loan, not grant terms, the fact that countries need this additional finance for reasons of benefit to others and as a replacement for previous transfers suggests that there is a need for this to be on concessional terms. For 'broad needs' more generally, for funding to enable a country to trade (or produce) more or more efficiently, there may be a clear source of returns to repay a loan. For some, however, for example assistance to government capacity to negotiate or to build new institutions, there can be expected to be a return to the country as a whole, but not an identified income stream. For these, whether loans or grants are appropriate should be decided in the context of normal aid criteria. It will depend on the income level of the country and on the use of the funds.

Both these problems suggest that there is a need for a new way to monitor both the overall supply of funds and their allocation to countries' needs to ensure that the new types of need are appropriately met and that the overall allocation to trade remains high and growing. Now that the WTO has accepted that meeting the costs of adjustment and providing for what countries 'need to assist them to implement and benefit from WTO Agreements' are legitimate concerns for it, it will need to take responsibility for identifying the procedures that will be needed and 'ensuring' that all of them take place. It could check that donors had committed ('bound' in trade terms) the funds which they have announced. In subsequent years, the WTO will need to monitor that the commitments are kept.

ILEAP Analytical Support Structure

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