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Edited by Roman Grynberg

Excerpt

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Introduction

ROMAN GRYNBERG

This book aims not only to document almost ten years' experience of small vulnerable states with the WTO but also to explain why the experiences have occurred. Since the formation of the WTO in 1995, small states have become increasingly vocal in their criticism of what they see as onerous rules from which they feel that they have not benefited. Now at this pivotal point in the history of the WTO when development issues are at the heart of negotiations, how the larger and more powerful WTO members address the legitimate trade concerns of its poorest and most vulnerable members will shape the perception of the institution throughout much of the century. If the Doha Development Agenda fails to address these concerns in a constructive manner that recognises the particular vulnerabilities of various groups, it will leave the WTO further weakened and undermined from the perspective of a group of countries that are emerging as the majority of its members.

Small vulnerable states and, in particular, small island states have endowed or inherent handicaps that have shaped their trade and economic development as well as the policy of the international community since the colonial era. The combination of smallness, isolation and dispersion of small pockets of population has shaped the range and type of products and services that these countries have been able to export. What the export activities of small vulnerable states have in common is that a surplus or quasi-rent has been needed to cover the inherent cost disadvantage faced by the private investor who has chosen to locate in small vulnerable states. This quasi-rent has been provided through legal instruments such as trade preferences which provided subventions to those investors in export-oriented activities. Other legal instruments such as tax concessions, and even the very sovereignty of these states, have provided the possibility for creating surpluses or quasi-rents that were needed for the survival of internationally competitive export-oriented production.

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It has not just been legal institutions that create this surplus, the market has also provided quasi-rents through niche exports or through booming sectors which have provided fuel for the development of what would otherwise be an uncompetitive private sector. It is the dismantling of the special trade and economic arrangements at the WTO that has served to so undermine the position of small states and resulted in their perception of the WTO as an institution that has, by and large, not served their economic interests.

What remains a common thread throughout much of the previous academic and policy research on small vulnerable states is that these countries do not generally have a special economic and trade problem. These studies have observed that small vulnerable states have high incomes, have achieved relatively high economic growth and, despite their recognised vulnerabilities, are generally not in need of assistance and policy advice that is in any way different from that of other developing states. This position certainly reached its pinnacle in the work of Easterly and Kray (see chapter 2) whose paper 'Small States, Small Problems' encapsulated the dominant position throughout the 1990s on small states. While there has been a shift in thinking on the subject recently, there has been precious little understanding or sympathy for the predicament of these states. The global consensus that emerged was that small vulnerable states are low- to middle-income countries and, in comparison to the economic constraints facing the least developed, the problems of small vulnerable states remain less challenging. Yet, despite the consensus of economic thinking, the problem of adjusting from trade preference dependence to a liberalised global trading environment has proved daunting.

Small vulnerable states have high-cost structures that stem not from poor policy but from inherited cost disadvantages. There can be no guarantee that, given the magnitude of these disadvantages, there exists any above-zero wage or factor price that will induce investors, whether local or foreign, to invest in these countries once the benefits of trade preferences and other sources of quasi-rent are removed. Only if these countries are able to develop niche market activities will they be able to survive in a far more liberalised world that will almost certainly follow the completion of the Doha Round.

The empirical studies of the impact of smallness, isolation and distance (chapters 3 and 5) for the first time provide quantitative evidence of the magnitude of the disadvantages faced by these states. The chapter by Winters and Martins also provides important policy advice on how the

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international community may wish to address some of the concerns facing the most disadvantaged. This includes the provision of possible temporary labour market access for nationals. Redding and Venables suggest the need for more infrastructure in their analysis of isolation and distance.

The trade performance of small vulnerable states over the last three decades is considered in chapter 6 where the results of analysis of trade data for the last thirty to fifty years shows a continual pattern of marginalisation in trade in both goods and services. While a declining share of world trade does not necessarily imply declining welfare for a state, it does measure, in one summary statistic, several aspects of the performance of the state and of the global trading system as a whole. First, the share of world trade reflects the productive efficiency of a country, i.e. countries that maintain growth levels of international trade above the global average by definition do not become marginalised. Second, secular declines in the share of world trade reflect the distributional equity of the trading system. If a large group of low-income countries, for example, are experiencing a secular decline in their share of world trade while high-income ones are experiencing an increase, the distribution of welfare benefits of the trading system will follow. Third, marginalisation, i.e. a decline in share of world trade, also reflects the political significance of a state. It was furthermore observed that investment share and aid levels are also in decline. The marginalisation of small states in the trade in goods has been pronounced irrespective of the time period considered.

The chapter by Winters and Martins reflects the high level of concern regarding the trade competitiveness of small vulnerable states. The chapter by Wignaraja and Joiner (chapter 4), which has developed a Small States Manufactured Export Competitiveness Index to measure the competitiveness of small states in the industrial sector, exhibits interesting results. It shows that despite serious cost disadvantages, some small states such as the Fiji Islands, Mauritius, Trinidad and Tobago have successfully developed from a state of vulnerability to a situation where they have a viable, internationally competitive industrial sector. While their experience is testimony that the predicament of some small vulnerable economies is not without hope for achieving competitiveness, concerns over the vulnerable situation of other small states, which have performed poorly on the export competitiveness index, remain.

The characteristics of small economies, centred on their size, vulnerability and governance capacity, combine to yield significant cost disadvantages

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that are large enough to undermine these states' capacities to participate in trade on a remunerative basis, even in their areas of comparative advantage. Diminishing trade possibilities serve primarily to compound the deleterious effects of small size on their economic welfare. The chapter by Horscroft (chapter 7) highlights the need to adjust multilateral trade rules to accommodate the concerns of small economies. The special characteristics of small economies also undermine the bargaining power of small states significantly, and therefore affect the likelihood of their achieving beneficial outcomes from the interstate negotiating process that determines global trade rules.

In chapters 8 and 9 the small vulnerable economy issue at the WTO is addressed in quite different ways. The fraught question of definition of small vulnerable states is addressed, with possibilities considered for an appropriate quantitative definition. Significantly the chapter by Davenport (chapter 10) shows how minor the consequences would be for the multilateral trading system of providing improved market access for small states. The chapter also shows that, on the basis of cluster analysis, there is much in common between small states and the least developed states, which are the only group of WTO members that are provided with substantial market access improvements.

It is the tangible experience of small vulnerable states with the most important and powerful of the WTO institutions, its dispute settlement mechanism, which has, more than anything else shaped perceptions of the organisation as being antithetical to the interests of its smallest members. The banana dispute, and its impact on the Caribbean, is considered in three chapters that should be read together to grasp the full breadth of the dispute. This is a dispute that has completely undermined the trade provisions of the Lomé Convention and necessitated the wholesale reform of trade relations between Europe and the African, Caribbean and Pacific (ACP) nations under the Cotonou Agreement which envisages negotiations with Free Trade Areas (FTAs) and/or Economic Partnership Agreements (EPAs). The EPAs will oblige these small states to provide free market access to EU goods in return for maintaining the existing market access. Throughout the ACP group this will necessitate a complete reform of taxation and trading systems that will occupy economic policy matters in these countries in the first decades of the century.

However, it is not just the well-documented banana dispute that has served to erode confidence in the WTO as a system of law, readily able to

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adapt to the economic realities of its weakest members. Recently the EU's sugar regime has been challenged by Brazil, Australia and Thailand. Many of the same ACP states that were dependent upon the preference arrangements available for their exports of bananas to the EU are similarly – and in some cases (Mauritius, Fiji and Guyana) more – dependent upon the sugar protocol. While there has, at the time of writing, been no decision by a WTO panel, an adverse outcome could seriously undermine the economies of the sugar-producing ACP states. Chapters 14 and 15 consider the legal and economic implications of the dispute.

If small states felt that two key export sectors were threatened by the dispute settlement mechanism, the need for a WTO waiver that resulted from the banana dispute exposed their economies to further risks. When the ACP and the EU sought an extension of the existing GATT waiver for the preferences temporarily available under the terms of the Cotonou Agreement at the Doha Ministerial Conference in 2001, the Philippines and Thailand, two developing countries with considerable export interests in canned tuna, held up the consensus on the waiver until the EU agreed to mediation over the access provided to Thai and Philippine canned tuna. Under the EU's Generalised System of Preferences (GSP), Thai and Philippine tuna is exported to the EU with the full most-favoured nation (MFN) tariff (24 per cent) while ACP tuna enters duty free. Chapter 16 provides an analysis of the impact on ACP states of the tariff quota that was eventually provided by the EU, ostensibly to Thailand and the Philippines. This initial tariff quota clearly presages a further reduction in the margins of trade preference available to ACP states which will undermine an export sector of vital interest to Indian Ocean and Pacific Island states.

The experience of the small states in general and the ACP in particular with the WTO's dispute settlement mechanism (DSM) has not been entirely negative. The DSM has provided for small WTO members a mechanism whereby they can, at least in theory, challenge much larger states and where, as aggrieved parties, they can seek redress which would certainly not be possible outside the WTO's legal system. Indeed, the success of Costa Rica in using the DSM has been proof that small states are capable of using it in their favour. Recently the small island state of Antigua and Barbuda has taken the US to the DSM over market access for internet gambling. It was widely reported that Antigua had won the dispute with the US, but at the time of writing the parties have agreed to suspend the dispute pending further consultation. If the US does not agree to bring its trade regime on

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internet gambling into conformity with its WTO obligations, the option available to Antigua is to impose trade sanctions on the US. The absurdity of such an outcome only serves to underline the clear limitation of the current DSM as it pertains to small states.

While the DSM has afforded opportunities for small states, it has simultaneously set off a chain reaction, beginning with the various banana disputes, that has served to undermine the economic base of many small states. Indeed, the ongoing negotiations between the six ACP regions and the EU for the completion of Economic Partnership Agreements which are ostensibly free trade areas stems from the banana dispute and the need to maintain a WTO-compatible trade regime. This will necessitate a painful adjustment of trade and taxation regimes of most ACP states and, because of the multiplicity of trade agreements with their explicit and implicit MFN obligations with other developed countries and regions, the ACP states will need to negotiate similar arrangements with other trading partners as well. Thus the banana dispute and what followed directly from it can be characterised as the dispute which completely changed North–South trade relations. What is peculiar is that the banana dispute, like the subsequent sugar dispute, included the small states only as third parties. They were not the ‘object’ of the disputes but rather suffered collateral damage in disputes between larger WTO members. This has added to the pervasive sense of powerlessness of the small states.

The book also considers new and emerging WTO issues of significance to small states. Three issues in particular are considered where the development of new rules or the implementation of existing rules creates serious challenges for small states. The first is the negotiation of potential new disciplines in the area of fisheries subsidies (chapter 17) which could have very damaging effects upon the economies of some of the smallest and poorest island states in the Pacific. Again, the impact is by way of ‘collateral damage’ where these countries, which are not even WTO members, may have their economic foundation undermined by virtue of disciplines negotiated in Geneva.

The second issue is the export of financial services which has emerged over the last twenty years as a growing and viable offshore financial sector (chapter 18). The development of regulations essentially by OECD countries, which have not consulted or taken into account the interests of small vulnerable states, has served to weaken their position and undermine the commercial advantage of the offshore financial sector in small vulnerable states. The need for WTO disciplines on the formation and imposition of

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essentially plurilateral standards by institutions dominated by developed countries was raised by small vulnerable states at the WTO. The development of the Harmful Tax Initiative, the work of the Financial Action Taskforce and the Basel Committee are considered in relation to the development of the financial services sector in small vulnerable states.

The third issue is the impact that the Agreement on Subsidies and Countervailing Measures could have on those developing countries, small or otherwise, that maintain export processing zones (EPZs) (chapter 19). Clearly, for those that are not LDCs or low-income countries, there remains the considerable risk that their EPZ regimes are not compatible with their WTO obligations. The phasing out of export subsidies constitutes a further diminution of the rents available to exporters operating in small states.

The final chapter addresses two specific institutional issues and the actual experience of small states – the first is accession to the WTO and the second the advice being offered to small states during the WTO's Trade Policy Review. For almost ten years, small developing states which, during the years of the GATT, were either not members of the organisation or played no noticeable role, have simultaneously complained about their inability to implement what they perceive as burdensome and onerous obligations of the Uruguay Round while lining up in large numbers to join the WTO. This apparent contradiction is explored in part in the experience of Vanuatu – a small LDC in the South Pacific which has had a particularly traumatic experience with its accession to the WTO. For many observers, there seems little direct trade benefit to countries like Vanuatu from accession as they would not be able to negotiate improved market access for their limited range of exports. However, there are numerous reasons why small developing countries choose to undergo the difficult and intrusive process of accession that are specific to the geopolitics of their region. However, in the case of Vanuatu, accession, unlike in many post-Soviet transition economies, was motivated neither by trade nor by political considerations. Accession to the WTO means an ability to participate in what has in effect become a global parliament where the world's commercial laws are negotiated. Membership of GATT, where negotiations were simply about border measures, by micro-states like Vanuatu certainly made no commercial sense. However, now that the WTO has become increasingly involved in negotiating what eventually become national commercial laws, membership becomes an imperative to all those who wish to have any impact on their own domestic laws.

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To say the least, the experience of small vulnerable states with the rules-based multilateral system has not been an entirely happy one. The Doha Development Agenda, as the Doha Round is called, is an opportunity to address the legitimate concerns of such states. These states are, however, so politically weak that they are easily overlooked and, if developed countries are able to come to mutually acceptable terms with the large developing countries, i.e. India, Brazil, China, South Africa, etc., it is entirely plausible that bilateral pressures from the large developing countries can be used to induce small states to agree to another agreement that they perceive is not in their economic interest. Such an outcome would serve not only to marginalise and alienate a large number of the WTO's weakest members, it would also further erode confidence in the multilateral trading system and leave it in disrepute.

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PART I

Theory and evidence

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A theory of trade and development of small vulnerable states

ROMAN GRYNBERG

1.1 Introduction: the theory of comparative advantage *ad extremum*

The purpose of this chapter is to attempt to draw together the common thread of the historical experience of trade and development of the small island states of the central and western Pacific within the context of economic theory. The theory of comparative advantage has, since Ricardo, been enunciated as a positive statement that nations will trade in those areas where they have a comparative advantage even if they have an absolute disadvantage in all areas. If a theory is to be general in nature, it must apply to all cases. There is perhaps nowhere better to challenge any theory than considering its applicability *ad extremum*. Indeed the smallest, most disadvantaged and remote of the micro-states of the central and western Pacific, e.g. Tuvalu, Kiribati and Niue,¹ constitute a fascinating test of Ricardian trade theory for they provide examples of states which do not consistently trade in either goods or services, and maintain existing consumption levels from migration, remittances and aid. In such extreme cases, it is difficult to see how Ricardian theory of comparative advantage applies as an explanation of observed behaviour. Those who are wedded to Ricardian theory of trade as a ‘tautology of impregnable circularity’ would explain the observations from the remote islands of the South Pacific as merely a case of high transaction cost stemming from transport and the absence of economies of scale.

These are the views of the author and not necessarily those of the Commonwealth Secretariat or any of its member governments.

¹ Kiribati consistently exports seaweed and Niue and Tuvalu have only minor and ad hoc exports of products such as taro or copra but in all cases production for export or for subsistence consumption constitutes only a very minor proportion of the observed subsistence of the population. Consumption is determined largely by aid levels. At least two other countries of the central Pacific, Nauru and the Marshall Islands, have virtually no production and subsist largely from remittances and aid.